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Article *in* The Journal of Private Equity · May 2013

DOI: 10.3905/jpe.2013.16.3.033

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Working Capital Adjustments: *One Size Doesn't Fit All*

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Merger and acquisition (M&A) lawyers and accountants spend an inordinate amount of time negotiating, interpreting, and sometimes litigating working capital provisions. Is all this fuss really necessary? The answer is that it depends. In order to fully answer this question, it is necessary to first understand how the working capital adjustment provisions typically found in merger and acquisition agreements actually work. It is equally important to look behind the provisions and be clear on what they are intended to achieve. Only then can you get a clear picture as to whether a long, drawn-out negotiation over working capital is worth the effort.

WHY WORKING CAPITAL MATTERS

Most purchase and sale agreements contain one or more post-closing purchase price adjustment provisions, the most common of which is a working capital adjustment. Buyers want to ensure that they buy a business on a basis in which it has sufficient working capital to meet the immediate cash needs of the business, including obligations to employees and trade creditors. Buyers typically base their purchase price for a business on a "going concern" basis and do not want to contribute additional capital immediately after closing. Conversely, sellers want to retain the earnings and profits of the business generated for periods prior to closing.

The understandable desire of buyers and sellers to preserve or protect the value they bargained for is straightforward in concept but unfortunately often results in protracted negotiations and complicated contractual provisions. The problem is that the purchase price is typically based on historical and projected earnings and a normalized balance sheet. Most transactions contemplate a certain amount of time between signing, and closing and financial statements are rarely available for the exact moment when a purchase agreement is signed. Accordingly, the parties need to make certain assumptions on which the purchase price is based. These assumptions become a baseline, and the purchase agreement usually contains a true-up mechanism to ensure that the seller's financial situation at closing has not changed one way or another between signing and closing. In the absence of such a provision, any increase in working capital after a deal is signed would result in a windfall to buyer and any decrease would effectively increase the purchase price.

IT'S ALL IN THE DEFINITIONS

Working capital is a measure of the net short-term assets of a business. Under generally accepted accounting principles (GAAP), working capital is defined as current assets minus current liabilities. In the mergers and acquisitions context it is important not to

accept this simplistic definition without further analysis. To begin with, GAAP itself provides a set of principles that embody a fair amount of subjectivity and allow companies to develop and apply their own methodologies. At a minimum, it is important in connection with the preparation of financial statements used to calculate a working capital adjustment to state that they shall be prepared in accordance with GAAP "as used in the preparation of the company's financial statements consistently applied." In some contexts, even more detailed description of the target's financial statement methodology is required.

It is also important to be precise about the elements used in the calculation of working capital. In my judgment, the problem is that many M&A lawyers wade into an area that is properly the domain of accountants. We are all sufficiently familiar with the terms involved in working capital adjustments that it is tempting to try to craft language that gets the deal done without bringing in the company's outside accountants. This is a fool's errand. At the end of the day, the working capital adjustment is a key component of value and needs to be calculated by the company's internal and external accountants. It is better to get their input in the negotiation of the contractual provisions rather than risk getting second-guessed if the calculation produces an unexpected result for the client.

Cash is a component of current assets under GAAP. Increasingly, however, deals are done on a "cash-free, debt-free basis." If the purchase agreement separately provides for the transaction to be done on a "cash-free, debt-free basis," the working capital adjustment needs to clearly carve out cash from current assets. It is equally important to define "cash" on a consistent basis to avoid any disconnect. Unlike most other working capital items such as inventory, accounts receivable, and accounts payable, cash isn't necessarily tied to a company's financial statements. The safest route is to define cash as determined in accordance with GAAP. This will clarify certain important items, such as the treatment of issued and uncashed checks. Under GAAP, cash is reduced in the company's financial statements when a check is issued. Similarly, cash is increased when a check is received.

Inventory and accounts receivable are generally the largest components included in the working capital calculation. Each has its own set of issues. With regard to inventory, the parties need to decide whether or not they will conduct a physical inventory. A physical inventory can be quite disruptive for a seller, particularly when real efforts are being made to maintain the confidentiality of the transaction. Alternatively, inventory can be calculated based on the seller's perpetual system, but the buyer will want to verify the accuracy of the system. There are also issues surrounding the valuation of seller's inventory. Is it being calculated on a first in, first out (FIFO) or last in, first out (LIFO) basis? How are obsolete and slow-moving inventory items being handled? Again, it is important to carefully define the methodology for valuing inventory, both historically and moving forward, to be sure the buyer and seller are on the same page.

Accounts receivable also pose valuation issues. Most businesses book reserves for doubtful accounts, but the manner in which they are calculated varies widely among companies. It is important at the outset to understand how the seller has historically treated its bad debt reserves. Some companies establish a general reserve that is based on a certain percentage of accounts receivable. Others establish specific reserves for troubled accounts. Some do a combination of the two. The point is that there needs to be a very specific discussion on what is acceptable in the target's bad debt reserve and how the reserve is to be treated for purposes of the working capital adjustment.

In short, the parties are well served to develop a specific list of the line items that are included in a working capital calculation. They also should be clear about the methodology to be used in calculating each line item. We increasingly see a sample working capital calculation attached as a schedule to the purchase agreement.

WORKING CAPITAL ADJUSTMENT MECHANICS

Most working capital adjustments are based on an agreed upon target of working capital. The simplest contractual provision is a "one-step" adjustment, whereby the buyer and seller agree on a working capital target, a number typically based on the normalized working capital of the business. After closing, the buyer will calculate the actual closing working capital based on the company's books and records. If the actual amount is less than the target, the seller owes the buyer the shortfall. If the actual amount exceeds the target, the buyer must pay the seller the difference.

There is also a "two-step" approach to working capital adjustments, whereby a baseline is set and the seller provides an estimate of working capital immediately prior

to closing that is trued up at closing against the baseline. This number is adjusted again after the buyer has had an opportunity to fully review the seller's books.

There are endless numbers of iterations of these basic provisions. Some parties agree to a "deductible" to avoid small working capital adjustments, while others agree to "collar" the calculation. Whether all these machinations are worth the effort is unclear, but given the complexity, it is wise to include dispute resolution procedures that are specific to working capital disputes. Typically, these type of disagreements are referred to a mutually agreed upon accounting firm for resolution. The costs of the proceedings are frequently charged disproportionately to the party whose calculation necessitated third-party involvement.

THE EUROPEAN SOLUTION: THE "LOCKED BOX" MECHANISM

The traditional sale process creates a fair amount of uncertainty in that the working capital adjustment can affect the purchase price both when the parties agree on the baseline and later when the actual amount of working capital is trued up against the target. This process also tends to be very time consuming. Buyers and sellers in Europe are increasingly turning to the "locked box" mechanism to address these problems.

The locked box mechanism attempts to lock in the purchase price by including working capital at a much earlier stage in the process. After the buyer completes its financial due diligence, the purchase price is fixed based on a recent historical balance sheet. From that point, there can be unexpected working capital leakage, and the agreement prohibits sellers from making a distribution from the business other than in expressly agreed upon circumstances. Sellers are typically compensated for any projected profits during the interim period through an increase in the purchase price or an interest rate mechanism.

The locked box mechanism has a number of advantages. It cuts down significantly the time spent on negotiating the working capital provisions of the purchase agreement. It also limits the post-closing time spent on accounting matters, thus leaving the buyer more time to spend on more important topics such as integration, business performance, and any changes it hopes to implement in the business. It is estimated that nearly half the deals done in the United Kingdom last year incorporated the locked box mechanism. It is only now beginning to find its way into deals in the United States.

PRACTICAL TAKEAWAYS

Working capital is an important aspect of the value of a transaction. I think that from the seller's perspective it is something that should be addressed as early in the transaction as possible. The purchase price hasn't really been set until the parties set the working capital baseline. Sellers should recognize that once they execute a letter of intent granting exclusivity to a buyer, they have lost a lot of leverage. No seller wants to have its sales process tainted by a broken deal. Some buyers take advantage of this vulnerability by effectively reducing the purchase price in the guise of a working capital adjustment. What would normally be viewed as the historical financial attributes of a business take on a life of their own in negotiations and become the basis for reworking the target's normalized working capital. Sellers beware.

There is no substitute for accountants. Get them involved from the outset, and you will save yourself a lot of aggravation. These are accounting calculations, albeit covered in legal verbiage. Attach examples to cut down on the possibility of misunderstandings.

It is also important to be precise about the closing mechanics. Who owns the closing day's profits? It matters. Similarly, avoid provisions that encourage either side to "time" the closing based on collections, payroll, and so on. It is better to sort all of these things out up front.

Practitioners should also be sure that the working capital provisions of the purchase agreement mesh with the remainder of the agreement. For example, income taxes are frequently addressed on a standalone basis. Similarly, the indemnification provisions often allocate specific liabilities to the seller. Care needs be taken that the working capital adjustment language does not conflict with these provisions.

Finally, it is worth considering the locked box approach. It may cut down on legal fees and simplify what has become a cumbersome part of M&A deals.

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