The Neutral Accountant’s Role in the Arbitration Process: Resolving Working Capital & Earnout Disputes Without Costly Litigation

As the global value of merger and acquisition (M&A) transactions reaches unprecedented heights, costly and time-consuming disputes can arise post-transaction over a variety of issues, whether through market volatility affecting valuations, ambiguity in the purchase and sale agreement (PSA) or outright fraud.

Two commonly contested areas post transaction are working capital and earnout disputes. Since these disputes involve differences in the interpretation of accounting or financial reporting and valuation, parties may be obligated to engage a neutral accountant as part of an arbitration process instead of entering costly litigation. In the arbitration process, a neutral accountant delivers a binding decision, but follows a more streamlined procedure very different from a trier of fact in a courtroom, which may save the parties a significant amount of time and money.

Working capital represents the difference between the current assets and current liabilities in the statement of financial position (or balance sheet). In M&A transactions, generally a target working capital amount is established prior to the close of the transaction. After the close, a closing balance sheet is prepared for the acquired business and a new working capital calculation is performed. Disputes can arise between the buyer and seller based on differences between the target working capital established in the PSA and the working capital calculated from the balance sheet prepared as of the closing date for the transaction. When disputed items cannot be resolved between the buyer and seller, the PSA includes terms under which the parties can select a CPA to act in a neutral capacity to provide a final resolution.[1]

Resolving working capital disputes involves the analysis, interpretation and judgment of particular areas of generally accepted accounting principles (“GAAP”) by the CPA as a neutral accountant. The neutral accountant’s assignment also requires professional objectivity. Therefore, it is important that the neutral accountant establish a process that allows for the gathering of information useful to the neutral accountant in rendering a final decision. The processes put in place should not be biased toward either party.

Earnout provisions are typically used when the buyer and seller cannot agree on the future prospects of the business being acquired. The earnout provision within a purchase agreement requires a buyer to pay additional consideration to the seller after the Closing Date if the acquired business can meet contractually defined benchmarks (e.g., achieving a certain level of revenue). Disputes arise between the buyer and seller when the calculation of the earnout is interpreted differently by each party based on the terms outlined in the purchase agreement. Disputes over earnout amounts can also arise when either party believes that the operations of the acquired business post-closing has not been managed the way that the parties intended throughout the earnout period.

The Role of the Neutral Accountant

It is not uncommon for PSAs to contain clauses that call for an independent accounting or consulting firm to resolve differences between the parties related to working capital or earnouts when the buyer and seller cannot reach an agreement on their own, since these differences involve accounting or financial reporting issues. It is rare that the PSA provides specific guidelines as to how to administer the neutral dispute resolution process, but the neutral accountant can help the parties with setting up the process to adjudicate the dispute. Generally, the process will contain the common elements of an arbitration process as outlined below:

Preliminary Conference

At this stage, the neutral accountant conducts a preliminary conference with the parties to provide all the information necessary to execute an engagement letter. The engagement letter will define the neutral accountant's scope of work, the disputed items that need to be resolved, and specific dates by which element of the dispute resolution process will be completed.

Discovery

Discovery is the process by which the parties exchange and obtain information. The extent of discovery is often agreed to by the parties. In most neutral accounting engagements, discovery is limited to the exchange of documents and computer files and accessing the parties' employees (if permitted by the PSA). In certain circumstances, discovery may be extended to allow the parties to submit expert reports to aid in the presentation of their case. In the event there is a dispute about whether certain items or procedures are allowed under the discovery rules agreed upon by the parties, the neutral accountant can rule as to whether the items should be produced or the procedures should be allowed.

Written Statements

After the preliminary conference and discovery, the parties should have enough information to prepare written statements of their positions to submit to the neutral accountant. These written statements of position should provide the neutral accountant with a summary of the transaction and the parties' position regarding the disputed items for which the neutral accountant will render a decision. The statement of position should contain arguments, supporting documents and references to relevant accounting literature and acquisition agreement provisions. If appropriate, the parties may also provide declarations of witnesses and expert reports.

It is also useful to have the written submissions on a staggered basis, allowing each party the opportunity to challenge facts or statements presented by the other party.

Questions from the Neutral Accountant

The neutral accountant may have their own questions that have not been answered by the parties in their written submissions. These questions are provided in written form as interrogatories and are noted as a component of the dispute resolution process in the engagement letter. As an alternative (or in addition to, under certain circumstances), the neutral accountant may desire to interview parties to the dispute, which can include current and former employees of the acquired company.

Hearings

If the parties have agreed to a hearing, such questions can be reserved and asked by the neutral accountant in real time, although it is often more efficient and cost effective for the parties to provide submissions and answer neutral accountant questions in writing. The decision whether to have a hearing should be discussed in the preliminary conference and addressed in the engagement letter. If either party desires a hearing, the neutral accountant will usually honor such a request.

Decision and Award

The final award and decision can take several forms. Often, the parties require that the neutral accountant provide a reasoned report setting forth the amount(s) to be awarded for each issue in dispute and the rationale for the award. There should be a clear understanding in advance among the interested parties about what will be provided by the neutral accountant, as there are cost and other considerations that will go into the decision of what kind of report should be requested from the arbitrator. Often, most parties desire a detailed report that explains the reasoning for the neutral accountant's decision. The neutral accountant should require that all fees and expenses incurred for the engagement be paid prior to the issuance of the neutral accountant's report.

The Neutral Accountant's Role in Working Capital Disputes

Most PSAs contain a clause requiring that the closing balance sheet conform to GAAP consistently applied over a relevant period prior to the sale. While GAAP is rules-based, certain areas of GAAP require judgement on the part of the financial statement preparer. The judgements made can lead to disputes between the parties as to whether the closing balance sheet was prepared in accordance with GAAP or GAAP was consistently applied. One example of a situation where a dispute may arise is when the buyer may propose an adjustment to the closing balance sheet based on an accounting method different from the accounting method that was applied by the seller. In this example, a dispute could arise if the buyer claims that the seller used an accounting method that was inconsistent with the buyer's understanding of the terms in the PSA. Another example would be when the seller prepares the financial statements used in negotiating the PSA using one methodology and subsequently switches to another methodology before the closing to a method more favorable to the seller. Lastly, GAAP requires the accountant to estimate balances for uncollectible amounts on accounts receivable and reserves on inventory.

Besides a dispute between the parties related to the accounting method used, disputes may also arise as to the proper estimate to be recorded in the financial statements when both the buyer and seller apply the same methodology. Under these circumstances, the seller will prevail if the seller is able to show that its estimate is appropriate under GAAP. This would be the case even if the buyer's estimate was also found to be appropriate under GAAP.

In addition to consistency in the accounting methods applied, there may be questions about whether subsequent events should be considered in the closing balance sheet. There are two types of subsequent events: Type 1 provides additional information about circumstances that existed at the closing balance sheet date while Type 2 provides information about circumstances that came into existence after the closing balance sheet date. In general, Type 1 subsequent events are always considered by the neutral accountant and type 2 are not.

The neutral accountant can use their own familiarity and understanding of GAAP to address issues of whether GAAP has been appropriately and consistently applied and whether subsequent events can be considered in the preparation of the closing balance sheet. The neutral accountant can also use their own familiarity with GAAP to determine the appropriate estimates and amounts to include in the financial statements.

Working Capital Dispute Case Example

A seller's methodology for estimating uncollectible accounts receivable consisted of reserving 50 percent of accounts receivable that had been outstanding between 60 and 90 days and 100 percent of accounts receivable that had been outstanding over 90 days. The buyer's methodology was the same as the seller's methodology. However, the buyer claimed that the seller's estimate understated the uncollectible accounts receivable by $10 million.

The difference between the two amounts could not be resolved by the parties, so a neutral accountant was retained to resolve the dispute per the terms of PSA. Further investigation into the matter by the neutral accountant revealed that the buyer's collection practices around accounts receivable was less aggressive than the sellers. Unlike the seller, the buyer rarely used collection agencies and did not pursue litigation as a method to collect outstanding receivables. Therefore, the neutral accountant found that the seller's estimate of uncollectible accounts was reasonable under GAAP.

The Neutral Accountant's Role in Earnout Disputes

Earnout disputes can arise when the parties' intentions are not effectively reflected in the PSA's earnout provisions or when those provisions result in different interpretations. An example of a common issue that arises in earnout disputes is what should be considered revenue for purposes of calculating the earnout threshold. For example, the seller may complain that the buyer deliberately tried to avoid paying earnout consideration because post-closing the buyer may have chosen to discontinue certain products or customer relationships. Conversely, the buyer may argue that any revenue from new products that were not contemplated by the parties at the time the PSA was negotiated should be excluded from any earnout calculation. Another area of dispute, similar to working capital disputes, is whether GAAP was consistently applied in the financial statements that were used for the earnout calculation.

One of the biggest issues between the parties regarding the earnout calculation is whether the buyer decided to run the business in a materially different way than the seller post-close, particularly if it appears the buyer changed the way the business was run to avoid paying any earnout consideration.

Sometimes, restrictions around how the business can be operated during the earnout period are included within the PSA.

The neutral accountant can rely on their own experience with reviewing and understanding earnout considerations in PSAs as well as their GAAP expertise to resolve the dispute between the parties.

Earnout Dispute Case Example

ABC Company acquired a business segment that provides equipment to manufacture widgets from XYZ Company. As part of the acquisition, XYZ Company had the opportunity to receive additional consideration through an earnout clause in the PSA. The amount of the additional consideration was dependent on the amount of sales achieved by the business segment during the 12 months following the closing date.

The business segment had five major customers that made up a significant portion of the revenue. The revenue recognition policy of XYZ Company is to recognize equipment revenue once the equipment has been both delivered and installed. Generally, it takes 30 days to deliver and install the equipment after being ordered.

ABC Company provided revenue data to XYZ Company for the 12 months following the closing date that showed XYZ Company was not entitled to any additional consideration. Upon further investigation, XYZ Company found out that several equipment orders to three of the major customers took 60 days to install, which pushed the revenue recognition for this equipment beyond the 12 months following the acquisition. XYZ Company believed that if past practices had been followed, this revenue would have been included within the 12-month period following close and would have resulted in XYZ Company receiving additional consideration under the earnout clause in the PSA. ABC Company argued that the 60-day period for these equipment sales were the result of either supplier shortages that were unforeseen or customer delays regarding when they wanted the equipment to be delivered and installed.

The parties decided to retain a neutral accountant to handle the dispute. Based on the production of documents and the statements provided by the parties, the neutral accountant found that some of the sales to the major customers could have been delivered prior to the end of the 12-month period but not to the level that would have allowed XYZ Company to be entitled to additional consideration under the PSA.

Summary

Neutral accountants can generally be used to resolve working capital and earnout disputes between the buyer and seller because, in most cases, the dispute involves interpretations around accounting issues, not legal issues. Using their knowledge of GAAP and familiarity with the financial language used in PSAs, the neutral accountant can help parties resolve the dispute. The neutral accountant can assist the parties in determining the process to be used in resolving the dispute and can provide a ruling on any issues around discovery and the format of how the parties will communicate with the neutral accountant (i.e., position papers or expert reports). Utilizing the neutral accountant can result in a more efficient and less costly resolution of the issues in the dispute versus enduring a lengthy and expensive litigation process.

[1]The neutral accountant can also be referred to as the arbitrator, reviewing accountant, independent accountant or expert.

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