

Modifying the Representation and Warranty About Financial Statements Being Prepared in Accordance With GAAP

(PART 1 OF 2)

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This article reviews the customary representation and warranty (“**R&W**”) in stock and asset purchase agreements concerning a target company’s financial statements being prepared in accordance with generally accepted accounting principles in the United States (“**GAAP**”). However, many private companies, especially small, closely-held, and family-owned companies, do not prepare their financial statements in accordance with GAAP. That is, their financial statements deviate from GAAP. Yet, many attorneys representing buyers require the R&W to include such language.

This article proposes how attorneys representing sellers can respond to such a position. Part 1 of this article will address modifying the R&W. Part 2, which will appear in the next issue of *Deal Points*, will address identifying the most common deviations from GAAP.

What is GAAP?

What exactly is GAAP? It is a set of accounting rules, standards and procedures used to record transactions in a company’s books and records and to prepare and present financial information. GAAP was developed and is maintained by the Financial Accounting Standards Board (<https://www.fasb.org>). By following GAAP, a company ensures that its financial statements reflect the company’s financial position (e.g., financial condition, results of operations, etc.) in a consistent and comparable manner.¹

Customary Representation and Warranty

Customary forms of R&W about a target company’s financial statements can be found in the American Bar Association’s (the “**ABA**”) model form of stock purchase agreement and Practical Law’s forms of stock and asset purchase agreements. The ABA’s Model Stock Purchase Agreement, published in 2010, provides:

“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 (the effect of which will not, individually or in the aggregate, be material) and the absence of notes (that, if presented, would not differ materially from those included in the Audited Financial Statements). The Financial Statements reflect the consistent application of GAAP throughout the periods involved, except as disclosed in the notes to the Audited Financial Statements.”²

The ABA’s Model Asset Purchase Agreement was published in 2001 and may be somewhat outdated. Its financial statements R&W implies but does not expressly state that the financial statements were prepared in

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¹ See generally Corporate Finance Institute discussion of GAAP at <https://corporatefinanceinstitute.com/resources/accounting/gaap>.

² Model Stock Purchase Agreement, § 3.4 (ABA 2010) (emphasis added).

accordance with GAAP: “Such financial statements fairly present... the financial condition and the results of operations, changes in shareholders’ equity and cash flows of Seller as at the respective dates of and for the periods referred to in such financial statements, all in accordance with GAAP.”³

The ABA’s language in its Stock Purchase Agreement is 15 years old. More recent customary language may be found in Practical Law’s forms of stock and asset purchase agreements. For example, its pro-seller forms provide:

*“The Financial Statements have been prepared in accordance with GAAP applied on a consistent basis throughout the period involved, subject, in the case of the Interim Financial Statements, to normal and recurring year-end adjustments and the absence of notes. The Financial Statements fairly present in all material respects the financial condition of the Company as of the respective dates they were prepared and the results of the operations of the Company for the periods indicated.”*⁴

Practical Law’s pro-buyer long forms contain the same “prepared in accordance with GAAP” language, but include additional language that may be added to other parts of the R&W, which additional language is not relevant to our analysis.⁵

These customary types of R&W are acceptable for public companies, which are required to have audited financial statements prepared in accordance with GAAP, and large private companies that often have audited financial statements for specific reasons (e.g., lender financing requirement).

However, such R&W are not appropriate for, and often not applicable or acceptable to, many private companies. As a result, the R&W must be modified because a seller cannot agree to a R&W that is inaccurate, which may result in post-closing indemnification (i.e., reimbursement) of any losses incurred by a buyer from relying on such an inaccurate R&W.

Modifying the Representation and Warranty

Practical Law’s commentary to its various forms addresses situations where the target company’s financial statements are not prepared in accordance with GAAP:

*“Not in accordance with GAAP. In that case, the accounting principles, policies, and procedures used in the target company’s preparation of the financial statements should be disclosed in a disclosure schedule and the seller should represent that the financial statements have been prepared in accordance with these disclosed accounting principles.”*⁶

The ABA is in the process of developing short-form agreements for smaller (e.g., private company) M&A transactions, but has not yet published such agreements. However, its draft stock purchase agreement, circulated for comment in September 2024, includes an alternative use of “Accounting Principles” instead of GAAP:

“3.4. Financial Statements. Sellers have delivered to Buyer complete and correct copies of the Financial Statements. The Financial Statements were prepared in accordance with [GAAP/the Accounting

³ Model Stock Purchase Agreement, § 3.4 (ABA 2010) (emphasis added).

⁴ Practical Law, Stock Purchase Agreement (Pro-Seller Long Form), § 3.06 (emphasis added). See also Practical Law, Asset Purchase Agreement (Pro-Seller Long Form), § 4.04.

⁵ See Practical Law, Stock Purchase Agreement (Pro-Buyer Long Form), § 3.06; Practical Law, Asset Purchase Agreement (Pro-Buyer Long Form), § 4.04. Accord, Practical Law, Stock Purchase Agreement (Pro-Seller Long Form), Commentary to § 3.06; Practical Law, Asset Purchase Agreement (Pro-Seller Long Form), Commentary to § 4.04.

⁶ Practical Law, Stock Purchase Agreement (Pro-Seller Long Form), Commentary to § 3.06. See also Practical Law, Stock Purchase Agreement (Pro-Buyer Long Form), Commentary to § 3.06 (“The substance of this representation changes if the target company’s financial statements are not in accordance with GAAP. In that case, the accounting principles, policies, and procedures used in the target company’s preparation of the financial statements should be disclosed in a disclosure schedule.”).

Principles], are consistent with the accounting records of the Company, and fairly present the financial position of the Company as of the dates thereof and the results of the operations and cash flows of the Company for the periods indicated.”⁷

It defines the term “Accounting Principles” as “the commercially reasonable historical accounting practices and policies of the Company consistently applied by the Company in the preparation of the Financial Statements.”⁸

Real Life Examples

Such a modification to the financial statements R&W is a step in the right direction, but it does not go far enough.

The parties will want to know the specific accounting principles used to prepare the financial statements. Or, that the financial statements were prepared in accordance with GAAP, except as disclosed in the purchase agreement or its disclosure schedules.

That is, identifying the deviations from GAAP. The foregoing can be illustrated with some examples from recent transactions.

In one transaction, the R&W provided:

*“Except as set forth on Schedule 4.4(b), the Financial Statements have been prepared in accordance with GAAP applied on a consistent basis throughout all of the periods covered by the Financial Statements, subject to the absence of explanatory footnote disclosures and to normal recurring year-end adjustments that are not material to the Company or the Business.”*⁹

The Schedule stated:

“The Financial Statements have been prepared by management using a modified accrual method of accounting. The deviations from GAAP include, but are not limited to, the following:

- No application of revenue recognition standard, ASC 606;
- No application of new lease accounting standard, ASC 842; and
- No inventory testing, including any applicable reserve.”

A second transaction included a similar R&W with a schedule identifying the following deviations from GAAP:

1. *The value of inventory is understated on the Company’s Financial Statements.*
2. *Accrued but unused paid time off is not shown as a liability on the Company’s Financial Statements.*
3. *The Company records revenue from product sales upon the receipt of cash from customers, tracked with QuickBooks.”*

In a third transaction, the R&W provided that “the Reviewed Financial Statements were prepared in accordance with the Accounting Principles. Instead of a disclosure schedule, the purchase agreement defined the term “Accounting Principles” as “GAAP, as modified by the practice of the Pre-Closing Accountant who prepares the Company’s financial statements on a cost basis to match the tax returns prepared by them.”

Based on all the foregoing, an acceptable R&W concerning the preparation of financial statements would read as follows:

[Alternative 1: Except as set forth on Schedule x.xx, the Financial Statements have been prepared in accordance with GAAP applied on a consistent basis throughout the periods covered by the Financial Statements.] [Alternative 2: The Financial Statements have been prepared in accordance with the Accounting Principles applied on a consistent basis throughout the periods covered by the Financial Statements.] The Financial Statements are consistent with the accounting records of the Company, and fairly present in all material respects the financial

⁷ ABA Draft Short-Form Stock Purchase Agreement (Version 2.0 September 2024) (emphasis added).

⁸ *Id.*

⁹ (emphasis added).

condition of the Company as of the dates thereof and the results of the operations and cash flows of the Company for the periods indicated.

The disclosure schedule or the definition of Accounting

Principles would describe the deviations from GAAP.

Conclusion

When a target company's financial statements are not prepared in accordance with GAAP, a seller's attorney must modify the customary R&W in a purchase agreement and disclose how the financial statements deviate from GAAP. This article proposes such a modified R&W.