Every year a company’s financial statements are affected by changes to the Generally Accepted Accounting Principles (GAAP), which constantly evolve. Changes to GAAP affect a company’s results of operations and financial condition as presented in its financial statements, as well as related public disclosures like earnings releases, MD&A (Management Discussion and Analysis) and risk factors.

Changes to GAAP may also impact existing contracts that contain provisions tied to financial metrics or statistics derived from financial statements. For example:

- Credit agreements, which use accounting terms (such as net income, total assets and debt) in various financial covenants, and in certain cases availability for future borrowing, that may be keyed off metrics such as inventory and accounts receivable.
- Indentures governing bonds, which use these types of accounting terms in provisions that determine whether a company can incur additional debt, grant liens or make dividends.
- Merger and acquisition agreements may contain earn-out provisions that result in additional post-closing payments based on the target company’s performance, which in turn is often measured by reference to financial metrics such as revenue or net income.
• Employment agreements and related compensation arrangements often tie bonuses to various measures of the company’s profitability.

GAAP IN CONTRACTS
Whether a company will benefit from a change in GAAP or suffer unintended negative consequences may depend on how GAAP is defined in its underlying contracts. In general, it is defined in one of two ways: either as it may be amended from time to time (i.e., floating GAAP), or as it is at the time of the contract (i.e., fixed GAAP).

With floating GAAP, as accounting principles change so too do the meanings of contractual provisions tied to GAAP. With fixed GAAP, the company must keep separate books, one set for its GAAP financial statements and another set in order to make calculations under the contract.

As GAAP evolves over time, it is important to understand the impact any changes may have on the company’s existing contracts and what the company should disclose about these arrangements in its public filings. Changes in accounting principles could, for example, have a material impact on the company’s revenue recognition policies, the timing of expenses (capitalization versus expense), the write-off or write-down of tangible and intangible assets, the valuation of inventory, the booking of reserves, whether an instrument or obligation is accounted for as debt, and the company’s hedging and derivatives policies.

For example, a change in accounting for earn-outs in business combinations went into effect in 2009. In general, prior to the change, acquirers were required to record the cost of earn-outs only when there was reasonable assurance that the earn-out payment would be made. That could take several years to determine, depending on the earn-out provision.

Under the new rule, acquirers are generally required to record any cash earn-outs and other contingent consideration as liabilities at fair value as of the acquisition date, and to record any changes in the assigned fair value as of each financial reporting date, including any reversal to the extent the earn-out expires. This can create significant income statement volatility for acquirers going forward.

As a result, where a contract such as a credit agreement has floating GAAP, a company may discover that its calculation of a debt ratio is suddenly changed, as an earn-out is recorded as a liability much sooner than originally anticipated. This could impact a company’s ability to incur additional debt. This rule change, on the other hand, would not impact a similar contractual provision where GAAP is fixed, although it would require a company to maintain two separate books.

Additionally, a new revenue recognition accounting standard will begin affecting bundled sales arrangements entered into or materially modified in the first quarter of 2011 for calendar year-end companies. In bundled sales arrangements, companies sell customers products or services that are delivered at different times rather than at once. An example would be the sale of a mobile phone with a two-year service contract.

In general the existing rules require objective criteria, such as third-party evidence, to recognize revenue on separate deliverables over the life of a bundled sales arrangement. Without such objective criteria, companies often are faced with deferring the revenue until delivery and performance of all the products and services, or recognizing the revenue ratably over the life of the arrangement.

Under the new accounting standard, companies generally will be required to recognize the revenue on each deliverable when delivered or performed, using estimated selling prices. This could result in much earlier recognition of revenue.

One strategy, often found in credit agreements, is to include a provision permitting the parties to revisit contractual terms when there are changes in GAAP.

This change therefore could translate into an improvement for a company in the calculation of certain compliance measurements, ratios or compensation arrangements in underlying contracts. It also could work against the company if, for example, certain contractual provisions were drafted specifically to account for the company’s then existing revenue recognition policies.

Similarly, compensation arrangements and incentive programs may be affected by this change, as the timing of revenue recognition shifts. Again, whether a company will benefit from this rule change or will suffer unintended negative consequences may depend on how GAAP is defined in its underlying contracts.

Although tying accounting terms to GAAP as of the time of the contract may result in the need for two separate accounting books, it does provide certainty regarding the interpretation of whatever contract provisions rely on accounting terms.

Another way of addressing the issue, one often found in credit agreements, is to include a provision permitting the parties to revisit contractual terms when there are changes in GAAP. It’s also possible to avoid the issue of changes in GAAP entirely, by tying contract financial to measures that are not affected by it (such as unit sales or cash), rather than such GAAP measures as revenue or income.

DISCLOSURE ASSOCIATED WITH ACCOUNTING CHANGES
Companies should make sure their public disclosure not only reflects the current state of GAAP, but also – if it’s known – the future impact that proposed changes may have.
Companies also should consider providing qualitative or even quantitative disclosure to aid investors in reconciling past with current performance where accounting changes make certain period comparisons difficult to understand. Companies should consider these changes when preparing financial statements, earnings releases, MD&A and risk factors.

An acquiring company choosing to include a cash earn-out provision in an M&A transaction, for example, should consider including disclosure about the impact of earn-outs on its results of operations in its earnings press releases and periodic reports. It should also consider including risk factor language in its periodic reports and any offering documents that highlight the potential for associated income statement volatility.

Likewise, companies affected by the new revenue recognition rules should consider disclosing the increased use of estimates in revenue recognition, and providing qualitative and perhaps quantitative disclosure of the period-to-period effect of the accounting change in MD&A disclosure. They also should consider revisiting existing risk factors (or including new ones) that address period-to-period comparability limitations, and reviewing their use of non-GAAP financial measures that are used to disclose effects related to the new rules.