

Reference Accounts: **Bear Traps**

A question that arises at the start of any transaction, and goes to the heart of the pricing of the target company, is whether the sale and purchase should operate by reference to the last accounts, completion accounts or locked box accounts. A Buyer will typically base their offer on the most recent financial statements, which are usually the audited/statutory accounts or unaudited management accounts, as that will have formed the basis of their expectation of the financial position (and therefore the value) of the target company. However, these accounts only show the historical position to the most recent accounts date and there is usually a period to completion that is not covered by them. The last accounts are perhaps most often used where the price is fixed between the parties prior to completion (e.g., it is based on an historical price earnings ratio).

In many transactions, a completion mechanism is used to determine the final acquisition price and the two widely accepted mechanisms to do this are to use either Completion Accounts or Locked Box Accounts. These two alternatives can be briefly summarised as:

1. Completion Accounts – the initial price can be defined in the Share Purchase Agreement with the final price being calculated after completion by reference to accounts that are drawn up to the completion date.
2. Locked Box Accounts – are prepared at an agreed date prior to completion and then “locked” to allow no subsequent adjustment. What is termed “leakage” is restricted by specifying certain transactions that cannot be undertaken in the company in this period as they would cause its value to fall (for example, distributions to shareholders). The locked box mechanism tends to be friendlier to the seller and is often used in a sellers’ market.

Whichever set of accounts are being used, it will be necessary to know how tax is being provided for in those accounts and the extent to which they provide for tax. The answers to such tax questions can in certain situations feed through to the eventual sale price and will have a direct impact as to how the Tax Covenant operates. Failing to properly understand how a tax liability, or, just as importantly, a tax asset, washes through the reference accounts (and interacts with the consideration) is one of the most significant risks at play in an M&A deal, both for clients and corporate advisors. As ever with tax matters, the parties should be obtaining professional advice.