KDP KOMAREVSKI DIMITROV & PARTNERS

Completion Mechanisms

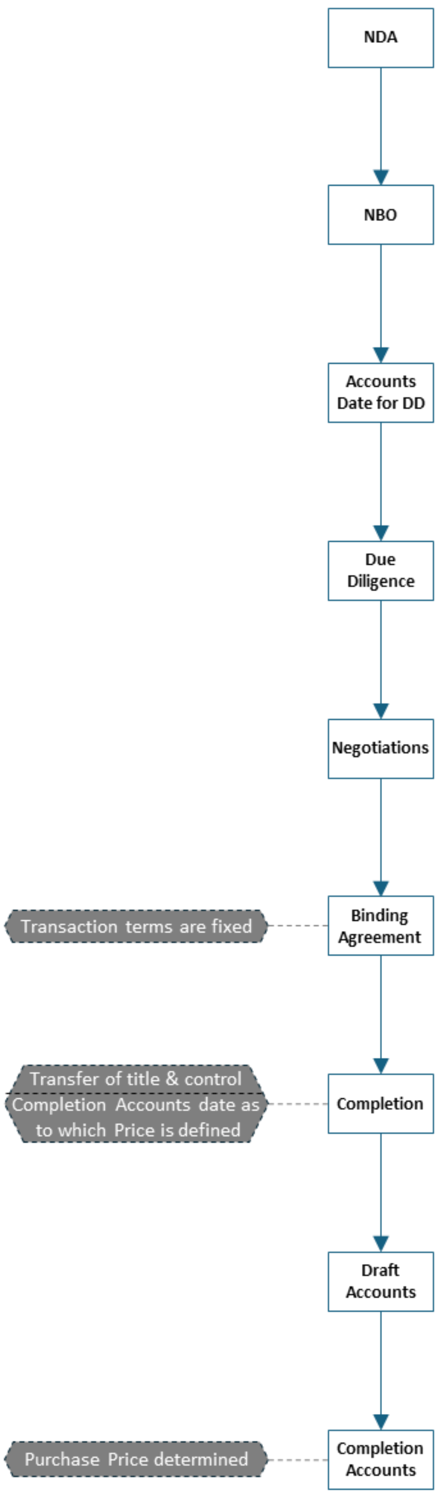
Completion Accounts vs Locked Box Accounts

Part 2

Completion Accounts

Figure 1

Completion Accounts mechanism



Part 2. Completion Accounts

The Completion Accounts Mechanism is praised in the M&A world for more accurately capturing the Equity Value. The simple reason is that the Equity Value is calculated as at the date of Completion. This allows to reflect into the Equity Value every transaction of the Target made by the date the Seller transfers the title and control (see *Figure 1*).

To the above key feature of the Completion Accounts mechanism, we add several other practical aspects.

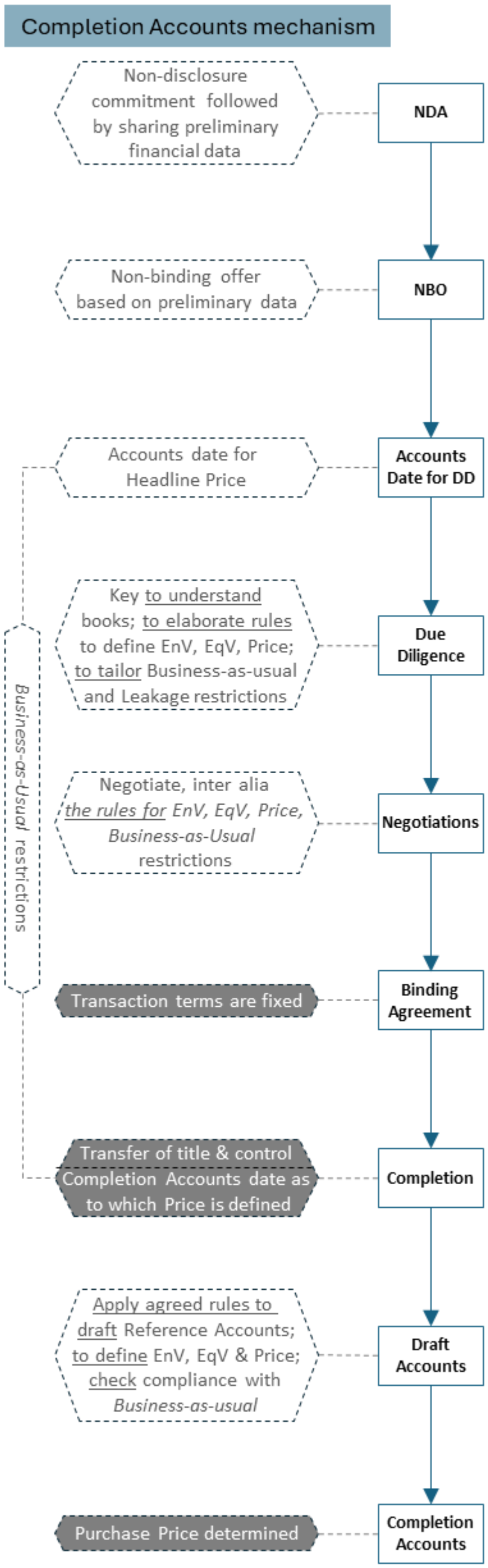
__The due diligence of Target's accounts:__ Under the Completion Accounts mechanism, the buyer's due diligence is based on accounts that precede Completion. These accounts help to determine the headline purchase price for the SPA, but the final purchase price is determined later, based on the Completion Accounts. This does not mean that the due diligence of the first accounts should be underestimated. It remains of high importance because: (a) it analyses Target's EBITDA to assess if adjustment is required, and to reconfirm or fine-tune preliminary non-binding assessment of the Enterprise Value; (b) it also provides crucial information about the Target's cash and debt positions, as well as normal level of working capital; (c) it establishes a reference point to compare to any further activities of the Target. Considering the importance of the accounts provided for due diligence, it is a market standard that the seller provides representations and warranties[1] as to correctness and completeness of these accounts to give comfort to the buyer's reliance on them for the binding headline purchase price. Also, the parties would attach to the SPA the reviewed accounts, or even *"initially trued-up"* accounts, which reflect certain reclassification of items agreed between the parties (the "**Reference Accounts**"). The Reference Accounts justify also the partial payment that is typically made upon signing the SPA ("**Signing**").

__"Business-as-Usual" restrictions:__ Representations and warranties for correctness and completeness of the accounts provided for due diligence are one side of the coin. The other side is the seller's undertaking not to change the accounting policy of the Target by Completion. In fact, such undertaking is part of a wider range of Seller's undertakings under the SPA to continue the usual course of business until Completion (so called "**Business-as-Usual Restrictions**"). Such restrictions would limit the involvement of the Target in transactions, which are outside its core business activities, and/or which exceed certain materiality thresholds. Timewise, such restrictions would cover the period from the Accounts Date to the Completion Date. Any transactions in deviation of these restrictions, if made prior to Signing, would typically be subject to mandatory disclosure to the buyer, and if made after Signing, would require (ideally) prior authorization by the buyer. In both cases the SPA should specify the impact on the final purchase price of transactions that are outside the ordinary course of business. Compliance with the Business-as-Usual Restrictions is subject to robust check in the period after Completion, while the Draft Completion Accounts (i.e. the predecessor of the Completion Accounts) are being prepared.

__Defining the equity adjustment rules:__ Since the final purchase price under the Completion Accounts mechanism is determined after Completion, the SPA cannot contain finalized purchase price. Instead, the SPA focuses on the rules defining the treatment of various items in the accounts, such as cash, debt or working capital.

[1] Under Bulgarian law, the breaches of representations or warranties are treated as contractual breaches and there is no statutory difference in the liability for a breach of representations, warranties or any other undertakings and contractual obligations. In each case, the affected party may claim damages and, if the breach is material – rescission of the contract. The scope of the liability for breach of representations and warranties can be modified contractually, though.

Figure 2



Definitions of the debt, cash, trade payables and trade receivables, net working capital, etc., would be the minimum required content, but a tailored SPA would certainly address also so-called cash-like and debt-like items, as they are often at the border line with the working capital. Cash would typically include cash in hand, cash in transit and at bank and cash equivalents. Debt would be outstanding borrowings and indebtedness in the nature of borrowings (other than trade debts). Working capital is usually defined as the difference between: (a) inventory, trade and other receivables from ordinary course of business, including prepayments; and (b) trade payables and other payables incurred in the ordinary course of business and deferred revenue. Having the Reference Accounts as an enclosure to SPA always helps "crossing" the bridge from Enterprise Value to Equity Value. It also facilitates consistency with the Draft Completion Accounts and smoother discussion on the Completion Accounts, fairly justifying any post-Completion reclassification of items.

The Completion Accounts: As mentioned above, the Completion Accounts are prepared as at Completion Date and, naturally, it takes some time to prepare these after Completion. The party responsible for preparation of the Completion Accounts is usually agreed in the SPA. In practice, by the time the Transaction reaches the point of preparing the Draft Completion Accounts (as the predecessor of the Completion Accounts), the buyer already has title and control over the Target, so it is typical that the preparation of the first Draft Completion Accounts is assigned to the buyer. Once prepared, these accounts are provided to the seller for review. Usually, the period for preparation of the Completion Accounts is agreed in the SPA and is identical to the period for their review. An important legal aspect of this completion mechanism are the principles guiding the preparation of the Completion Accounts. Typically used hierarchy:

(a) Specific accounting policies. To mitigate post-Completion disputes, resulting from reclassification of accounting items in the Draft Completion Accounts, the parties should agree on specific accounting treatment of certain items to be adopted in the Completion Accounts. These policies will prevail over policies applied in the last accounts;

(b) Consistency with the last (audited) accounts. Unless specific accounting policies are agreed, the Completion Accounts should follow policies of the last (audited) accounts of the Target;

(c) Applicable accounting standards (IFRS, GAAP, national). Items which do not fall within the specific accounting policies, or the last accounts should be booked in accordance with the chosen accounting standards, including the effective date (particularly given the significant changes to UK GAAP in recent periods).

Disagreements on the Draft Completion Accounts are reported as the most common risk for the Completion Accounts Mechanism.

Common reasons for such disagreements are reclassification of accounting items with dual nature, which are not explicitly defined in the SPA; inconsistency in applying the Target' specific accounting policy; inadequate period for determination the normalized level of working capital; aggressive provisioning concerning debts, risks or revenue; etc. In case of disagreements on the Draft Completion Accounts, the parties would typically save some time to try and settle the dispute, but if they fail in reaching mutual agreement, they would refer the matter to a third party – independent expert, which, however, will also be required to follow the guidance for preparation of the Completion Accounts agreed in the SPA, so defining the cash-like and debt-like items and other working capital normalization rules in the SPA at the first place is key for the success of this dispute resolution measure (*Figure 2* provides the full picture of the Completion Accounts Mechanism).

Please reach out to us if you want to discuss!

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