Grant Thornton

With rising deal volumes, expect an increase in M&A disputes

Best practices for mitigating and resolving disputes

Where there are deals, there can be disputes. With the uneven rebounding of economic conditions in 2023 after an M&A slowdown, there have been more disputes over post-closing calculations of purchase price adjustments such as working capital true-ups and earn-outs. And with increased deal activity forecasted, a further uptick in disputes should be expected. Buyers and sellers should be prepared with tools necessary to prevent those disputes or resolve them when they arise.

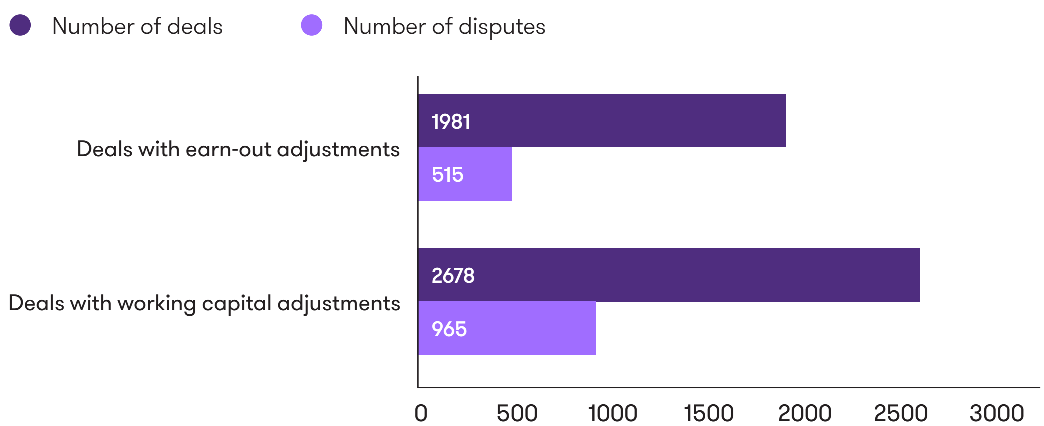
These were the essential outcomes that surfaced in the 2023 Grant Thornton M&A Dispute Survey, which provided in-depth data on the trends that deal participants are experiencing in the current environment. While the proportion of deals resulting in disputes appears to have decreased since the firm's previous survey, dispute activity has increased with the increase in overall deal volumes.

"Disputes persist for understandable reasons," said Grant Thornton Purchase Agreement Advisory Leader Max Mitchell. "When there are strong motivations to close deals quickly, parties can gloss over difficult conversations up front, deferring decisions until post-closing. Contingency and subjectivity are built into the process. And a great deal of money is at stake."

The 2023 survey reflects the views of 150 active deal participants on both the buy-side and sell-side of transactions, who worked on a total 3,668 deals in calendar year 2022 — across a broad range of industries and of varying deal sizes, from under $250 million to over $1 billion. It also conveys a spectrum of M&A experience: Respondents included M&A investment bankers, CFOs and corporate development teams, M&A attorneys and litigation counsel, private equity investors, and professional services accountants (M&A dispute experts, arbitrators and financial due diligence specialists). The majority of deals (61%) took place in the United States.

Inside you'll find our views of dispute causes, best practices for proactively mitigating or reactively resolving them, a discussion of the role of the neutral accountant, and full survey results.

Deals and disputes



Percent of deals in the survey resulting in:

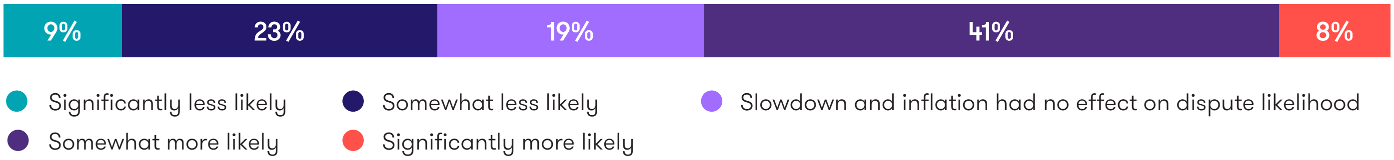
26%
Working capital dispute

36%
Earn-out dispute

- The 1,981 deals with earn-out adjustments generated 515 disputes.
- The 2,678 deals with working capital adjustments generated 965 disputes.

The fundamental causes of disputes

When considering deals so far in 2023, has the threat of economic slowdown and/or inflation affected the likelihood that you will dispute working capital, compared with the past?



Deal participants are facing a new set of distinctive headwinds. There are lingering supply chain issues that led to diminished inventories or, conversely, excess inventory stockpiled in anticipation of shortages. A plurality of respondents said the looming challenges of economic slowdown and inflation will lead to somewhat more disputes.

Grant Thornton M&A professionals have also seen deals drag on after the hurried activity of 2021, and more recently, we have observed widening valuation gaps. These delays have led to causes of disputes potentially being overlooked when companies do not perform sufficient due diligence throughout the process.

In addition, the root causes of disputes persist:

- The natural inclination to argue when parties have different interests.
- The sheer deal fatigue that can set in as the process proceeds.
- The reality that different legal, banking and accounting professionals are often involved in the negotiation, implementation, integration and separation, legal drafting, and underlying accounting of any given deal.
- The necessity of balancing and mitigating possible areas of disagreement without slowing down the deal process.

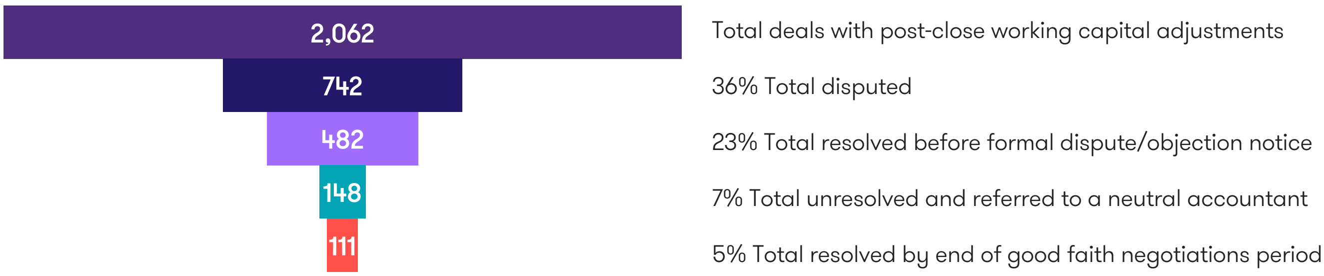
All these causes are rooted in human nature and difficult to change. Fortunately, best practices for mitigating M&A disputes are similarly enduring.

The larger M&A context

Among the many changes since our last survey, which focused on 2019 deals, was the drastic 2020 slow-down, a meteoric 2021 bounce-back, and an edging back toward a "new normal" in the number of deals. Besides being generally anomalous, 2020 was a time of low deal activity with 29,981 deals recorded in North America, according to the PitchBook Global M&A Report for 2022. By contrast, subsequent activity has been robust, with nearly 42,000 deals in 2022, albeit with room for more activity. Valuation gaps remain, and buyers have cash to make acquisitions and may simply be waiting for more favorable financing. Many sellers are holding out and awaiting higher valuations. Because these larger trends shape negotiations, they ripple throughout the specifics of deals.

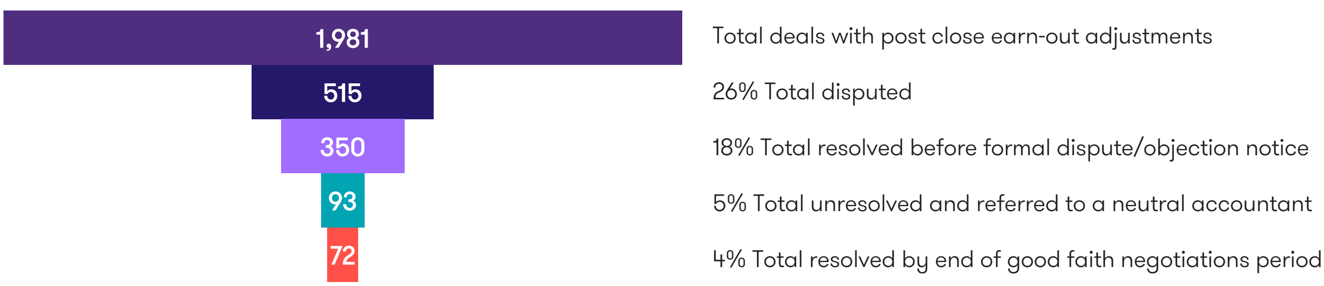
"While M&A activity is unlikely to soon equal the record-breaking pace we saw during 2021, there is still an appetite for platform and add-on acquisitions in the current market," said Grant Thornton Managing Principal of Transaction Advisory Services Elliot Findlay. "Although high interest rates present challenges and some sellers are holding assets longer, buyers are having success tapping into alternative funding sources and debt structures to complete deals."

Of deals in the survey with post-closing working capital adjustments, how many became disputed?



Takeaways: This tracks with our larger findings that, while the percentage of disputed deals appears to have decreased, with an overall rise in the number of deals the absolute volume of disputes rose from our previous survey. And those deals that were disputed were twice as likely to be referred to a neutral accountant (11% vs. 5% in our previous survey). This argues for greater care in the process of determining neutral accountants and, as always, proactivity with language in purchase agreements that is open to unfavorable interpretation to avoid such scenarios.

Of deals in the survey with post-closing earn-out adjustments, how many became disputed?



Takeaway: While this generally affirms the trends Grant Thornton is seeing, including an increasing use of earn-outs, just a quarter of deals with post close earn-out adjustments were disputed. This may reflect the fact that earn-outs inserted in volatile pandemic-era deals have been more definitively achieved or missed entirely, thus never being in dispute.

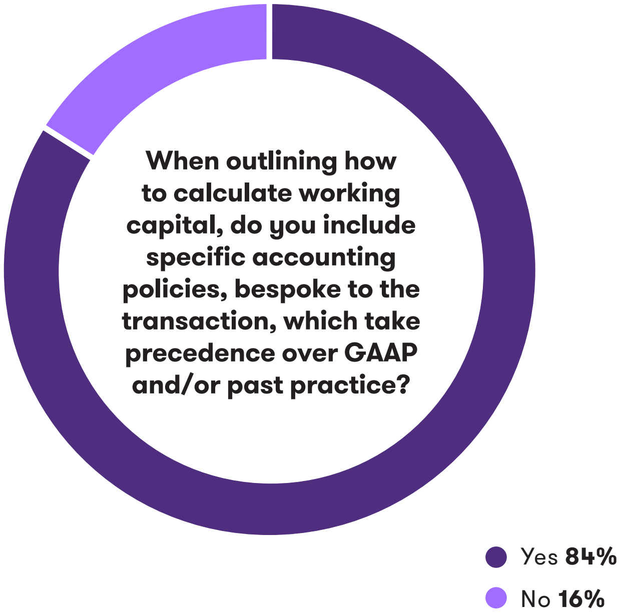
Key factors

What increases the likelihood of a dispute?

Grant Thornton M&A Dispute Services Leader Charles Blank described the core drivers of disputes. “Broadly speaking,” Blank said, “the more judgment calls the accounting for purchase price adjustments require, or the more open-ended the terms are, then the more likely it is that the parties will disagree.” The first step in addressing disputes is identifying their potential causes. As we shall see, causes can vary by industry and there will always be deal-specific nuances to address, though they can also fall into useful categories.

1. Vague language

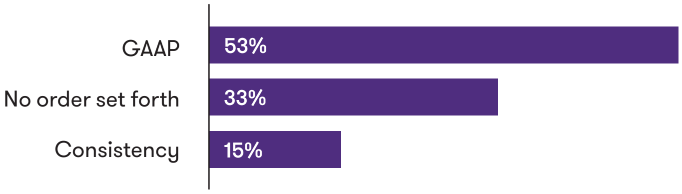
Despite understandable pressures to close deals, respondents showed an increasing willingness to take the time to craft specific accounting policies, bespoke to the transaction. The basis of calculations of working capital and earn-outs historically relied on a brief reference to “GAAP,” or “GAAP, consistently applied,” (implying consistency with the seller’s past accounting methods). Both bases of calculation can be highly prone to dispute, given that GAAP in some cases allows for myriad applications, and “consistently applied” is generally open-ended, with buyers often disagreeing with the sellers’ judgments when compared with their interpretations of GAAP. Those deals that did include some specific language experienced working capital disputes 36% of the time, compared with 38% for those who did not. While the difference may seem slight, in our experience, an “Accounting Principles” exhibit appended to the purchase agreement that sets forth the accounting principles and policies to be applied in the calculations of working capital and/or earn-outs is becoming increasingly popular and a helpful tool in mitigating disputes, or at least accelerating their resolution. Still, vague language in purchase agreements continues to complicate earn-out and working capital calculations, particularly in instances when these exhibits or appendices are the last sections of the purchase agreement drafted. As deal fatigue sets in, negotiations can be tense.



For example, the parties might agree to calculate the allowance for doubtful accounts consistent with the seller’s past practice, as this approach is more straightforward than codifying a specific practice. But then they may later disagree if the buyer believes the assumptions used by the seller do not conform with GAAP, or if the buyer takes a more prudent approach. Often, a buyer’s view and a seller’s view can differ, even though both may still be in accordance with GAAP.

On 33% of deals, parties fail to set forth a precedence between GAAP and consistency in calculating working capital or earn-outs. A majority (53%) of respondents suggest GAAP should override consistency, which leaves much open to interpretation in some cases.

Do most of your deals have GAAP or consistency take precedence?



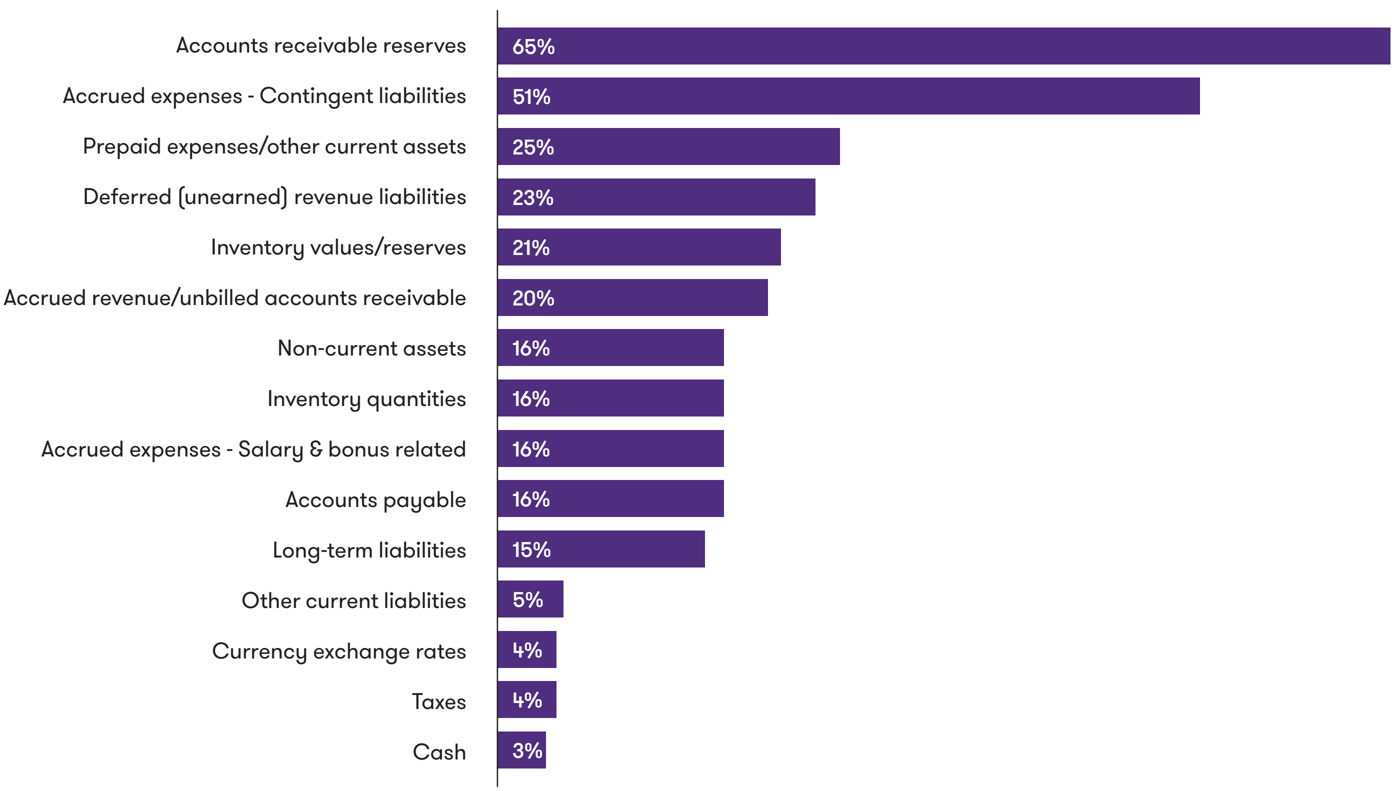
2. Purchase price adjustments

Parties often prefer to rely on purchase price adjustments rather than "Absence of Certain Changes"/accounting/financial representations and warranties ("R&W"), and this preference is for good reasons. First, purchase agreements often provide for dispute resolution protocols that differ between disputes over purchase price adjustments as compared to R&W disputes: Disputes in purchase price adjustments are often resolved by a determination by a neutral accountant. Disputes over warranties, on the other hand, are resolved through litigation. Furthermore, purchase price adjustments, such as working capital true-ups and earn-out payments, ensure dollar-for-dollar recourse and facilitate negotiation. With R&W, high claim thresholds and burdens of proof can preclude any meaningful resolution at all — for example, to prove a seller did not manage their working capital consistently in the normal course of business, one must prove what that normal course is, and further how they deviated from that — essentially, replicating a purchase price adjustment to prove a breach of representation.

However, purchase price adjustments can be open-ended. Adjustments by their nature assume there will be some degree of change, and change is never fully predictable. While post-closing true-ups of cash and indebtedness aren't free of subjectivity, the complexities of earn-outs and working capital are especially likely to spur disputes, given the potential subjectivity surrounding recognition and measurement of certain current assets and current liabilities (e.g., accounts receivable reserves). But you can still anticipate and address, or provide guidance for addressing, possible areas of disagreement by interpreting and clarifying contractual terms.

- **Working capital calculations**
  Almost two-thirds (65%) of respondents indicated that, among balance sheet items, accounts receivable reserves "posed the most post-acquisition working capital disputes."

Rank the top three balance sheet statement areas that pose the most post-acquisition working capital dispute?



This is a key example of an area where reliance on GAAP or consistent practice may not provide sufficient clarity to mitigate a dispute.

Even when parties might seek to apply a more formulaic approach (such as recognition of an accounts receivable reserve of X% for accounts aged X days), determining reserves often still involves some degree of managerial judgment. Additionally, buyers and sellers may adopt significantly different approaches to their own financials.

Another item involving significant material judgment, contingent liabilities, also contributed to a significant number of disputes.

Timing itself can also be an issue. Disagreements can often emerge regarding whether to consider new information after the closing, up to the date of the submission of the closing statement, or beyond. Further, a seller may question whether a buyer can apply their judgment to subsequent events. And "judgment" often turns into "disagreement."

Avoidable controversies can arise when specific terms are not specific enough — even with more straightforward matters, such as which currency exchange rates source to use.

- **Earn-outs**
  The survey revealed the relationship between earn-out metrics and the percentage of disputes reported. The results were noteworthy — and aligned with Grant Thornton's experience.

  Mitchell explained that: "Measuring adjusted EBITDA resulted in slightly more disputes than EBITDA and that's understandable given that the adjustments are often poorly defined or based on vague concepts. In particular, we encounter an overreliance upon 'extraordinary, non-recurring, or exceptional items,' a concept highly pertinent to a financial due diligence exercise, though not one for which there is a GAAP standard. The FASB eliminated the concept of extraordinary items back in 2015."

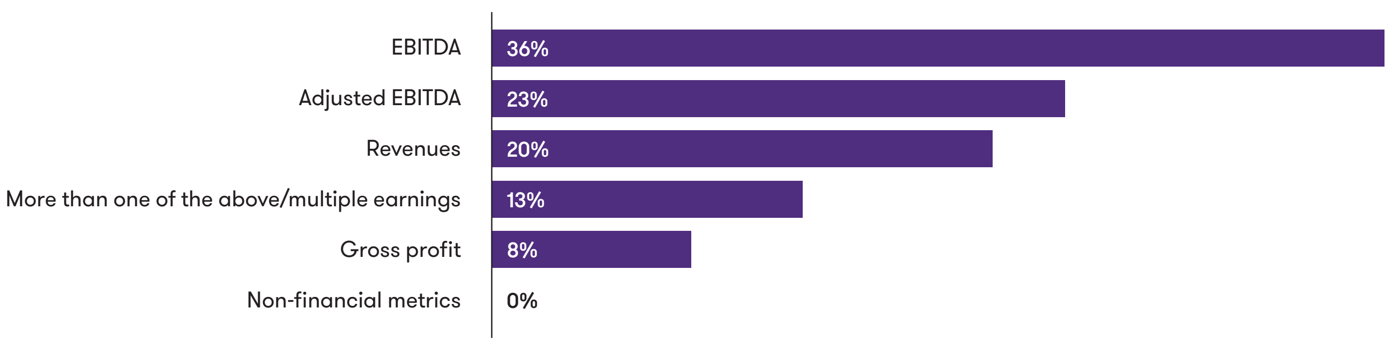
  On average, 26% of earn-outs are disputed. For those who most commonly used "Adjusted EBITDA," this rises to 28%. Similarly, 32% of earns-outs based on gross profits were disputed (vs. 26% for the wider population), likely due to the difficulty and potential subjectivity of delineating cost of sales vs. operating costs.

  Thirty-six percent of respondents used "EBITDA" (on an unadjusted basis) as the measurement basis for earn-outs, making this the most common choice. These respondents encountered comparatively fewer disputes (22%). This aligns with our team's experience — that the further one strays from reported metrics into the world of adjustments, the more likely it is those adjustments become disputed later.
  This is not to suggest that any earn-out can be rid of all risk. To the extent there is something to be measured, it can be managed and perhaps manipulated.

  Even straightforward earn-out measurements such as revenue become complicated if the people who negotiate them are not the people who calculate them. Any shared, unspoken, or at least undocumented assumptions are lost.

  On a deeper level, while earn-outs are a useful tool, they often merely postpone conflict, in particular where they are used as a value-bridging item between parties who might not otherwise sign a deal.

What do you typically use as the measurement basis for earn-outs?



How to guard against disputes

With more deals, there will inevitably be more disputes. But these best practices can help.

1. Clarify Your Methodology

Vagueness is the bane of purchase agreements. The more clarity you can achieve in the drafting, the better. Ambiguity lends itself to confusion and, in some cases, manipulation.

Of course, it is impossible to predict every novel interpretation and unusual contingency in inevitably complex deals amidst unpredictable conditions. There will always be unknown unknowns.

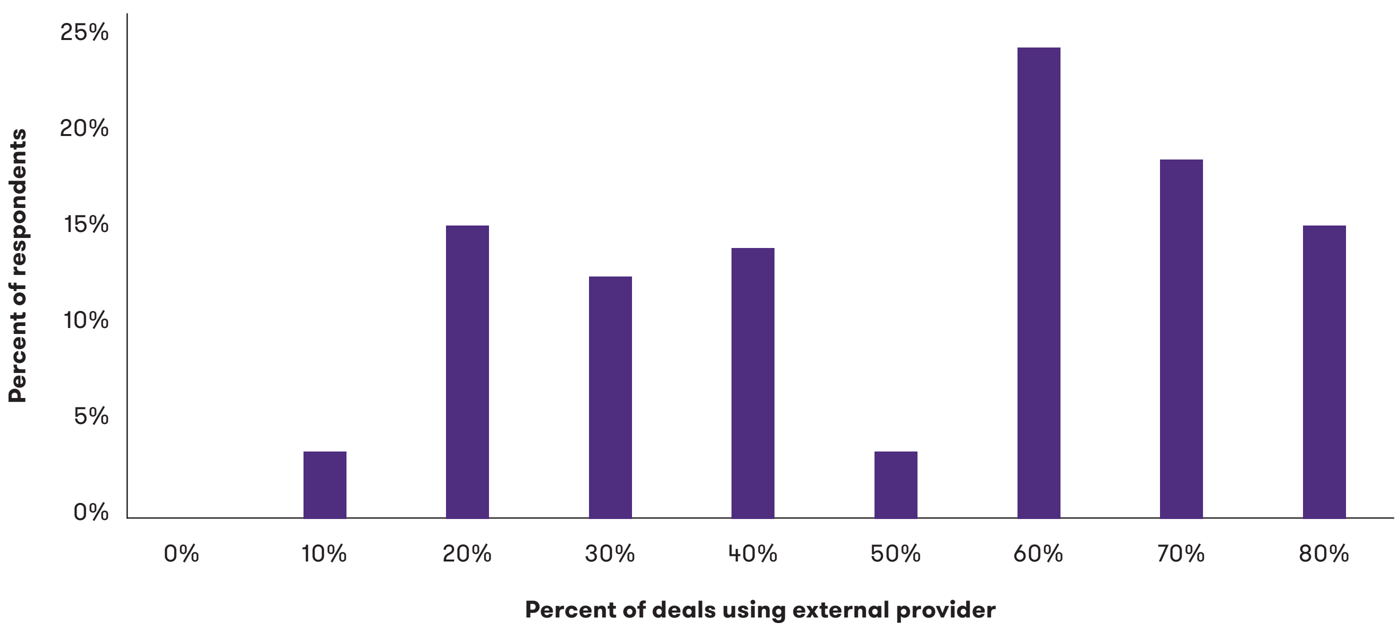
However, there are practices that can greatly reduce uncertainty and identify ambiguities before they ripen into issues. This begins with a willingness to devote attention early in the process to possible areas of contention. Financial due diligence (whether internally prepared or externally sourced) can be a powerful ally in such endeavors. Yet dealmakers on average reported that less than half (41%) of their deals involved an external financial due diligence provider.

Forgoing due diligence heightens the risks associated with transactions. As the deal takes shape, committing to consciously exploring its implications can head off time-consuming and resource-draining contention later.

Beyond undertaking robust due diligence, there are additional approaches that both survey responses and professional experience have shown to be best practices in guarding against disputes.

There is increasing consensus that specific accounting policies and a defined accounting hierarchy can help mitigate disputes. While better than nothing (and on rare occasion, there is no calculation basis set forth in the purchase agreement at all), both "GAAP" and/or "consistency" in calculating working capital and/or earn-outs may leave too much open to interpretation for some elements. GAAP can be open to subjective interpretation and consistency cannot predict the future. Neither fully addresses the intricacies of the closing balance sheet or the earn-out calculation. (Indeed GAAP may offer specific guidance on year-end and interim financial statement preparation, but not to M&A output). These M&A considerations need to be tailored to each purchase agreement.

On what percentage of your 2022 deals did you involve an external financial due diligence provider?



This customization means sellers should ask questions such as:

- “What new areas of accounting have arisen since the last financial statements that could confound our reliance on consistency?”
- "Which areas require material judgment?”
- “Are there commercially negotiated treatments than can be referenced?”
- “Have there been adjustments to the ‘target working capital’ that we need to factor into our closing calculations?”
- “If we have applied different treatments from period to period historically, can we be specific enough in identifying them and specifying which take precedence?”
- “When differing approaches present themselves, what should take precedence? Have we made it clear whether specific policies, our past practices, or GAAP controls?”

That last question raises a host of considerations and potential for contradictions. Often, our professionals will encounter deals that reference all the above, with no precedence.

A surprising 33% of respondents reported that most of their deals set forth no precedence between “GAAP” and “consistency” in the calculation of working capital and/or the earn-out. Given these possibilities for dispute, you might ask: while each transaction has its own contours, do certain issues recur? Can we flag them and adjust our practices? The chart below will help.

a. Specific Accounting Policies

Circumstances	Considerations	Examples
No written accounting policy in financial statements or elsewhere	Consider that reliance on past practice is only as strong as those past practices. Inconsistent historical application can be ripe for dispute.	• Revenue recognition and deferred revenue • Accounts receivable reserves • Inventory reserves • Legal/environmental/warranty provisions
No historical balance in reference period	Consider that consistency can only be applied where there is historical practice to apply it with. Consider changes in factual circumstances that may introduce new items into closing statements.	• Newly created trial-balance/general ledger line items • Recent acquisitions • Changes in GAAP
Account estimate is subjective	Consider key balances that may be reliant on significant judgments or management estimations.	• Revenue recognition and deferred revenue • Accounts receivable reserves • Inventory reserves • Returns reserves/warranty reserves
Specific commercial treatments	Consider fixing dollar amounts for assets/liabilities, agreeing there will be no change to carrying values, or agreed deviations from past practice and/or GAAP.	• No variation in previously static balances • Agreed cash-like addition for off-balance-sheet assets • Treatment of off-balance-sheet items • Inclusions/exclusions
Foreign currency balances	Consider the impact of fluctuations in underlying foreign currency on material working capital balances. The enterprise value may be derived from a different currency to functional currency, particularly with cross-border transactions, which can create inconsistencies when measuring working capital at closing.	• Agree on basis and source of exchange rate to be adopted • Agree on treatment of any hedging arrangements
Difference in accounting at year-end vs. interim dates	Consider that certain balances may only be calculated once a year, and the closing balance sheet may likely not occur at such date.	• Accrued PTO • Bonus accruals • Annual Rebates

The same approach can be applied to both earn-outs and working capital.

While it is sensible to identify and address likely contentious issues, it's also essential to specify guidelines that apply to a broader set of matters, given one cannot (nor need not) prescribe a calculation basis for every item.

b. Consistency with a specific set of financial statements

The words "consistently applied" can help clarify the approach to post-closing calculations, but they can also promulgate dispute. When specifying consistency, one should ask: Consistent with what? This asks the deal team to assess which financial statements could be referenced and if there are material differences between them. Are there differences between the daily trial balance, monthly accounting, and year-end reporting? Invariably the answer is yes — yet often no such detail is set forth.

c. Applicable GAAP

Hierarchies allow you to comprehensively address all accounting matters, with varying degrees of specificity. While specific accounting policies can be used to mitigate specific risk, and consistency is a generally advisable next step, a reference to GAAP (e.g., U.S. GAAP or IFRS) will clarify the treatment of items not covered by them. By agreeing to a framework such as GAAP as of a historical date or closing, you can address unforeseen, new or unspecified circumstances.

Especially in cross-border transactions, if there are differences between the GAAP historically adopted in financial statements and the GAAP to be adopted for the closing balance, identify the impact of each to ensure a mutually agreeable approach is settled upon.

2. Provide an example (but understand the limitations)

Humans think in examples — and that includes the humans who draft complex M&A deals. As early as the letter of intent stage, sellers can work to prepare an illustrative enterprise value-to-equity price bridge, illustrating their expected view of the purchase price adjustments, and gaining clarity early on. If used, the seller can then effectively compare multiple bids from potential buyers and/or dispel unreasonable pricing expectations. Even with comparable enterprise value/EBITDA offers, the resultant equity price may differ significantly — and more so when a post-closing true-up becomes contested. When intentions are expressed as dollars, and unspoken assumptions are quantified, sellers can avoid frustrated transactions.

The benefits of preparing examples don't all flow to sellers. Both parties can avoid post-closing contention by proactively agreeing on components of cash, debt and working capital; quantifying cash-like items; and illustrating working capital. All parties will have a sharper view of what the potential proceeds might be.

A sample calculation of working capital pre-closing provides a reference point in post-closing preparation and review. Parties can refer back to pre-signing intentions in instances where drafting does not give a definitive direction.

Since all illustrations are by nature illustrative, unforeseen circumstances may alter them.

Take pains to be comprehensive. Target working capital calculations (also known as the "working capital peg") typically contemplate pro-forma adjustments, normalizations and exclusions, though often such normalizations may not apply for closing calculations. Net working capital calculations may need to contemplate all current assets and current liabilities, at closing, unless specifically addressed in the agreement (either through a definitional exclusion or a specific accounting policy).

To reduce subjectivity, hierarchies with specific, stated guidelines should take precedence over a table of numbers. Understand that a human error in an illustration need not be perpetuated.

Crafting dispute resolution clauses

Inserting clear dispute resolution procedures in the purchase agreement can reduce the number of topics to negotiate later.

Such a clause should include:

- The timeline for this process, including:
  - The number of days the buyer has to prepare working capital or earn-out schedules
  - The number of days the seller has to respond to the buyer's schedules, and the number of days the parties have to negotiate a resolution in good faith
  - The basis by which the parties can extend these processes if necessary
- Guidance on the neutral arbitration process, with a named neutral accountant agreed to by both parties, or with a methodology to select one
- How to allocate the neutral accountant's fees
- Defined scope for the purchase price adjustment determination

The purchase agreement may also include the submission process, so there is one less item to negotiate after closing.

For smaller disputes, that might mean one submission to the neutral accountant. For larger disputes, that could mean both initial submissions and rebuttal submissions, as well as questions and requests from a neutral accountant.

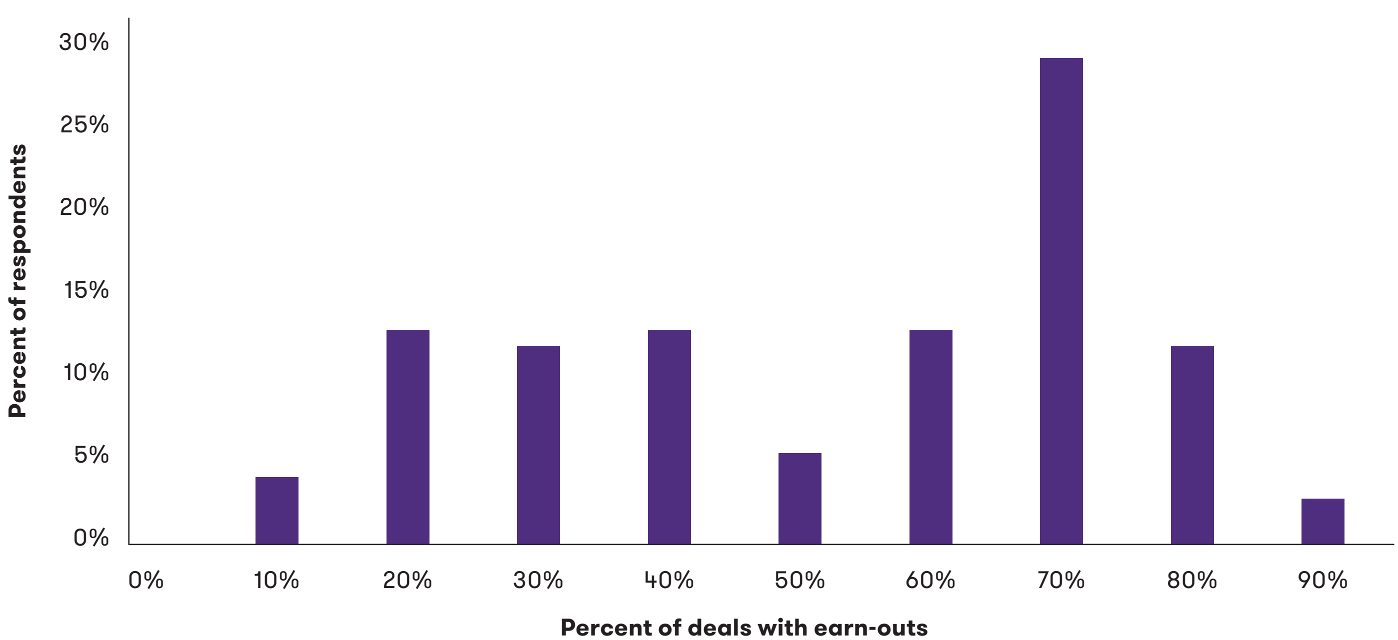
3. Manage earn-out timing, scheduling and metrics

Earn-outs are powerful, popular tools. They help true-up and validate the headline price, distribute post-closing risk, allow confident sellers a greater upside, give buyers the benefit of post-closing performance, and motivate any target company executives who stay with the business after closing.
But poorly drafted earn-outs can proliferate disputes and even damage the business.

Timing

A best practice is to negotiate early: at the letter-of-intent stage or prior to exclusivity (subject to ongoing negotiation and diligence). At this stage, parties can balance commercial pressures and desires to complete the deal. Often an earn-out adjustment inserted very late in a deal process will be hurried and dispute-prone.

On what portion of deals do you see earn-outs being used?



Parties
This is one of many areas where various parties, with varying perspectives, including accountants, can help ensure earn-out targets are achievable and nothing is overlooked. It is rarely the case that too many cooks spoil the earn-out broth, and the input of accountants can be the key ingredient.

Success criteria

- Are earn-out clauses clearly described, objectively measurable and fair?
- Is risk shared appropriately?
- Are they within the seller's influence?
- Are they achievable?

Unreasonable earn-out targets can damage relationships and depress post-deal results. A buyer should approach an earn-out situation hoping to pay the amounts in full, since their achievement represents the absolute culmination of their deal hypothesis.

Metrics
One might consider a combination of financial and non-financial metrics to reduce the chances that a single metric can be manipulated with tactics that may damage the business long-term. For example, an earn-out could be met by achieving a certain level of EBITDA, revenue, and customer retention.

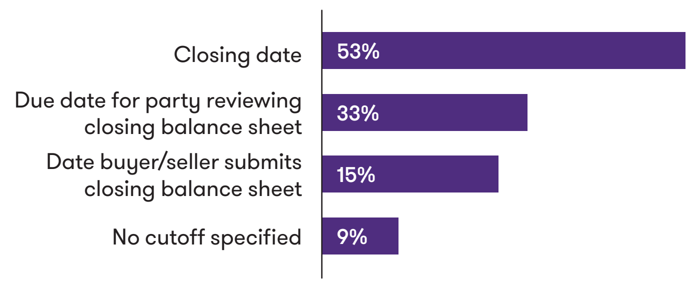
Accounting basis
All earn-out metrics should be readily calculable, with appropriate specified practices, hierarchies, and GAAP interpretations. Also ask: will the accounting system of the target acquired be kept on a standalone basis post-closing, or absorbed into the accounting system of the buyer post-closing? Will this system allow for clear tracking of the earn-out metric(s)?

4. Specify a subsequent events cutoff

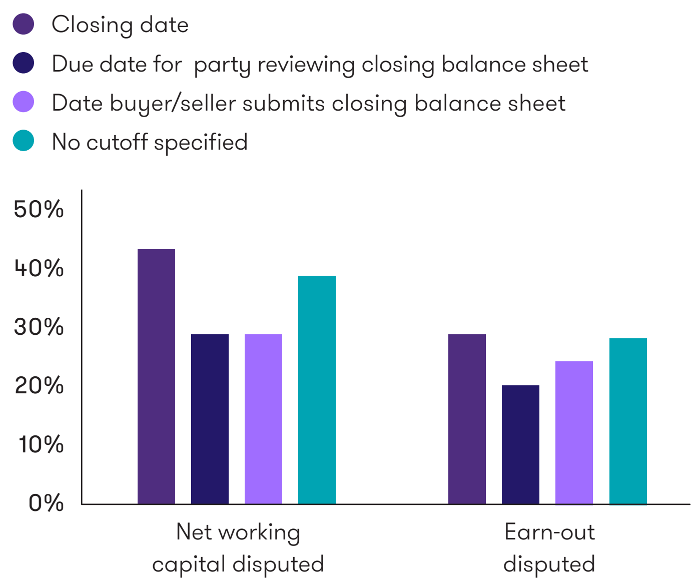
When parties disregard events occurring subsequent to closing, the percentage of disputed working capital true-ups increases from 36% to 43%. Earn-out disputes also rise slightly.

Fewer disputes happen when there is a clear cutoff date for information to be considered in calculating working capital or an earn-out, although parties should be aware that setting the closing as the cutoff date can itself be a cause of disputes. By its nature, accounting requires a degree of hindsight and setting the closing as a cutoff deprives the parties of that hindsight.

Do you set forth in the agreement the date to which you will consider new information, with regard to the post-closing NWC adjustment?



Net working capital and earn-out disputes based on cutoff date



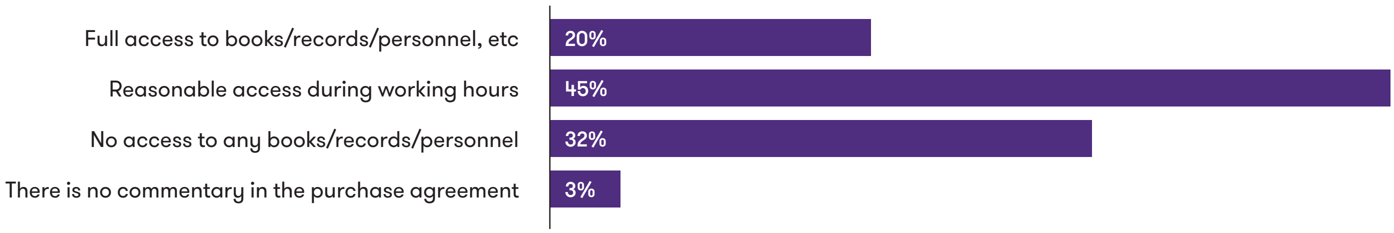
5. Choose reasonable access

Decisions about access can also affect the percentage of disputes. If a seller's access to information is cut off completely at closing, disputes are more likely to arise because the seller won't have sufficient access to the post-closing information they need to evaluate the buyer's calculation of the working capital true-up. In fact, the "good faith" negotiation period could be a seller's "last resort" for obtaining such information.

Not surprisingly, 65% of respondents choose either "full access" or "reasonable access during working hours" as the level of access provided to sellers post-closing.

Of course, "reasonable" is itself open to interpretation and thus dispute. But it can be spelled out as "rights to request data and conduct discussions with personnel." Remaining gray areas can be resolved through negotiation. And "reasonable" is flexible enough that it can accommodate unanticipated situations. While not perfect, provision of "reasonable" access to sellers post-closing tends to reduce the intensity and frequency of disputes.

With regards to the sellers' level of access after the closing date, what level of access do your purchase agreements typically set forth that the seller should have?



6. Use a locked box mechanism

When asked what approaches might have resulted in fewer disputes, just 27% of respondents believed a locked box mechanism may mitigate risk. Especially in the United States, this tool is undervalued and occasionally misunderstood.

With the locked box mechanism, the purchase price adjustments for cash, debt and working capital are each derived from a historical balance sheet. After diligence and review, it acts as a proxy for the closing balance sheet.

Locked boxes avoid the need to prepare, review and potentially dispute the closing balance sheet; they free buyers to focus on integrating the business; and they expedite payment. Sellers can have all funds available for distribution immediately after the closing.

Still, they are not without contention. Decisions need to be made on what comprises "debt" vs. "working capital," and what the normal level of working capital is. Some best practices can maximize the benefits of the locked box mechanism:

- Carefully set the historic date: A balance sheet that is too recent may not have been adequately scrutinized by the sell-side, nor subject to sufficient diligence from the buyer. If it's too old, the balance sheet may be stale, and there's an increased risk of leakage or an inaccurate value accrual.
- Review leakage: The parties should carefully craft language so they can identify acceptable and unacceptable leakage and adjust the price accordingly.
- Use a "value accrual" (profit ticker) to reflect the changes in the balance sheet: This will reflect the profitability earned by the business in the locked box period.
- Ideally avoid significant gaps between signing and closing. The "value accrual" concept is more likely to be inaccurate if spread across a longer period.

Based on your experience, which approaches would have resulted in fewer disputes in your deals?

(Percent of respondents indicating that an option would result in fewer disputes)

People

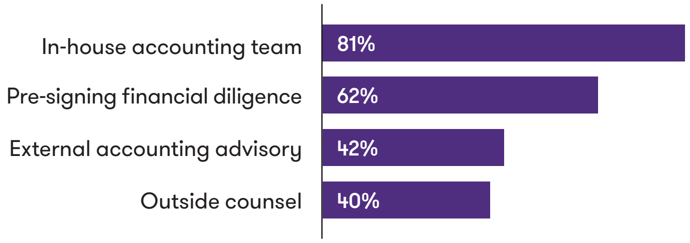
Deals are complex, evolving, and unique.
A team of professionals can suggest policies and practices that are optimized for your circumstances.

Mergers and acquisitions are team sports. Having the right people working on your deal is crucial to success. The key is tapping as many perspectives as possible to identify possibilities — or problems — and then applying expertise. This is especially true at two key stages: diligence and dispute.

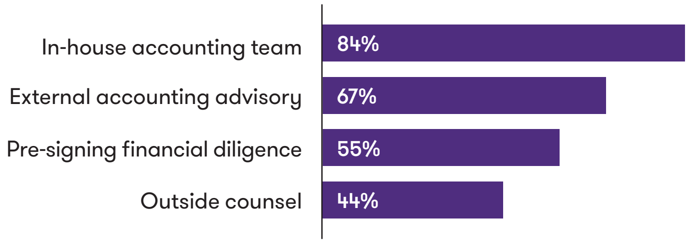
1. Prioritize diligence

Given the scope and importance of the M&A transaction, it's advisable to bring in external providers to help in the preparation and review of closing statements. More than half of respondents — 62% of buyers and 55% of sellers — reported they bring in the pre-signing financial due diligence team (which is only feasible if there has been a pre-signing financial due diligence team) to prepare post-closing statements. Slightly fewer — 40% and 44%, respectively — used outside counsel. Given the closing statement is an output of the purchase agreement, it can be a best practice to use those same parties, both legal and financial, who helped prepare the purchase agreement, since they understand its requirements.

When you prepare the post-closing statement, who assists you?



When you review the buyer's post-closing statement, who assists you?



External diligence providers bring a familiarity with the closing statement process, including applying GAAP and the relevant computation-related definitions in the purchase agreement, as well as experience interacting with both the buyer and seller. They offer fresh perspectives that balance the familiarity of the in-house teams. Ideally all parties are pulling together to prepare or review the closing statement.

2. The value of fresh eyes and deep experience

Post-acquisition disputes carry high stakes and place extreme demands on your resources. At the same time, in-house resources may be fully occupied with the separation or integration processes.

While M&A challenges may be new to certain accounting staff, external accounting advisers can bring extensive experience in post-acquisition closing statement preparation and disputes. They are more likely to anticipate what will be sought by a neutral accountant in resolving a dispute. And they have time to focus on a response.

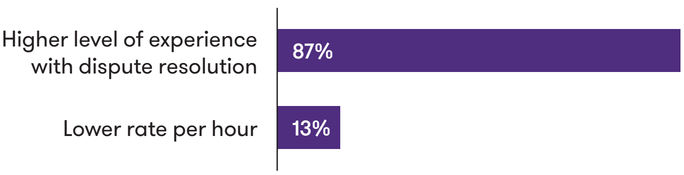
Finally, they can look at your practices with fresh eyes, so they help ensure that they are explicit enough that neutral and even adversarial parties will interpret them favorably.

3. Prepare for the possibility of a neutral accountant

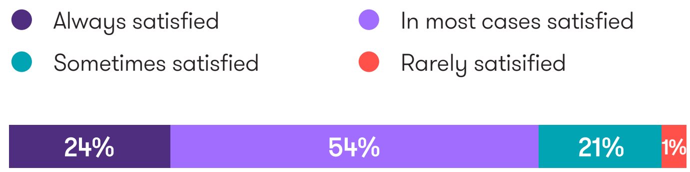
Respondents indicated that the threat of an economic slowdown or inflation makes them somewhat more likely to dispute working capital. The recent economic uncertainty helps explain why over 10% of working capital disputes and 7% of earn-out disputes wound up in the hands of a neutral accountant. A neutral accountant's role begins when a buyer and seller cannot agree to the closing balance sheet or earn-out calculation of the target company. The purchase agreement will typically call for both parties to submit their positions to the neutral accountant, who will then apply the terms of the purchase agreement to reach a final and binding determination as to the proper treatment of those items that remain in dispute. Because such an accountant must be acceptable to both parties, it's important to have thought-out criteria and a rigorous process to identify a neutral accountant to resolve the remaining disputes.

Our respondents confirmed that, given the amounts at stake, decisions should not be based on price. Instead, respondents indicated that they value most highly the depth of experience of a neutral accountant, which is not a surprise, given that the role requires a blend of applying GAAP and contractual terms. Of the 13% of respondents who valued a lower cost neutral accountant over those with higher levels of experience, just 4% were "always satisfied" with the result, compared with 26% of respondents who valued more experienced neutral accountants.

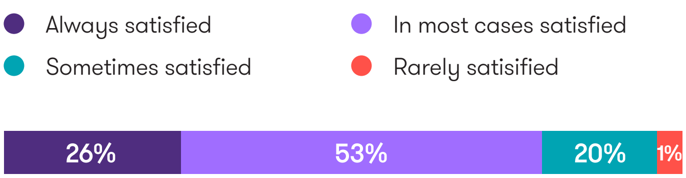
In selecting a neutral accountant, which do you value more highly: higher level of experience with dispute resolution or lower rate per hour?



All respondents: For any disputes that were resolved by a neutral accountant, have you been typically satisfied with the result?



Respondents who value experience with dispute resolution: For any disputes that were resolved by a neutral accountant, have you been typically satisfied with the result?



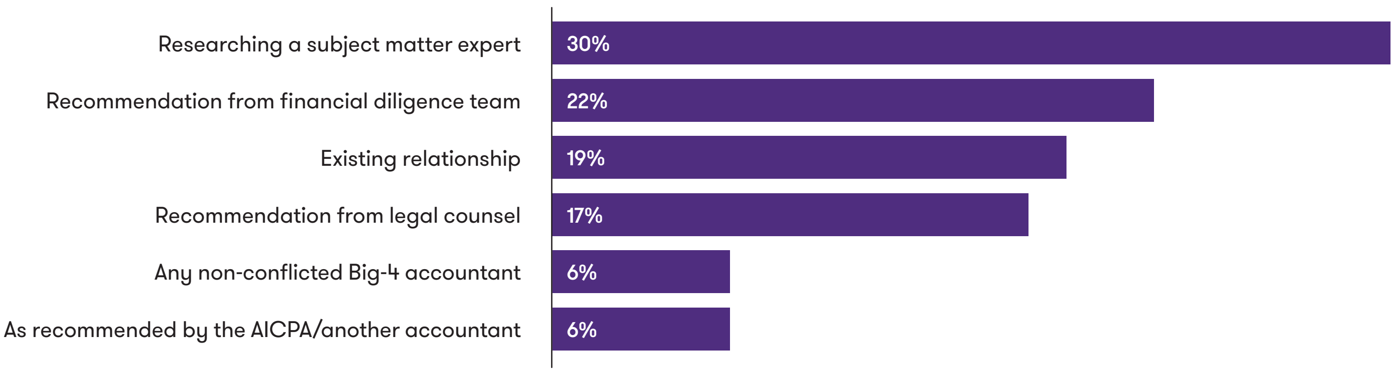
Respondents who value lower rate per hour: For any disputes that were resolved by a neutral accountant, have you been typically satisfied with the result?

Our respondents identified candidates for neutral accountant through a variety of sources: 30% of respondents indicated that they researched a subject matter expert, 22% indicated that they were recommended a neutral accountant through their financial diligence team, and 19% indicated that they had an existing relationship.

Our respondents found that the most effective neutral arbitrator possesses specific accounting and industry knowledge. Once engaged, our respondents indicated that a neutral accountant is most effective by asking "better questions" of the disputing parties before reaching a determination, and by "including more detail for the rationale in the neutral accountant's final determination" and "fairly evaluating each disputed item."

The importance of detail and deliberation is reinforced by an accountant's professional responsibility to maintain objectivity and obtain sufficient evidence from the disputing parties to support conclusions. Grant Thornton Forensic Advisory Services Manager Tom Cassidy advised that, "given that the neutral accountant is limited to the evidence developed by the parties, it's crucial to develop a full record, with clear positions, articulated rationales, and sufficient support."

How do you typically select your neutral accountant?



Conclusion

While disputes often arise out of the exigencies of the deal, they can be mitigated by taking a disciplined, considered approach before deal fatigue or deadlines accelerate the process; applying specific accounting policies and imposing a clear hierarchy; and by bringing the full experience of an exceptional team to the diligence and dispute stages.

Appendix: Pre-signing debate

While this report has focused on the key issues that arise post-closing when dealing with purchase price adjustments, as well as best practices for mitigating them, there are myriad road-blocks deal participants encounter in ever reaching an agreement.

Two of the more pertinent examples are explored further below:

1. Setting the right target

The working capital target typically averages working capital over the "trailing 12 months" (TTM), but not always. This can remove the effects of seasonality and month-to-month fluctuations.

The working capital delivered at closing is compared to the "target working capital" figure, also known as the working capital "peg." As such, the calculation of the working capital target can cause a significant change in the equity price — if it is set higher, it becomes more likely there will be a closing working capital deficit, and, if set lower, it's more likely the seller delivers a working capital surplus. When a business has a growing, positive working capital, buyers typically prefer a more recent working capital reference period. This is more likely to yield a higher target working capital to which the actual working capital delivered is compared, and result in a lower final purchase price.

Deal participants are often party to significant debate as to what "normal" working capital really looks like, which can be a highly subjective area. Informed parties may leave value on the table if they are not fully prepared for such discussion.

One methodology for selecting the reference period for the working capital target is to align the working capital reference period to the EBITDA period that underpins the enterprise value. The rationale is that the working capital target represents the requirements of the business at the level of earnings used for the headline price. For example, in a deal where the enterprise value is directly based on the growth potential of the business, it may be appropriate to include an element of forecast in the working capital target.

We recommend being fully prepared for these discussions by leveraging the working capital analysis, including any applicable adjustments, normalizations and inclusions and exclusions set forth within the financial due diligence.

On transactions involving a working capital target, what reference period is typically used to calculate the working capital target?

2. Handling deferred revenue

Almost one-third (31%) of all respondents said the treatment of deferred revenue depends on the nature of the deal, with 49% considering it to be debt-like, and 21% considering it a component of working capital, though these results varied considerably from industry to industry.

In general terms, deferred revenue represents a liability on the balance sheet for goods or services invoiced to customers, prior to the fulfillment of such obligations (such as the product or service being delivered). In accordance with GAAP, the liability is released, and revenue is recognized once certain performance obligations are met.

Deferred revenue by its very nature may not be straightforward, so it should come as no surprise that the treatment of deferred revenue in purchase price adjustments is equally complex.

It must be considered on a deal-by-deal basis, considering the enterprise valuation basis, and the specific attributes and nuances of the deferred revenue balance (or balances).

Considerations may include:

- How consistent and short-term the deferred revenue cycle is
- The extent to which the buyer will incur costs post-closing
- Whether it is increasing or decreasing over time
- Any seasonality of the deferred revenue cycle
- Whether the deferred revenue relates to monies received in advance (cash, for which there is a price adjustment) or outstanding accounts receivable (generally a component of working capital).

It is unusual for non-cash backed deferred revenue to be treated as debt-like (i.e., if the corresponding asset is accounts receivable within working capital).

To avoid potential derailment of a deal process during later stages, we recommend that deal principals identify, analyze and agree upon the treatment of deferred revenue as early as possible in the process.

When negotiating the deal, is deferred revenue typically considered to be a debt-like item or a working capital item, for the purposes of a purchase price adjustment?

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