

Understanding Financial and Tax Considerations in Technology M&A Transactions

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Managing the complex landscape of mergers and acquisitions (M&A) in the technology sector demands a deep understanding of regulatory frameworks and financial complexities unlike those found in other industries. As tech companies increasingly become targets for consolidation and expansion, thorough due diligence is paramount for buyers and sellers.

What sets the tech industry apart is its abundance of regulatory issues compared to other industries, necessitating more extensive advisory analysis to understand the related rules and regulations. As a result, there is a heightened scrutiny of the regulatory and economic landscape and a corresponding increase in compliance procedures within the technology industry.

Understanding and addressing these concerns can significantly impact the efficiency and success of the transaction process while also mitigating potential risks. Eight crucial financial and tax considerations tech companies should carefully evaluate before proceeding with an M&A deal:

1. **Revenue Recognition:** Startups and unaudited companies often prioritize

cash flow and growth over Generally Accepted Accounting Principles (GAAP) basis revenue reporting. The current accounting standard focuses on customer contracts, addressing challenges for tech companies such as reporting of implementation fees, multi-year contracts, multiple revenue streams, and discounted pricing.

2. **Deferred Revenue:** Many high growth tech companies use basic or entry level accounting software which leads to limited deferred revenue tracking. Manual tracking in spreadsheets introduces human error and attracts scrutiny during due diligence. Deferred revenue can impact net working capital (NWC) calculations, posing complexities associated with accounts receivable and ultimately revenue recognition.
3. **Commissions:** While companies often expense employee commissions when paid, GAAP reporting is more intricate. Commissions are considered customer acquisition costs and should be capitalized on the balance sheet and amortized unless a practical expedient applies for upfront expensing.
4. **Capitalized Software Development:** While GAAP requires the capitalization and amortization of certain software development costs, this is generally not an area of accounting focused on by startups prior to their first audit or due diligence process due to resource constraints. Depending on the type of software developed by the company, it may be subject to accounting rules under either ASC 350-40 or ASC 985-20 (internal-use software vs software held for sale) which dictate different rules around when and which types of development costs to capitalize. Sellers are at risk of following the incorrect set of rules as it applies to their developed software, leading to the potential misstatement of capitalized development costs and related amortization expenses.
5. **Accrued Liabilities and Cutoff:** M&A due diligence often examines year-to-date and trailing twelve-month periods. Without a monthly accrual process, there's a risk of overstating or understating expenses in each period, complicating the due diligence analytical process and determination of NWC targets for the purchase agreement.
6. **Sales Tax:** Sales tax and other state and local complexities arise due to varying laws and filing requirements across state and local jurisdictions. This is especially true as it relates to the evolving use and definition of

software and information services which can vary state by state. A pro-active analysis of sales tax compliance should be performed as it relates to preparing for a M&A transaction and more importantly as it relates to increased and continuing tax liability exposure to each state.

7. **Financial Reporting Function:** Financial due diligence evaluates a target's reporting function and capability. It often includes reviewing the monthly close process, understanding the depth of the accounting department, and understanding the ERP and related systems, and the general ledgers and subledgers that may exist. It also includes obtaining process narratives, performing walkthroughs to understand if the designs of critical financial controls are effective, and providing recommendations on ways to improve.
8. **Customer Base:** Beyond annual recurring revenue (ARR) and monthly recurring revenue (MRR), strong customer retention is vital for business-to-business or direct-to-consumer companies. Additional diligence should be extended to customer cohorts and customer concentrations to best reflect ongoing relationships with key customers.

Before engaging in an M&A transaction, a comprehensive understanding of financial and accounting considerations is crucial. It is important to consider the key aspects to ensure a smooth transaction process and minimize post-transaction risks.

For more information or to discuss how to best prepare your tech company for a future deal, please contact [Chris Noble](#), [Adam Pizzo](#), or your Anchin Relationship Partner.