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Their Financial Challenges

Beware of the Working Capital Adjustment in M&A Transactions

When negotiating the purchase price of a company, the buyer has certain expectations of what they are buying. Ideally the acquired company will be able to meet its short-term cash operating requirements within the framework of the assets and liabilities being acquired. To ensure that the buyer doesn't find itself in a position of investing more cash into the company after the transaction closes because of a shortfall in available working capital, M&A transactions usually include a minimum required working capital as of the transaction close date. Since it is difficult to accurately calculate working capital on the exact close date the buyer and seller agree to reconcile the amount a few months later. The agreement provides for a retroactive purchase price adjustment to compensate or penalize the seller if there is more or less working capital than agreed. At the date of the transaction close, there usually is a designated amount of the purchase price placed into an escrow account for future resolution of this matter as well as for other potential deal issues.

The concept of establishing the minimum required working capital seems like a straightforward concept but is susceptible to miscalculations and misinterpretations if not analyzed and documented properly. I have seen millions of dollars in purchase price consideration disappear solely from disputes over the appropriate calculation of the adjustment. The following are some business and accounting issues you should consider when developing and negotiating the minimum required working capital amount.

READ EVERY WORD. Be active in the negotiation process. Read every version of the agreement with specific attention to any changes to the working capital requirement terms. The finance team needs to work closely with the legal team. The lawyers are not accounting experts, nor should it be assumed that they understand the details behind specific line items on the company's balance sheet. Small changes in wording can have a large impact and change the intended financial outcome. It is easy to find reasons not to read and understand the entire agreement. Lawyers craft these agreements primarily with legal ramifications in mind. The attention span of the reader is not usually one of the criteria considered. But a thorough understanding of the entire agreement is critical to ensure that concepts considered in the formulation of the working capital requirements are correct and are consistent with other sections of the agreement. For example, the agreement may provide indemnification for certain legal issues separate from their impact on working capital. You will want to make sure that these legal issues are excluded from the reference balance sheet and the ultimate formula for the calculation of working capital so as not to have a duplicative impact on transaction consideration.

SPECIFICITY IS YOUR FRIEND. Eliminate where possible the need for judgment. Clearly specify which accounts should and which accounts shouldn't be included in the calculation. Include definitions for each account. Specify if account values are derived before or after consideration for the accounting treatment of the transaction. Purchase accounting may result in surprises to the seller. Some accounts such as prepaid marketing expenses may have had value for the seller, but become worthless to the buyer as of the date of the transaction and could be interpreted as such if not clear in the definition of accounts. Include a reference balance sheet and related reference working capital calculation. Including a recent balance sheet which is linked to a working capital calculation in conformity with the terms outlined in the agreement can be used as a guide for the final reconciling calculation and is also an important reference if there are disputes regarding the calculation. Often times, these calculation formulas exclude cash and debt accounts. Make it clear if any of your current liability accounts are specifically considered debt and excluded from the calculation.

BE DETAILED. Accounting is often as much of an art as it is a science. Valuation of inventory and other current assets is not always formulaic and can be argued with large ranges of valuation outcomes. Conceptual liabilities for potential legal exposures, product liability warranties, bad debt reserves, and other current asset offsets or liabilities are not easy to pinpoint. They are subject to the opinions of the individuals making the estimates. While the seller may believe that the company has conservatively recorded exposure for these and other liabilities, that does not prohibit the buyer from taking an even more conservative, or in their minds realistic, valuation approach and severely impacting the available working capital. Clear documentation and agreement between the parties during negotiations can reduce the number of potential disputes in the calculation.

GAAP IS NOT YOUR FRIEND. Don't rely on GAAP (Generally Accepted Accounting Principles) as a shortcut to defining how current assets and liabilities are to be reflected in the calculation. GAAP provides the standard framework of guidelines for financial accounting and contains specific as well as conceptual guidance. While the guidance may help resolve a dispute if it is conceptual it probably will not ultimately provide the clear guidance to a specific issue in your calculation. Reliance on GAAP interpretations ultimately provides the buyer with flexibility as they are usually in the seat of making the interpretations.

ACCOUNT FOR THE CALENDAR. Understand the timing of the transaction. Certain balance sheet accounts are impacted by seasonality in the business. Don't assume a recent balance sheet will be reflective of the financial position of the company as of a future transaction close date. Also consider the impact of a mid-month transaction close. Many balance sheet accounts have a different profile at different times of the month. Consider the timing of regular invoicing, payroll processing, customer payment trends and other intra-month activity on the calculation of working capital. Also consider that some non-current assets or liabilities as of the reference balance sheet date could become current as of the close date.

USE EXPERTS. Use an expert (CPA firm or other financial consultant) to assist in the preparation of the reference balance sheet and working capital requirements and negotiate for the engagement of that expert to participate in the preparation of the closing working capital calculation. The sellers needs to protect their interests and ensure that the ultimate calculation doesn't end up solely in the hands of the buyer subject to their calculations, discretion and interpretation of issues. Often, when it is time to do the calculation months after the close of the transaction, the company management who participated in the crafting the documents and negotiation of the terms may be gone from the company and buyer personnel are solely in charge of all of the financial aspects of the company. The contracting of seller designated experts can help alleviate the impartiality of the buyer and their experts.

PAD THE CUSHION. Ultimately, even with good intentions, diligent work, and competent oversight, there will be some aspect of the calculation that didn't move in the anticipated direction for both the buyer and the seller. To provide for this exposure, you should take conservative positions in your reference balance sheet that will be used to negotiate the ultimate working capital requirement. Also, negotiate a cushion in the agreement. In order to have a successful transaction, in addition to following the guidance above, both parties should benefit from a cushion between the expected working capital available at close and the balance required in the agreement. It doesn't help either party move forward if they are stuck arguing terms of a nearly complete transaction months after the fact.

As I mentioned earlier, I have seen millions of dollars in purchase price consideration disappear solely from the lack of following some of the above criteria. Don't let that happen in your transaction.

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