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Under the Microscope: Dissecting Errors to Evaluate RWI Damage Claims

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After an M&A transaction, a buyer may discover certain misrepresentations as to the target company's historical reserves. These misrepresentations often result in a RWI claim by the acquiring company. In these cases, it is critical for the insurer to carefully evaluate alleged damages — a complicated process that requires it to identify the different components of the balance sheet error. Typically, these distinct components consist of a recurring portion, and a non-recurring portion.

Recurring Portion of Errors

The recurring portion of the error should reflect the amount of incremental annual expense that will be incurred in the base year and thereafter, in perpetuity. In estimating the incremental expense, appropriate expenses must be matched with corresponding revenues for that same period to determine the impact on profitability. Once the incremental annual expense associated with the error is determined, the valuation expert is able to right-size the recurring quantum of loss. This is the amount that can be capitalized by either applying the deal multiple or by capitalizing the cash flow in perpetuity to estimate the alleged damages.

Additionally, if the recurring portion of the error is finite in nature, (e.g., a temporary blip in performance) then it would be inappropriate to apply the deal multiple as that would imply an element of perpetuity.

For example, if a company consistently undervalues its inventory up to the year before a transaction, its cost of goods sold may be underestimated, thus inflating gross profit and consequently EBITDA. To the extent the deal is underwritten based on projections built on such inflated profitability, this would inflate trailing and forward-looking EBITDA. Assuming this error can be determined and ring-fenced to a specific period, and assuming the deal was underwritten using only a market approach

(e.g., EBITDA multiple), it would be appropriate to estimate the impact on value by multiplying the incremental expense with the deal multiple or capitalizing the expense at the deal capitalization rate.

However, it is important to only account for the incremental expense associated with each specific year—again, expenses for a given period must match revenues. We often see the insured book the entire expense for all prior years in the 12-month period leading up to the acquisition. The natural consequence of doing this is a mismatch between the expense adjustment and the revenues generated for that same period.

Accounting v. Valuation

From an accounting standpoint, capturing the entire impact of errors in the prior period is indeed correct. In 2005, the Financial Accounting Standards Board issued Statement no. 154, Accounting Changes and Error Corrections. According to the Journal of Accountancy, the appropriate interpretation of Statement no. 154 is that companies should:

> … report the correction of errors in previously issued financial statements as prior-period adjustments, with a restatement of prior-period financial statements. The carrying value of the assets and liabilities should be adjusted for the cumulative effect of the error for periods before the earliest period presented.[1]

Essentially, this means that the accounting treatment as to errors points to a “catch-up”—or cumulative effect approach—with the cumulative effect of an error from prior-year financials being reported on the current year’s income statement in a manner similar to an extraordinary item.

However, from a valuation standpoint, unusual expenses and non-recurring items are typically excluded from valuation metrics such as EBITDA in order to determine a company’s normalized earnings potential. Historical and projected financial statements are typically adjusted for nonrecurring, noneconomic, or other unusual items to normalize EBITDA. These normalizing adjustments eliminate anomalies and facilitate comparisons with guideline companies. The American Society of Appraisers’ (ASA) Business Valuation Standards define normalized earnings as:

> “…economic benefits adjusted for nonrecurring, non-economic, or other unusual items to eliminate anomalies and/or facilitate comparisons.”[2]

The ASA also provides guidance in applying the market approach (i.e., public comparable and transaction multiples) by stating:

Adjustments to the financial data of the subject company and guideline public companies should be considered to minimize differences in accounting treatments when such differences are significant… Unusual or nonrecurring items should be analyzed and adjusted as appropriate.[3]

As such, in considering financial metrics to be applied to a multiple, valuation professionals typically measure the profitability of a company disregarding non-recurring items, as these are not expected to affect the company's future profitability. Examples of non-recurring items include litigation fees, gains or losses from early retirement of debt, income or loss from discontinued operations, employee-separation costs, and accounting adjustments.

Therefore, accounting errors from prior periods should not impact the financial metric used for valuation purposes, because this is a one-off, extraordinary item that does not reflect normalized financial performance.

Applying Different Methodologies

However, things may get more complicated in our example. Assuming the deal was underwritten also using a discounted cash-flow analysis (DCF), the resulting value in the DCF may also be overstated as a result of the undervaluation of inventory. If the forecast relies on understated inventory, future working capital investment required to grow the business would also be understated, resulting in more free cash flow and an inflated value for the DCF approach. In addition, the underestimated cost of goods sold (as we explained earlier) would also contribute to inflate the DCF approach. The combined impact on value in the DCF from both the lower working capital and higher profitability should be in line with the impact on value calculated in the market approach. In this example, one would need to rerun both approaches (market and DCF) with the correct valuation of inventory and analyze the impact based on each approach. The resulting alleged damages from each approach (DCF and market) represent two different methods for estimating the alleged damages. The values should be in close range of each other and can thus be used as a basis to estimate alleged damages from the recurring portion of the error.

It's important to note that in rerunning the DCF, one would typically include the impact of the error, and maintain all other assumptions from the DCF used to underwrite the deal in order to limit the error's effect. In our prior example where inventory was underestimated, one would need to adjust the inventory to the appropriate level and make sure the impact flows through to all line items that would be affected. In the example, projected cost of goods sold and working capital may increase as a result of increasing the value of inventory, thus negatively impacting cash flow for the entire forecast. Rerunning the DCF with the adjusted cash flows and applying the same discount rate used to underwrite the deal would yield a lower value. The difference in value between the original DCF and revised DCF with lower cash flows would result in the quantum of loss from the recurring portion of the error.

Non-Recurring Portion of Errors

The non-recurring portion of the error should reflect the one-off adjustment to realign the misstated balance sheet item to the correct amount on a dollar-for-dollar basis. Consider our prior example,

where the target company underestimated the value of inventory. Assume that the buyer and seller agreed to a purchase price adjustment based on a working capital peg (i.e. normalized level of working capital — this is common in M&A transactions). This allows the buyer to be compensated for shortfalls in working capital and vice versa (seller compensated for surplus). In our example, the buyer may have received an unjustified negative pricing adjustment due to the shortfall in working capital as compared to the peg. To estimate the non-recurring portion of the error one would have to realign the working capital to account for the correct value of inventory. The difference between the understated working capital and the correct working capital would be the basis for estimating the value of alleged damages on a dollar-for-dollar basis. Again, note that in this example, the buyer may have received an unjustified discount in the form of a pricing adjustment. As such, in our example, the non-recurring portion of the error would offset the recurring portion.

Conclusion

Balance sheet errors have two components: recurring and non-recurring. To estimate alleged damages, the recurring portion must be capitalized and the non-recurring portion must be taken at face value. In quantifying the recurring portion it is crucial to consider only the incremental expense associated with the corresponding revenues for a specific period. Although the process of dissecting the error in different components can be complex, agreeing on a framework based on recurring versus non-recurring errors may ultimately save time, energy, and money.

The views and opinions expressed in this article are those of the authors and do not necessarily reflect the opinions, position, or policy of Berkeley Research Group, LLC or its other employees and affiliates.

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1 J.O. Hall and C.R. Aldridge, “Changes in Accounting for Changes,” Journal of Accountancy (February 1, 2007), 45–50.

2 American Society of Appraisers, ASA Business Valuation Standards (2009).

3 ASA (2009).

About Peter Bianco: Peter has 15 years of experience in the valuation of illiquid securities, fairness and solvency opinions, valuation of general partner and limited partner interests, strategic management consulting, project management, and advanced financial modeling developed within the consulting and private equity transaction services space.

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