LEVERAGING THE ACCOUNTANT'S EXPERTISE IN M&A TRANSACTIONS

By: David B. Deutsch, Esq. and David H. Freedman, Esq.

I. INTRODUCTION: THE ACCOUNTANT HELPS DRIVE THE DEAL

A. Overview. In M&A transactions, the accountant possesses the deepest insights into the target's financial history. This specialized knowledge heavily influences two critical areas: valuation and deal structuring. This outline provides actionable guidance and technical details for accountants advising either buyers or sellers.

B. The accountant shapes what the buyer pays.

1. Builds the purchase price. Because deals are frequently valued as a multiple of normalized EBITDA, accounting adjustments directly drive the final purchase price. Normalizing reported earnings—by adjusting for owner compensation, one-time expenses, and related-party transactions—shifts the base valuation and alters the ultimate transaction value.

2. Sets the working capital peg. A typical transaction includes a "working capital peg," which represents the normalized level of net working capital the seller must deliver to the buyer at closing. This target is typically calculated on a pro forma basis and attached as an exhibit to the definitive purchase agreement. The accountant's historical, month-by-month working capital analysis serves as the baseline for negotiating this amount.

3. Debt-like items affect payout. In cash-free, debt-free M&A deals, the purchase price drops dollar-for-dollar by total debt. Buyers often expand the "debt" definition to include non-traditional liabilities—like deferred revenue, unpaid bonuses, or customer deposits—directly reducing the seller's final cash proceeds.

4. Sizes synergies and integration costs. For buyers, the accountant validates projected cost savings against one-time integration expenses to prevent overpaying for unachievable operational synergies.

C. The accountant shapes how the deal is built.

1. Assists in structuring the transaction. Whether structured as an asset or equity purchase, a transaction carries heavy tax and accounting implications. The accountant is uniquely positioned to model these outcomes—along with tax elections and rollover equity frameworks—to optimize value for the client.

2. Sizes escrows, holdbacks and liability caps. The accountant identifies key risk areas during financial due diligence. These findings help the parties determine the appropriate size for general indemnity escrows, special escrows, and liability caps.

3. Keeps the deal on schedule. Preparing and delivering financial statements, due diligence responses, disclosure schedules, flow of funds and closing statements on time removes friction and secures the critical path to closing.

4. Supports lenders, including the new SBA requirements. Acquisition lenders rely heavily on the accountant's verified financial data to approve financing. This support is especially critical for SBA-backed transactions, which now require compliance with strict new guidelines (detailed in Section VI).

5. Defines earnout metrics. When a purchase price includes contingent payments, the accountant helps select measurable financial targets and draft the accounting definitions used to calculate them.

6. Contributes to the deal documents. The accountant's input belongs in the letter of intent (LOI), the definitive purchase agreement, its exhibits (such as an illustrative working capital calculation) and the disclosure schedules.

II. WHAT THE ACCOUNTANT BRINGS TO DUE DILIGENCE

A. Diligence: testing the seller's story. Financial due diligence tests whether the financial story told by the seller holds up. The key workstreams are summarized below.

1. Quality of earnings (QoE) analysis. A QoE report evaluates the accuracy, recurring nature, and sustainability of reported earnings.

   a. It isolates normalization adjustments (such as non-recurring, non-operating and owner-related items) and verifies revenue recognition, cutoff and accrual accounting practices.

   b. A sell-side QoE report, prepared before marketing the business, lets the seller control the financial narrative and eliminate late-stage transaction surprises.

2. EBITDA validation. Because the purchase price is typically a multiple of EBITDA, every individual adjustment has a multiplied impact on enterprise value. Consequently, each proposed add-back must be thoroughly documented and defensible.

3. Proof of cash and balance sheet review. The accountant reconciles reported revenues and expenses directly to bank statements (proof of cash) and tests the integrity of receivables, inventory, accruals, and reserves—all of which establish the baseline for the working capital peg.

4. Debt-like and off-balance-sheet items. Diligence uncovers value-reducing obligations that may not appear as traditional debt on the balance sheet, including unfunded liabilities, deferred maintenance capital expenditures, guarantees, unpaid taxes, and contingent exposures.

5. Employee benefit obligations. Accrued vacation and paid time off, unpaid bonuses, deferred compensation, severance and change-in-control payments, and any unfunded benefit plans should be identified and quantified.

6. Stress-testing financial forecasts. Management's projections are evaluated against historical trends and key operating assumptions. This analysis is critical when an earnout structure or lender debt-service coverage ratio depends on future results.

7. Prepare UIA Form 1027. For Michigan transactions, the accountant assists with Unemployment Insurance Agency (UIA) Form 1027 to determine whether the buyer will inherit the seller's unemployment tax experience rating and outstanding liabilities.

III. WORKING CAPITAL AND PURCHASE PRICE ADJUSTMENTS

A. Working capital: getting the number right. The post-closing adjustment mechanism is where accounting judgment directly dictates the final cash paid at closing.

1. Purpose. The adjustment ensures the buyer receives a normalized level of working capital at closing. It prevents the seller from manipulating value prior to closing by accelerating accounts receivable collections or delaying accounts payable disbursements.

2. Peg (target working capital). The peg is typically based on an average of historical net working capital over a trailing period, adjusted for seasonality and for items excluded from the definition (usually cash, debt and income taxes). The purchase price increases or decreases to the extent closing working capital is above or below the peg, sometimes subject to a collar or deductible.

3. Post-closing true-up process. The adjustment sequence follows a standard timeline:

    a. The seller delivers an estimated closing statement shortly before closing, and the purchase price paid at closing reflects that estimate.

    b. After closing, the buyer prepares the final closing statement within a negotiated period.

    c. The seller reviews the statement and may deliver a notice of disagreement; unresolved items are typically submitted to an independent accountant for a binding determination.

4. Accounting principles hierarchy. The agreement should state which rules govern the calculation, typically in this order: (1) specific policies set out in the agreement, (2) the target's historical practices, consistently applied, and (3) GAAP. Ambiguity about which tier controls is a frequent source of disputes; attaching an illustrative working capital calculation as an exhibit is strongly recommended.

5. Closing estimates. Closing estimates must be prepared in good faith and utilize the exact methodology applied to calculate the peg. Artificially aggressive estimates are ultimately reversed during the post-closing true-up and erode trust between the transaction parties.

IV. EARNOUTS AND CONTINGENT CONSIDERATION

A. Earnouts: pay for performance, not lawsuits. An earnout structure defers a portion of the purchase price, making it payable only if the target business achieves specified post-closing financial or operational milestones.

One Towne Square, Fifth Floor, Southfield, MI 48076
p (248) 354-4030 | f (248) 354-1422 | maddinhauser.com

1. Bridges valuation gaps. Earnouts align transaction parties when they disagree on future financial performance. They allow the seller to capture maximum value if their growth projections are realized, while protecting the buyer against overpaying.

2. Selecting the performance metric. A revenue metric is easier to calculate and harder to manipulate but can reward unprofitable growth. An EBITDA or gross profit metric better reflects enterprise value but exposes the seller to post-closing buyer cost allocations, corporate overhead charges, and internal accounting choices.

3. Definitions and accounting policies. To prevent disputes, the metric must be defined with absolute precision. The definitive agreement must explicitly account for transaction expenses, corporate overhead allocations, integration costs, and the impact of subsequent bolt-on acquisitions. Attaching a sample earnout calculation as a contract exhibit is strongly recommended.

4. Structure. Key economic and legal terms must be clearly negotiated, including:

    - Measurement periods (e.g., annual vs. cumulative multi-year tiers)
    - Payment caps, performance thresholds, and floor limits
    - Payout structures ("all-or-nothing" cliffs vs. graduated linear payouts)
    - Catch-up provisions for trailing performance deficiencies
    - Acceleration triggers upon a subsequent change of control or sale of the business

5. Buyer operating covenants. Sellers often request covenants restricting how the buyer runs the business during the earnout period; buyers resist limits on their operating discretion. The agreement should state clearly what, if any, obligations the buyer has.

6. Ambiguous terms drive litigation. Earnouts are among the most frequently litigated provisions in private M&A. Clear definitions, reporting rights and a defined dispute process reduce that risk.

V. FINANCIAL REPRESENTATIONS, WARRANTIES AND COVENANTS

A. The seller's financial promises. The seller's representations about its financial condition allocate risk; if a representation proves untrue, the buyer may have an indemnification claim. Accountants should review these provisions against what the books can actually support.

1. Financial statements. The seller typically represents that its financial statements are complete and correct in all material respects and were prepared in accordance with GAAP (or a stated basis), consistently applied. Any departures should be disclosed.

2. Assets and records. Representations commonly cover the accuracy of books and records, adequacy of internal controls, collectability of receivables and the condition and salability of inventory.

3. Tax. Tax representations cover filing of returns, payment of taxes, absence of audits and similar matters. Pre-closing taxes are frequently addressed through a separate indemnity.

4. Undisclosed liabilities. This catch-all representation protects the buyer against hidden obligations. The seller guarantees that the business has no liabilities or balance-sheet exposures other than those explicitly stated on the baseline balance sheet, incurred in the ordinary course of business since the balance sheet date, or detailed in the disclosure schedules.

One Towne Square, Fifth Floor, Southfield, MI 48076
p (248) 354-4030 | f (248) 354-1422 | maddinhauser.com

5. Negative covenants. Between signing and closing, the seller agrees not to take specified actions outside the ordinary course (for example, changing accounting methods, incurring debt or making unusual distributions) without the buyer's consent. Representations that no material adverse change has occurred serve a similar protective function.

VI. NEW SBA REQUIREMENTS (SOP 50 10 8.1)

A. New SBA rules: what changes for clients. Effective October 1, 2026, the SBA's updated Standard Operating Procedure (SOP 50 10 8.1) reshapes change-of-ownership lending. Because many lower-middle-market acquisitions rely on SBA 7(a) financing, transactional advisors must align deal structures with these stricter underwriting, equity, and diligence mandates.

1. Change-of-ownership loans. Under the updated SOP, change-of-ownership transactions are strictly divided into four distinct categories: Initial Acquisition, Business Expansion, Owner Buyout, and ESOP/Cooperative. Each category carries its own independent requirements governing equity injections, debt-service coverage, and permitted post-closing seller involvement.

2. Mandatory QoE at $3M+. For Initial Acquisitions and Business Expansions, an independent QoE report is required if the "Business Purchase Price" is $3 million or greater.

- Measurement: The $3 million threshold is calculated before netting out buyer equity, seller debt, or other financing, and explicitly excludes the appraised value of any owner-occupied commercial real estate.

- Requirements: The report must be ordered by and prepared for the lender (not the borrower) by an independent professional. It must include a proof of cash reconciling bank deposits to the income statement and tax returns over the last two fiscal years and trailing 12 months.

3. 1.25x historical debt service coverage. Underwriting anchors directly to historical cash flow, requiring a minimum 1.25x debt service coverage ratio (DSCR). Because lenders must utilize the normalized earnings figures verified by the independent QoE report rather than forward-looking projections, the accuracy of historical financials and the defensibility of seller add-backs are critical to securing the necessary loan sizing.

4. Debt capped at business valuation. SBA financing is strictly capped at the appraised enterprise value determined by a lender-commissioned independent valuation. Consequently, if the negotiated purchase price exceeds this valuation ceiling, the premium cannot be financed and must be covered entirely through increased buyer cash equity or qualifying seller debt.

5. Seller-side and buyer-side impact. Both parties must anticipate heightened transactional friction: sellers should expect exhaustive, bank-ordered financial scrutiny of their operational metrics, while buyers must budget for extended closing timelines (typically 60 to 120 days) and substantial upfront third-party diligence costs.

6. Earnouts and standby notes. To qualify for underwriting, contingent consideration and seller debt face rigid structural restraints. Earnouts must comply with strict SBA timing and payout restrictions, while seller notes counted toward the equity injection must be placed on full standby—prohibiting all principal and interest payments—for the entire term of the SBA loan.

VII. POST-CLOSING WORK AND TRUE-UPS

A. The true-up and the disputes that follow.

1. Buyer side. The buyer's accountant prepares the final closing statement, applying the agreed accounting principles hierarchy and keeping a clear record of every change from the estimate.

2. Seller side. The seller's accountant reviews the closing statement, requests supporting workpapers and access to personnel, and identifies items to dispute.

3. Deadlines. Contractual deadlines for delivery, review and objection are strictly enforced; a missed deadline can mean the closing statement becomes final and binding.

4. Dispute notices. A notice of disagreement should identify each disputed item, the amount and the basis for the position. Items not raised may be waived.

5. Battlegrounds. Common disputes involve reserves and accruals, inventory valuation, revenue cutoff, changes in accounting methods, and whether items belong in working capital or in debt.

6. Prepare UIA Form 1772. Post-closing, the accountant must prepare and file Michigan Unemployment Insurance Agency (UIA) Form 1772 (Notice of Change in Status / Report of Employer Transfer). This filing reports the transfer of the business assets to ensure the UIA correctly updates and links the respective parties' unemployment tax accounts and experience ratings.

B. Running earnouts and protecting claims.

1. Tracking. Maintain earnout calculations throughout the measurement period, using the agreed definitions, and preserve the supporting records.

2. Operations. Monitor post-closing operating decisions that may affect the earnout, such as cost allocations, pricing or customer transfers, and compare them to any buyer operating covenants.

3. Dispute forum. Purchase price disputes are often decided by an independent accountant acting as an expert, while broader earnout or indemnification disputes may go to court or arbitration. The agreement determines which forum applies to which issue.

4. Indemnification claims. Claims for breach of financial representations are subject to notice requirements, survival periods, baskets and caps. The accountant's quantification of loss is often central to the claim.

VIII. WHAT TO TAKE BACK TO YOUR PRACTICE

A. Where you add the most value.

1. Engage early (pre-LOI). The accountant adds the most value before the LOI is signed, when price, peg, structure and earnout concepts are still being set.

2. Documentation. Keep workpapers, add-back support and peg calculations organized; they become critical evidence in any post-closing dispute.

3. Post-closing. Calendar every contractual deadline and coordinate closely with counsel on closing statements and dispute notices.

4. Stay engaged through the earnout. Remain involved through the earnout and survival periods rather than stepping away at closing.

5. Relationships. Partnering effectively with deal counsel and the client throughout the transaction builds lasting referral relationships.