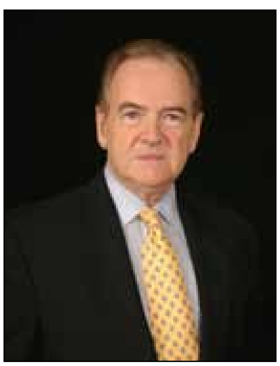
Changing Accounting Standards And How They Affect Financial Terms In Legal Documents

John H. Eickemeyer is a shareholder in the New York office of Vedder Price and heads the firm's Accounting Law Practice Group. He has been engaged for many years in the defense of liability claims against accountants and attorneys, including claims based on alleged audit and review failures, negligent tax advice and tax preparation, and alleged failures to detect defalcations. He also regularly counsels accountants on risk management and other practice issues, and represents accountants in regulatory and professional disciplinary proceedings. He is the co-founder and co-chair of the annual ALI-ABA program on Accountants' Liability and is the co-author, with Dan L. Goldwasser and Thomas Arnold, of the PLI Accountants' Liability treatise and is a member of the Quality Enhancement Committee of the New York State Society of Certified Public Accountants.



Vincent J. Love, CPA/CFF, CFE, is a Member of VJL Consulting, LLC. He has over 44 years of experience providing financial services to small and multinational companies. Since 1976, in addition to providing solutions to complex financial, reporting, ethics and governance problems, he has helped attorneys and their clients understand and explain the technical issues and damages in complex business litigation. He is on the Board of Editors for the CPA Journal and has authored a number of articles, commentaries and papers as well as a book, Understanding and Using Financial Data — An Ernst & Young Guide for Lawyers, first edition, published in 1992 and supplemented in 1994. He is also an acknowledged technical reviewer of various Commerce Clearing House GAAS and GAAP Guides. In addition, Mr. Love was the recipient (along with his co-author, John Eickemeyer) of the CPA Journal's 2009 Max Block Award for the outstanding article in the category Policy Analysis for the article ***IFRS and Accountants' Liability,*** and the 2010 Max Block Award for the outstanding article in the category of Informed Comment for the article ***When Rules May Weaken Principles: Enhancing Independence, Integrity, and Objectivity.***

John H. Eickemeyer and Vincent J. Love

Using accounting terminology in transactional documents can be tricky. Be sure to get the guidance of an expert.

THE U.S. accounting standards-setters and regulatory authorities are close to accepting a new set of standards for accounting and financial reporting for publicly traded companies. Standards-setters are also contemplating establishing a different, second, set of standards for non-public, private companies — those numerous enterprises who are not subject to regulation by the Securities and Exchange Commission (SEC) because they do not issue public debt or equity securities. Moreover, the SEC currently allows foreign registrants to file financial statements using International Financial Reporting Standards (IFRS). IFRS may also currently be used by U.S.-domiciled subsidiaries of foreign enterprises and foreign subsidiaries of U.S. enterprises.

In February 2010, the SEC reaffirmed its commitment to work towards accepting a single set of high-quality global accounting standards and expressed its support for the "convergence" of generally accepted accounting principles (GAAP) as applied in the United States and IFRS. SEC Release Nos. 33-9109; 34-61578, *Commis-*

sion Statement in Support of Convergence and Global Accounting Standards, February 24, 2010. On May 26, 2011, The SEC staff issued a report, *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System of U.S. Issuers—Exploring a Possible Method of Incorporation* (the "Framework"). This recently issued Framework explores the transition of accounting and reporting standards further and seeks comments from interested parties on the methodology to be used to migrate from the use of U.S. GAAP to IFRS, or some form of IFRS, for financial reporting by SEC registrants. The Framework makes it clear that the SEC has not yet made a determination as to whether to incorporate IFRS into the financial reporting requirements for registrants, and if so, just how this will be accomplished. The Framework is an exploratory paper focused on the possible method for achieving a change of accounting standards, possibly resulting in a different standard setting structure for establishing those changed standards. There is no extensive consideration in the Framework of any timeline for incorporation of any changes in the standards used by SEC registrants.

The Framework then goes on to discuss what the SEC staff term the "condorsement" approach in some detail, the Financial Accounting Standards Board's, (FASB) role as the body responsible for the acceptance, with or without change, of (International Accounting Standards Board (IASB) pronouncements and, of course, the SEC's traditional role as the final authority on any standards used by U.S. registrants. The Framework also addresses the benefits and risks related to the suggested approach. The SEC has received extensive comments on this Framework and further pronouncements about the potential incorporation of IFRS into the reporting system for publicly traded companies will surely be forthcoming.

While the standards-setting bodies and regulatory authorities are working diligently at convergence to minimize the differences between IFRS and U.S. GAAP, many differences remain. The number and the complexity of the differences are diminishing, though the FASB and IASB must still work through some important issues, including revenue recognition and valuation of financial instruments. Total convergence of these two standards may never occur and the original timeline for completing the FASB-IFRS convergence efforts has slipped. However, FASB chair Leslie Seidman recently reaffirmed that the two standards-setters will continue their efforts to assure "consistent application and consistent reporting around the world." Accordingly, while the pace of convergence remains unsettled, the trend at this point is still toward acceptance of some form of IFRS — perhaps with variations — as the preferred standard for U.S. financial reporting.

While the SEC and the standards-setters consider IFRS-GAAP convergence for public company reporting, the concept of establishing a second set of GAAP for U.S. private companies is also being evaluated. In December 2009, the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Foundation (FAF) and the National Association of State Boards of Accountancy (NASBA) announced the formation of a panel to study the issues relating to establishing a separate set of accounting standards for private companies. The international community is a step ahead, with the IASB having issued standards in July 2009 for use by small and medium sized enterprises (IFRS for SMEs). To date, even though IFRS for SMEs is not accepted in any major country, its use by private entities is increasing. A separate conceptual framework for the development of IFRS for SMEs has been established which sets in place a separate underlying basis for developing future standards for these enterprises.

In late January 2011, the Blue Ribbon Panel on Standard Setting for Private Companies (the "Panel") issued its report to the FAF. The Panel essentially recommended private company accounting standards rooted in the FASB standards with exceptions and modifications carved out for private companies, and the establishment of a "separate private company standards board to help ensure that appropriate and sufficient exceptions and modification are made, for both new and existing standards." *Blue-Ribbon Panel on Standard Setting for Private Companies, Report to the Board of Trustees of the Financial Accounting Foundation,* January 2011, p.2 (the "Panel"). The Panel also recommended some short-term transitional actions to administer the conversion and to provide relief for private companies.

Unfortunately, the FAF has initially decided not to establish an authoritative standard-setting board for private companies, much to the disappointment of the AICPA and many private company constituents. According to the U.S. Census Bureau, in 2005 there were over 6.6 million businesses in the United States, that employed one or more individuals versus only about 17,000 publicly traded companies registered with the SEC. Privately owned companies represent a substantial portion of the American economy. Over the years, as new and more complex standards have been added to GAAP, the informational needs of users of private company financial statements began to differ to a great extent from those of SEC registrants.

These differences in the needs of financial statements users have become more noticeable over the past few years. Consider the fact that the average holding time for a security has declined significantly, reflecting a change in the composition, and investment objectives, of the holders of equity securities. Investors now on average hold equity securities for a much shorter period of time than had been the case in prior years. The change in the holding period of equity securities traded on the New York Stock Exchange (NYSE), arguably the exchange trading the highest overall quality of equity, reflects this change in investment philosophy (Basic data from http://www.nyxdata.com/nysedata/asp/factbook/viewer_interactive.asp):

Year	**Turnover**	**Holding Period in Months**
2010	98%	12
2009	129%	9
2000	88%	14
1990	46%	26
1980	36%	33
1970	19%	63
1960	12%	100

Equity securities have become less of an investment vehicle and more of a trading medium. The investor who is holding an equity security for a short period of time has a greater need for knowing the exit value of an enterprise before making an investment/trading decision. Consequently, real-time fair value financial information is more important than historical cost-based data, the traditional financial accounting basis for financial statement valuation, for investors in a publicly traded company. But a private company financial statement user has other needs. The owners need the statements to evaluate management (stewardship), assess cash flow and requirements, assess return on their investment, and raise money through borrowing from lending institutions. The lenders need the statements to assess the entity's ability to service their loans. In the case of a collateralized loan, the lender will perform its own evaluation of the expected cash liquidation value of the loan collateral. Vendors would have the same concerns as the lenders — payment of amounts owed for the goods or services delivered — but in a much shorter timeframe than the lender. Consequently, real-time, fair value accounting is not as significant to the user of private company financial statements, even as its importance is increasing for financial reporting by public companies under both GAAP and IFRS.

DEALING WITH THE UNCERTAINTY CREATED BY CHANGING SETS OF STANDARDS AND ACCOUNTING APPLICATIONS • Many believe that it is sufficient to say in a contract that the financial statements or data "shall be prepared in accordance with generally accepted accounting principles." For a number of reasons this is increasingly not the case. Ambiguities can occur, since all of the differing standards allow for some discretion in estimating the components used to compute depreciation and inventory valuation, and in applying differing accounting based on an analysis of the underlying facts and circumstances. Also, GAAP, IFRS and private entity standards will not be static; rather, they will change to adapt to changing business conditions and practices, as with the current migration to IFRS, the possible implementation of "private company accounting," and the move from historical cost to fair value.

Moreover, following the recognized standards may not necessarily be in your client's best interest. A best practice to follow in drafting documents is to take the time to shape the accounting provisions to the needs of the individual party. This may require knowledge that is beyond the scope of the attorney's training. An understanding of the different standards and alternative methods for accounting for an event will help in drafting better agreements and avoiding unwanted results.

The best way to deal with the possibility of a change to an alternative standard and the way those standards are applied is to specifically state in the document that choices in the governing standard and method used should be consistent with prior periods and consistent throughout the period that the agreement covers. Additionally, if the client will not have control of the entity's records, it may want to include in the agreement a list of the relevant accounting policies and practices that are to be followed in interpreting the agreement, or specifically state the governing standard, i.e., GAAP, IFRS, or other recognized standard as it existed at the date of the agreement.

Changes in the specific standards used can have, and have had, a dramatic effect on all kinds of legal agreements. In recent years, for example, preparers of financial statements have had to account for the changes related to fair value replacing historical cost for some assets and liabilities. The resulting changes in the reported value of assets or liabilities can have a significant effect on covenants and warranties that specify certain financial-related ratios and relationships. Changes in the definition of the components of the balance sheet have the potential to shift assets and liabilities that were formerly classified as short-term into long-term, or capital into a liability. This could play havoc with all of those agreements that include financial statement based covenants. Fair value accounting versus historical cost accounting can also affect balance sheet covenants.

Changes in GAAP may suddenly give many banks the power to dictate, due to the violation of a debt-related restrictive covenant caused by the change, that certain loans are due immediately. This will put the bank in a position to negotiate more favorable terms, waive the violation, or amend the agreement. There can also be a fee associated with changes to the lending agreement. Nothing would have changed in the financial situation of the entity — only the standard applied in determining the amount used in a calculation would have changed. If a party wishes to avoid such acceleration, its counsel should be sure the agreement provides for the application of a consistent and defined set of standards during the period in question.

Moreover, GAAP, IFRS, or any other recognized standard, may not offer the best guidelines to follow for an entity's proposed transaction. A party may want to write in specific exceptions to reliance on a recognized standard or give an alternative calculation or definition.

DRAFTING LEGAL DOCUMENTS THAT INCLUDE FINANCIAL LANGUAGE • Since most lawyers are not accountants, they need to be especially careful when using accounting terminology in drafting transactional documents, particularly given the current fluidity in the world of accounting standards. Terms chosen in haste, ignorance, or relating to superseded standards and concepts can either make the lawyer an unwilling participant in his or her client's undoing, or lead to unwanted disputes and litigation. When accounting terminology is included in an agreement, the increasing potential for changes in the applicable accounting standards makes it advisable to seek the help of an accountant who is aware of the potential changes and who can analyze how they could affect an entity's financial statements. Preventive action at the beginning of a business transaction is less expensive than litigation at the end.

The major reason accounting information is difficult to handle in drafting an agreement is well known: financial data can be manipulated, even within the boundaries of the various standards and "good accounting practice." Such common measures as a current ratio, for example, can be changed by last-minute transactions that may, in the long term, damage the entity, while providing a short term "fix" to comply with a restrictive covenant. One of the most important points to remember when drafting legal documents is that the party in control of financial decisions often has the ability to manage the financial data for its own purposes.

Further complicating the matter is that many of the amounts displayed on financial statements are based on judgments and estimates. Although this is not a new complication, with the implementation of IFRS, the accounting used to record economic events will be determined more on the basis of principles, rather than being specifically prescribed by rules, as is generally now the case under GAAP. Disagreements often arise over the adequacy of reserves or the acceptability under the standards of different methods of computing reserves. As it is more principles-based, IFRS requires a greater application of reasoned judgment in establishing financial estimates and determining the proper accounting for an economic event.

General Principles of Drafting

Often, attorneys draft agreements by adapting an agreement they previously used to a new transaction. Some precautions are in order, however, when financial language is involved. The following is a suggested list of guidelines to follow when drafting legal documents that contain accounting concepts.

1. Use proper accounting terminology. Some lawyers often use such phrases as "good accounting practices" or "true and correct." Unfortunately, these phrases are not defined in current accounting literature, and a disagreement over their meaning is likely to occur when a deal turns sour. "True and correct" implies absolute precision and the meaning of "good accounting practices" is open to many interpretations and misinterpretations. The correct terms are "GAAP" or "IFRS" and "present fairly, in all material respects,… in conformity with GAAP" or "present fairly, in all material respects, (or give a true and fair view of)…in accordance with IFRS." In any legal document, it is important to use precise accounting terminology. Specify the standards being used in the document and the terminology applicable to those standards.

2. Have the client's accountants review the agreement(s). Legal documents most often have both accounting and tax implications. Many attorneys know the tax implications of contracts, but few understand how transactions are treated on financial statements and how the language used can affect warranties and covenants in then-current or changed circumstances;

3. Mutual documents are not necessarily fair. Many attorneys believe that all the terms in an agreement should apply equally to all parties. The fallacy in this thinking is aptly pointed out in a quote from the French social commentator, Anatole France, in the 19th century: "The law, in its majestic equality, forbids rich and poor alike to sleep under bridges, to beg in the streets, and to steal their bread." (Le Lys Rouge, 1894, Chapter 7) A purely parallel contract may not serve "rich" and "poor" parties equally. An agreement that gives both parties the right of first refusal to buy the other's interest may be meaningless to the party who owns 20 percent of the entity and cannot afford to buy the remaining 80 percent. And, the 80 percent interest represents control, so it will likely be worth a higher price per share to a third party.

4. Test drive the mechanics of the calculations. When financial-based calculations, covenants, or warranties are included in an agreement, it is advisable to "run the numbers." For example, if there is a loan agreement that has restrictive covenants based on certain ratios or calculations, the accountant should calculate the ratios and balances now and look at the entity's projected budgets and forecasts and determine if those ratios can be achieved in the future. Can the company meet the criteria based on a current evaluation of possible future events? How will an expected change in accounting standards affect the calculations? Electronic spreadsheets are ideal for stress testing calculations by running "what if" scenarios or other analytics, quickly and inexpensively.

5. Use a percent of the bottom line if in control of the business decisions and accounting, and a percent of the top line if the other party is in control. Financial results can be legally manipulated. Judgments affecting such items as useful lives of depreciable assets, bad debt reserves, and obsolescence reserves for inventory can often be determined within a range of acceptable results and are not restricted to a single fixed amount. Maintenance and other types of discretionary expenses can be delayed or accelerated. These determinations affect the bottom-line earnings and net worth of an entity, but not the top-line revenues. Consequently, the entity that will be in control of business decisions or accounting judgments, will want to negotiate for an agreement keyed to the bottom-line (net income). The opposing entity will want to key the agreement to the top line (gross or net revenue). Revenue recognition principles are in a state of flux during this convergence period and IFRS is far less rules based than GAAP, leading to a greater application of reasoned judgment. These conditions should be cause for greater scrutiny of any ratio, calculation, or amount related to revenue that is included in a contract.

6. Control of the accounting is less important for longer-term agreements. The longer the term of the agreement, the less the party who controls the accounting can manage the timing of expense recognition effectively. It is easier to manipulate numbers in the short term or for one discrete project among many. For example, a company can only forego maintaining its machinery and equipment for a finite period without affecting its earnings capacity. Also sooner or later, if the company accelerates its expenses, it will generate more profit in the future, unless its accounting is dishonest. While revenue can be manipulated, it is more difficult and generally only works for a very short period of time. For instance, sales at the end of a reporting period can be increased by giving customers incentives to buy (discounts, etc.) or decreased by reducing the sales effort. These manipulations will only work for a short period since overly aggressively selling will generally reduce sales in the subsequent period by reducing demand and, if selling efforts are curtailed, demand will build up in the subsequent period. This type of "legal" manipulation cannot continue for a long period of time without hurting the entity by losing sales to competitors or raising customers' expectations concerning discounts, possibly leading them to wait until closer to a quarter or year end to strike a better bargain. One approach to protect a party that is not in control of business decisions and the accounting is to use a longer measuring period for a contingent payout.

THE IMPORTANCE OF ACCOUNTING TERMINOLOGY • Unless they are defined, some accounting terms may lead to later disagreements and possibly litigation. Examples of such terms are "consistently applied" and "material."

Simply because an accounting policy or procedure has been consistently applied in the past, it is not necessarily GAAP. A reserve for bad debts may be computed using a method that applies a specific percent to each receivable category, for example: 0 percent for current receivables; 2 percent for receivables over 30 days old; 5 percent for receivables over 60 days old; 25 percent for receivables over 90 days old; and 100 percent for receivables over 180 days old. In the past, the reserve that resulted from this historically derived calculation may have been adequate to comply with GAAP, which requires that receivables be valued at the amount that will be collected.

The method used in the past to determine the amount of the reserve may simply be an expedient, but as long as it properly values the receivable balance, it is an appropriate way to determine the reserve. If the economic or business environment changes, the method used to calculate the reserve (which was acceptable in the past) may not adequately value the receivables at the current date and the current statements therefore may not be in accordance with GAAP. Unlike methods of depreciation, which are recognized in GAAP, mechanical formulas for reserves for bad debt are only a means to an end. The end is an adequate reserve.

GAAP issues frequently make a big difference in acquisition agreements. For example, a seller of a business may have historically over-reserved for uncollectible receivables. The company may have always used a mechanical percentage-driven formula to determine its reserve. However, an account-by-account analysis of collectability may be prepared for the closing date balance sheet and the reserve substantially reduced, increasing the company's net worth (and the purchase price, if it included adjustments for increases in net worth over a stipulated amount). The buyer may object, but in vain if the closing-date balance sheet was required to be on a "GAAP basis."

"Materiality" is a term that has been the bane of the accounting profession's existence since its earliest days, and the term probably has generated millions of words of explanation in both legal and accounting literature. Materiality of financial data is defined in Financial Accounting Concepts Statement No. 2, as "the magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." SEC Staff Accounting Bulletin No. 99 – *Materiality; Codification of Staff Accounting Bulletins, Topic 1: Financial Statements; A. Materiality.*

In financial statements, quantitative materiality is determined in relation to earnings, net worth, and other relevant financial statement balances. In some cases, the concept of materiality can allow for variations of millions of dollars in account balances on financial statements. When purchase prices of businesses are tied to closing date balance sheets, does the buyer really want to pay millions of dollars more for the business because the exceptions were "immaterial?" Should materiality be based on the purchase price rather than on the financial statements' criteria, since the statements were prepared to determine the purchase price? Also consider, and possibly provide for, the qualitative criteria used in determining materiality, i.e., the difference between an unintentional error of a small amount and an intentional misstatement of a small amount in making corrections to a purchase price computation.

Many problems could be solved with a statement that defines materiality as an absolute number to be used individually and in the aggregate. Alternatively, an agreement could specify that materiality will be based on the purchase price.

AGREEMENTS THAT CONTAIN BALANCE SHEET ITEMS • Many representations, covenants and warranties in agreements are based on balance sheet items such as total assets, current assets, tangible assets, net worth, or working capital. An attorney drafting an agreement based on the company's balance sheet should try to make the underlying accounting principles work for and not against his or her client.

The key question in drafting agreements that are based on balance sheet items is again, "Who is in control of the business decisions and accounting?" Business decisions and accounting judgments have a big impact on the balance sheet. The party in control has some latitude in determining asset and liability values used for financial reporting.

Similar problems concerning control exist if there is a contingent payout related to old receivables. If an acquisition agreement states that the purchase price (usually when tied to working capital or net worth) will be reduced by the book value of all receivables over a certain age such as 180 days and that any collections on these older amounts will be for the benefit of the seller, and if the seller has control of the receivables for collection, it can harass a current customer of the buyer with its collection effort. On the other hand, the customer may not respond to pressure to liquidate the receivable since the seller no longer has the product or service the customer wants to buy.

If the collection of receivables is left with the buyer, the buyer may not pursue the collection for fear of alienating a customer and, in addition, has no incentive to pursue the receivable since the amounts collected belong to the seller. Before drafting provisions that relate to future activities or events, counsel must focus on who has control and what can happen in the future.

GAAP, or the other standards, can sometimes have unexpected effects on an agreement. Consider a multi-year bank loan that specifies a current ratio of at least 2:1. Under the standards, the outstanding balance of the loan becomes a current liability in the loan's final year. Do not unknowingly negotiate a shorter term for the loan. If the loan is shown as a current asset (which will occur in the last year of a multi-year loan), it may cause a violation of the current ratio restriction and accelerate the required liquidation of the amount owed. To avoid this situation, negotiate a special provision that any outstanding balance on the loan be deemed a long-term liability for the purposes of computing the borrower's current ratio.

Under current GAAP, if a loan covenant is violated the loan would normally then become due and payable, i.e., a current liability at year-end, but if the lender subsequently waives the violation before the financial statements are issued, the balance would be shown as long-term in the financial statements. FASB ASC 470-10-45-1. Under IFRS, however, if the loan was in violation at year-end, regardless of whether a waiver was later received from the lender, the loan would be shown as a current liability. IFRS IAS §1.74. This could play havoc with the company's current ratio and could trigger adverse consequences in other agreements. This issue needs to be addressed if IFRS is chosen as the governing standard or if the agreement is silent concerning the standard applied and the company subsequently decides to report its results in accordance with IFRS rather than GAAP.

Another interesting issue to consider is that IFRS does not allow inventory to be expensed using the Last-in-First-Out method (LIFO). LIFO is used by many U.S. business because of the tax benefit attendant thereto, but only if the method is also used for financial reporting purposes. This GAAP compliant method leaves early (lower) costs of acquiring inventory on the balance sheet, i.e., inventory would generally be undervalued compared to its replacement cost. The opposite is true for the income statement cost of sales expense. Later-incurred inventory acquisition costs, which are generally higher, are recognized as an expense.

The following are specific accounting concerns that should also be considered when drafting agreements that are based on balance sheet items.

1. Consider how the entity should value its assets and liabilities. Sometimes when including adjustments to net worth in the agreement to determine the purchase price, it is an advantage to a seller to seek full book value at the date of the last audited financial statements for both tangible and intangible assets, and at other times it would be in the seller's interest to use fair value at the date of the transaction for those assets. A seller of a business or a borrower may want the agreement to allow fair value (if more than book value) as the measure for all intangible assets, such as trademarks, patents, and goodwill. However, a lender may not be protected if a large portion of the borrower's net worth is represented by goodwill. If the company subsequently cannot repay the debt, its purchased goodwill may have become worthless, or at least diminished in value, as well. Also, GAAP and IFRS may require a change in asset value, but this may not be true in applying IFRS-SME or Private Company Accounting. Financial statement valuation of assets and liabilities is currently in a state of flux, and the timing of the recognition of a change in value is different for GAAP and IFRS. Determine what is necessary and incorporate language in the document that locks in the valuation desired — or the preferred method of determining that valuation — regardless of changes in the then-current standards, or adoption of a different standard, for financial reporting. Remember, the party in control has a greater ability to formulate more favorable accounting under IFRS' primarily principles based standards than under GAAP's heavily rules-based standards.

2. Consider whether the company is a single entity or part of a consolidated group of companies. In a parent-subsidiary relationship, it is important to focus on the aspect of control. Often a parent company can move assets between and among subsidiaries. Moreover, in a consolidated entity, costs of services benefiting certain subsidiaries can be allocated to those subsidiaries and the allocation methodology can differ within a tolerable range. It is helpful to understand the activity between the parent company and a subsidiary, especially as it pertains to cash. When preparing documents where one of the parties is a subsidiary of another company, covenants, warranties, and limiting conditions need to be designed recognizing the parent-subsidiary control relationship.

3. It is often advisable to specify how certain balance sheet items should be treated. Sometimes, special treatment of a specific balance sheet item will be beneficial to a party. It will be helpful to review the balance sheet for items that should receive special treatment and draft the relevant provisions to obtain the desired effect, being careful to consider the changing nature of accounting and reporting. For example, in an acquisition, it may be advantageous to base a purchase price on the company's net worth, with the exception that fixed assets be valued at replacement rather than historical cost, or at fair value. Or, a lender may want to put a limit on the loan amount that can be based upon the borrower's accounts receivable aging. In this situation, it is often useful to draft a provision that counts only receivables no older than the desired number of days. Alternatively, a limit could be placed on the portion of the qualified receivable portfolio that would be considered eligible collateral for borrowing purposes.

4. Be aware of the value distortions of assets on balance sheets. Under GAAP, fixed assets are recorded at cost, unless their value has been "permanently impaired" and reduced to a value aligned with their expected cash flow. The recorded value can be less than the fair value, which is often the case when using depreciated historical cost. IFRS allows for upward revaluations to reverse previously recognized impairment losses and the use of fair value in many instances in which GAAP prohibits the use of any upward revaluation over the originally recorded cost. Similarly, certain investment assets may also be recorded at cost under GAAP. A seller might want to value such assets at their current or fair market value. IFRS, on the other hand, may allow revaluation of the same asset to fair value at each balance sheet date. Remember that asset book value and even appraised value may never be recovered in insolvency or for specialized equipment in place in one location. Be sure to include wording in the agreement to lock in the treatment of the asset even if the applicable standard changes.

5. Consider treating certain contingent liabilities as actual liabilities for purposes of the agreement. Important contingent obligations to consider include the funding of environmental cleanups (whose existence often may not be known at the time the document is drafted), or liabilities resulting from pending litigation. There are significant differences in the way GAAP and IFRS treat contingencies. Under GAAP, as currently in force (there is an exposure draft outstanding at the time of this writing that will more closely conform GAAP to IFRS), a loss contingency is recognized on the balance sheet and in the income statement as an expense if it is "probable" that the loss has occurred. FASB ASC 450-20-25. "Probable" is defined in the standard as "likely to occur" and in practice is generally considered to be somewhere between a 70 and 80 percent chance of occurring. (There have been various studies of practice and articles on the meaning of "probable" related to contingent loss recognition that have differing results, most within the range of a 70 to 80 percent probability of occurrence. The AICPA (http://wiki.ifrs.com/Provisions-and-Contingencies) has used an 80 percent criterion when comparing IFRS-SME to U.S. GAAP: "The probability threshold for [GAAP] recognition of contingent liabilities is higher than 'more-likely-than-not,' [the IFRS and IFRS-SME standard] and is typically interpreted to mean about 80%.") Under IFRS, the controlling language is "more likely than not" (IFRS IAS §37.23) which is a more than 50 percent probability criterion.

Another difference between GAAP and IFRS relates to the amount of the contingency to be recorded. If there is a range of equally probable amounts, under GAAP the low end of the range is used. FASB ASC 450-20-30-1. Under IFRS, the midpoint of the range is used. IFRS IAS §37.39. But, all parties should bear in mind that all of these differences are subject to the convergence process, and may change with or without a full migration to IFRS in the United States.

Under IFRS, unlike the FASB standards, in those extremely rare cases, when disclosure of some or all of the information required under the standards for contingencies can be expected to seriously prejudice the position of an enterprise in a dispute with others, an enterprise does not need to disclose the information, but must disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed ISA 37.92.

AGREEMENTS THAT CONTAIN INCOME STATEMENT ITEMS • Many agreements have calculations and provisions that are based on a company's revenues or earnings. Typically, revenue or earnings formulae appear in acquisition, employment, consulting, license, franchise, and partnership agreements, preferred stock descriptive documents, and pension plan documents.

The first factor to consider when drafting income statement-related provisions is whether earnings or revenue is the more appropriate measure for the substance of the agreement. A revenue formula is generally best in employment agreements since often the prospective employee's talents would make a contribution to revenues, but the employee would have little or no control over the company's overall operations. Sales and marketing executives and independent contractors are typically paid on the basis of revenues, as are franchisors.

Another relevant question concerns the nature of the revenues or earnings. Are they those of a single company or a consolidated group? How are common and "headquarters" expenses allocated among entities in a group managed or controlled by another entity (where the party has rights in only one or some of the controlled entities)?

Is it earnings before or after income taxes, operating earnings or some other defined measure of earnings that is the best measure? Are earnings determined on the cash or an accrual basis? Are the applicable earnings, or losses, and the resulting payment based on monthly, quarterly, or annual earnings? Or, is the calculation based on cumulative results, so prior losses will reduce current earnings? Will the formula include or exclude extraordinary items? The answer to each of these questions most likely will have a significant effect on the amount of the revenues or earnings used in a calculation.

Proper terminology is essential to drafting agreements that can both be understood by the parties and meet the parties' expectations once they are place in operation. Terms like "net earnings," "earnings before income taxes" and "operating earnings" are defined in accounting literature and have specific meanings. "Earnings" is a term that can relate to a number of different permutations of operating results of a company and should not be used without the proper descriptive adjective, or a definition included in the agreement.

GAAP and IFRS have different standards for recognizing some revenue streams or expenses. The convergence process is attempting to narrow these differences but they may have an effect on the resulting financial statements' balances. Counsel should take care to assure that the proper qualifying language is included in agreements that are being drafted during these uncertain times.

All the standards favor the use of consolidated statements so that, if the agreement is silent on the subject, consolidated results will likely govern. In some cases consolidated data may not be the appropriate measure, e.g, in a bonus agreement for an officer of a subsidiary company who has no responsibility for the operations of any other entity in the consolidated group. Even though non-consolidated statements may be appropriate, they pose many problems because of the intercompany transactions and the allocation of common costs, income taxes, and the results of other related economic events.

Another consideration in drafting documents with revenue or earnings formulae is the treatment of "extraordinary items," and unusual revenues or expenses, such as those arising from purchasing or selling off operations. The definition of "extraordinary" is somewhat restrictive under GAAP and excludes many items that might be viewed by a layperson as extraordinary. For example, losses related to earthquake damage on the West Coast are not considered extraordinary because they recur, nor are losses from the World Trade Center attack in New York because of the continuing threat from terrorists. GAAP defines "extraordinary items" as being both unusual and infrequently occurring. This differs from IFRS, under which items are not treated as extraordinary if they result from the normal business risks faced by an entity and they do not warrant presentation in a separate component of the income statement. However, IFRS requires that an entity disclose the nature and amount of material items of income and expense separately in the financial statements. IFRS, IAS §1.97. When drafting earnings formulae, the parties may want to define "extraordinary items" differently than under GAAP or IFRS to exclude them from any calculation based on the income statement called for by the agreement.

Moreover, the parties may want to specify that, for purposes of the agreement, earnings be calculated on a cash, instead of an accrual, basis. For example, cash accounting may be more appropriate in both real estate and professional partnerships.

Finally, a single enterprise may use several different methods for computing depreciation for financial reporting and tax purposes. Under IFRS, some of the methods for computing depreciation and their application are prohibited or will give a different result than might have been the case under GAAP. It may be helpful, therefore, to incorporate guidelines for computing depreciation in the agreement if that element will be material to the transactions or operations contemplated by the agreement.

DOCUMENTS THAT CALL FOR FINANCIAL STATEMENTS • Many kinds of documents require a party to provide financial statements periodically, or contain warranties that refer to financial statements. The affected party must consider a number of issues. Which financial statement(s) should be required? Should the statements be those of the company alone, or should the agreement also require the statements of the parent and affiliated companies? Should the statements be annual, quarterly, or monthly? Should they be audited, reviewed, or compiled by a CPA? Before trying to answer that, it's a good idea to be clear about what those terms mean:

- **Audit.** "The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles. The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion. In either case, he states whether his audit has been made in accordance with generally accepted auditing standards. These standards require him to state whether, in his opinion, the financial statements are presented in conformity with generally accepted accounting principles and to identify those circumstances in which such principles have not been consistently observed in the preparation of the financial statements of the current period in relation to those of the preceding period." (AICPA, Professional Standards, Volume I, *U.S. Auditing Standards, as of June 1, 2010,* AU §110.01.)

- **Review.** "A review is a service, the objective of which is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework." (AICPA, Professional Standards, Volume II, *Statements on Standards for Accounting and Review Services, as of June 1, 2010,* AR §60.07.)
- **Compile.** "A compilation is a service, the objective of which is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. (AICPA, Professional Standards, Volume II, *Statements on Standards for Accounting and Review Services, as of June 1, 2010,* AR §60.05.)

The involvement of a CPA can occur at many levels. An attorney representing a client that is entitled to receive financial statements should consider the following options:

- That any opinion or report of an independent accountant be addressed to the other party as well as the party employing the accountant (thus making explicit the expectation that the identified other party will rely on the opinion or report);

- That the party supplying statements also subject those statements and the books and records to a review by another independent accountant (usually in anticipation of an acquisition); and

- That the auditor's report be unqualified, that is a "clean report" without any modifying language. ("An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles." AICPA, Professional Standards, Volume I, U.S. Auditing Standards, as of June 1, 2010, AU §508.10.

CONCLUSION • When drafting agreements, careful consideration must be given to how the particular accounting terminology used may operate, and affect the attorney's client, when the agreement is put into practice. Today, the change in accounting standards is so rapid that what was GAAP or IFRS at the time this paper was written may not be at the time that it is read — and, of course, there may be a change in which standard will be governing the entities in questions, such as from GAAP to IFRS. Be extremely cautious and have someone who is familiar with all of the standards and the changes that are occurring, and who has a logical, probing mind, to assist the drafter. Run the numbers under differing scenarios to be certain that there are no unforeseen "traps" when the economic environment changes. Be specific as to the set of standards — GAAP, IFRS, Private Company Accounting (if established), or IFRS-SME — that will be applicable and to the effective date of the controlling standards, principles, or rules that will be used under the provisions of the agreement. A failure to consider the effect of specific terminology and the changes that may occur in the world of financial reporting can come back to haunt the primary drafter by working to the disadvantage of his or her client or by drawing him or her into unwanted litigation if and when the agreement operates in ways that one party or the other did not expect or intend.