

It's worth being picky

Complex but important, working capital adjustments can trip up even the most amicable deal. Here are some tips

Most private acquisitions start with at least one happy event – seller and purchaser agree on a price. That event quickly leads to a new negotiation, as they realise that the balance sheet of the business is going to change between signing and closing. Income will be earned (or lost), payables and receivables will go up or down, and capital expenditures will be made. From a financial perspective, the target business will not be the same as it was on the date the business deal was made. With that in mind, a purchaser wants to make sure that it receives a business whose working capital is consistent with ordinary operations. A seller, on the other hand, wants to ensure that it retains any excess working capital. So they make a new deal. Such is the nature of the working capital adjustment.

Working-capital provisions are not simple to draft, and they are the most frequent source of post-closing disputes. Problems arise because specialists from two different fields, law and accounting, must cooperate closely to make the calculation work. Problems also occur because the provisions vary depending upon the nature of the business. Finally, problems arise because of the precision required to measure working capital changes. They differ from the abstract concepts that other acquisitions deal in, such as a material

adverse change or change in customer relations. Thus, the incentive and opportunity for mischief is great.

As the draftsman of the acquisition agreement for the transaction, it is imperative that the lawyer coordinates early and often with the client and its accountant regarding the working capital adjustment. One of the lawyer's responsibilities is to have the accountant review and comment on each draft of the purchase and sale agreement. Implementing accounting principles in legal documents is not always an easy task, and substantive issues can be lost in the translation. The lawyer should also review the business and accounting due diligence memoranda that are prepared in connection with the transaction. These memoranda will provide the basic framework for calculating working capital. They will probably include a detailed working-capital analysis, which identifies the components and risk areas of the working capital. They should also feature any deviations from generally accepted accounting principles (Gaap) and special assets or liabilities that need to be taken into account in the working capital analysis (for example, deferred revenue or liability reserves).

As part of the working capital adjustment, it is necessary to calculate a target working capital. This represents the normalised level of working capital of the target business before the closing, on which the parties have agreed. It also represents the working capital at the closing date of the transaction. The target working capital is measured against the closing working capital to determine whether an excess or a shortfall has occurred. The measurement also helps determine adjustments to the purchase price.

The target amount

As part of the overall business deal, the seller and the purchaser will agree on a target working-capital amount. They calculate it by determining the target business's average working capital over a defined period, before signing an agreement or term sheet (for

example, six or 12 months). Alternatively they may use a pre-signing balance-sheet date as a reference. The calculation of target working capital will depend on the historical and projected growth of the business. The parties will also consider seasonality or other industry trends that affect working capital. For example, if the business is seasonal, a particular month could be a high or low point in the business' cycle. It may be more appropriate to use an average than to choose a particular month as the target working capital amount. Conversely, the trailing working-capital average may not be the best measure for a business that has grown over the recent financial period. The working capital needed to operate the business at closing will be greater than the historical trailing average, and the price the buyer pays is based on the projected continued growth. Again, the accountant's input is critical for determining the appropriate target amount. When the parties have reached an agreement, the drafting of the working capital adjustment can begin.

Methodology

The focal point of any working capital adjustment is the choice of accounting methodology by which the adjustment will be determined. The methodology is defined as the accounting principles, methods and practices of the target business. They must be consistent with Gaap. Failure to have a clear accounting methodology is a recipe for a working-capital dispute.

The working capital calculation should be determined in accordance with the accounting methodology used in preparing the target company's most recently audited balance sheet. As far as is possible, these principles should be applied consistently, and in accord with Gaap. Although Gaap is open to interpretation and may allow for more than one outcome, the aim is to create a precise accounting methodology. Reference to the audited balance sheet promotes precision in a number of ways. First, the notes in the audited financial statements describe the application of the target business' accounting methodology; for example, the notes will describe whether the inventory is calculated on a Lifo or Fifo basis (last-in-first-out or first-in-first-out). The working-capital calculation will follow the treatment outlined in the financial statements. In addition, the auditor of the target business has already validated this accounting methodology. As a private company, the business is not subject to legal reporting obligations, and the management has prepared monthly and quarterly unaudited

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balance sheets that are solely for internal purposes. The methodology that the management has used is unlikely to be as clear and consistent as the auditors' methodology in preparing the audited financial statements.

The audited financial balance-sheet approach also complements the audited financial statement and warranty. Together they ensure that the historical audited financial statements "present fairly in all material respects the financial position of the company" and "were prepared in accordance with Gaap, applied on a consistent basis [with earlier periods]". Seller and purchaser gain an added layer of protection if the purchase and sale agreement provides that changes in accounting methodology made after the issuance of the audited working-capital financial statements will have no effect, even if Gaap has required them. Prevention of such changes allows for a so-called apples to apples comparison, and the target working capital is calculated based on the audited balance-sheet methodology.

Line items

The next step in formulating the working capital adjustment is to define working capital. A simple Gaap definition of working capital is current assets minus current liabilities. Current assets include cash and cash equivalents, accounts receivable, inventories and, in some cases, prepaid expenses. Current liabilities include accounts payable, compensation and benefits accrued, and income taxes and other liabilities accrued, to be paid within one year of the date of the balance sheet. A good starting point for deciding which assets and liabilities to include in the working-capital calculation is a review of the target's audited historical balance sheet and the accounting due diligence report. Rather than rely on the general Gaap working capital definition, the parties should specify the line items that will feature in the definition. The working-capital definition should expressly state that the calculation will not include assets or liabilities other than the enumerated line items and special balance-sheet rules (discussed below). This approach is a good way of maintaining consistency. It ensures that neither party will introduce a class of assets or liabilities that is not expressly defined as a component of working capital.

Special rules

The parties can introduce special balance-sheet rules for the contract, to ensure that the deal is captured. The rules on which they

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agree are a further refinement of the accounting methodology, which addressed the details of the transaction. For example, regarding inventory, the accounting methodology will dictate whether the parties use Lifo or Fifo. The parties could agree on special rules to determine a precise obsolescence policy or to determine the write-downs for obsolete inventory.

Liability reserves are an area where special balance-sheet rules can be used to introduce Gaap clarity. Under Gaap, the ability to reverse reserves is open to interpretation. A party can reverse the reserves even if it has not made a cash settlement. The inclusion of a liability reserve in the computation of target working capital reduces the target working-capital amount, because liabilities decrease working capital. If a party reverses a liability reserve that it has not paid, the amount of closing working capital will increase because the liability will no longer be on the books at closing. A seller may reverse the reserves to manipulate the closing working-capital calculation in its favour. A simple but effective way of dealing with this is to prohibit the reversal of reserves, except in cases where the party can satisfy the liability for which the reserve was created by a cash payment, on or before the closing date.

Cash

Cash is a ubiquitous line item, and it often creates confusion. Buyers and sellers sometimes argue about whether to include it in the working-capital computation. Because most private transactions are conducted on a cash-free, debt-free basis, the seller is entitled to the benefit of the target business's cash. A seller may realise this benefit by using cash-in-hand to repay debt and increase its equity value; alternatively, the seller may pay a dividend before closing, if the pre-closing covenants in the agreement do not prohibit it from doing so.

Some purchasers argue that cash should be included in the working-capital computation. The exclusion of cash may encourage the seller to manage the target business in a way that technically complies with the covenant's ordinary operation (a

concept far less precise than matching target and final working capital), but which increases cash-in-hand. The seller obtains the cash to the detriment of the purchaser's interests. The buyer's protection against this lies in setting the peg for the target amount. If the peg is correct, the seller has no incentive to build up and then extract cash from the business because it will have to return the cash to the purchaser as part of the working-capital adjustment.

If the parties calculate a working-capital estimate shortly before closing, they eliminate the seller's ability to extract cash pre-closing and return it some months later when the working capital has been determined. The exclusion or inclusion of cash in the working-capital calculation should not make a difference to the parties, subject to the float issue (discussed below). The calculation relates to the manipulation of current assets and current liabilities to create cash; the theory does not apply when a non-current asset is turned into cash because by definition, the working-capital adjustment does not cover non-current assets.

Consider a situation where the working-capital computation does not include cash. If a seller increases the cash by stretching payables or accelerating the payment of accounts receivable, there will be more cash. But the increased cash will reduce the amount of working capital that the seller delivers at closing. Stretching payables increases the current liability side of the working-capital computation (more payables), and reduces the net working capital. Acceleration of the accounts receivable will result in fewer current assets and a reduced net working capital. If the working capital includes cash, by contrast, acceleration of accounts receivable will result only in a shifting to one current asset – cash – from another current asset – accounts receivable. Because the manipulation of current assets and current liabilities to create cash has no net effect on either party, including cash in the working-capital adjustment to deal with this issue brings no benefits (this assumes that the working-capital adjustment is a dollar-for-dollar adjustment, and not measured

against a band or range of working capital).

Cash, of course, can be created in a variety of other ways – by failing to make or slowing down spending on capital expenditures, by R&D, or by advertising. From the purchaser's perspective, inclusion of cash in the working-capital computation does not solve the problem. Take the example of deferring a capital expenditure. If the expenditure is made, Gaap requires that the cash account be reduced by the

consequences if the working-capital computation did not include cash: a cheque is written for an account payable immediately before closing. At closing, the seller removes all the cash from the business (the bank-statement cash balance), including cash needed to cover the cheque in question. The application of the accrual-based accounting methodology requires a reduction of the amount payable to reflect the fact that the cheque was written, even

cash in the working-capital adjustment so that it does not have to contribute additional equity or borrow additional funds (at an additional cost) to pay for that excess.

In conclusion, to accurately accomplish the zero-cash, zero-debt business deal, the working-capital calculation should include cash. Including cash avoids the float issue. It means that the seller receives all the cash at closing. When the parties decide on this approach, they should see that the target working capital does not include cash in excess of the business' normal needs.

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amount of the expenditure. Gaap also insists that a corresponding capital improvement be booked as a long-term asset (a capital asset). If the computation of working capital has included cash, the amount of cash is increased and this benefits the seller. It does not reduce working capital in the same way as the examples of the accounts payable and accounts receivable described above, because the failure to make the expenditure does not affect current assets or liabilities. The only protection available to the purchaser regarding these expense items is to obtain a separate purchase-price adjustment; it may also construct narrowly-tailored, ordinary-course covenants.

The float issue

Including cash in the calculation of both the target working capital and the closing working capital does, however, remedy the float issue. The float is the difference that exists at any time between the accrual cash balance (the cheque-book cash balance) and the bank cash balance (the bank-statement cash balance). Floats refer to the time that it takes for incoming checks (receivables) to clear and be converted into cash and for outgoing checks (accounts payable) to clear after being cashed by third parties. Consider this example: the seller writes a cheque to pay an account payable. Gaap requires a reduction in cash and a corresponding reduction of the amount payable. From a working-capital perspective, the transaction is a non-event because offsetting entries feature on the liability and asset side of the balance sheet. But consider the

though there is no cash to cover payment of the liability. It also requires a simultaneous reduction of the cash balance. But because cash is not part of the working-capital adjustment, the accounting entry for the cash reduction is made solely for book-accrual purposes. Consequently, the purchaser is paying the seller more (because the seller received the benefit of all of the target's cash), and the working-capital computation no longer mentions liability for the payable (thereby increasing closing working capital). Although it is possible to create balance-sheet rules to address the float issue, the simplest approach is to include cash as a line item in calculating the target and closing working capital.

From the seller's perspective, the working-capital adjustment should feature excess cash as a safeguard against leaving cash behind at closing. Several events can result in cash being unintentionally left behind. The operation of the seller's cash-management system and the realisation of sales made immediately before or on the closing date drive the cash balance at closing (the balance will probably not be known until after closing). Including cash as a working-capital line item ensures that the seller obtains the benefit of all cash, whether extracted as a dividend or through the working-capital adjustment. The purchaser should avoid a deal structured on a debt and cash-free basis because the seller is entitled to keep the excess cash, although that depends on whether cash is trapped in foreign subsidiaries or serving as a deposit for obligations that are in dispute. The purchaser may cap the amount of excess

Debt

Another line item that needs to be considered separately is indebtedness. Indebtedness has two components: the current portion of indebtedness, comprising all payments due within twelve months of the balance-sheet date; and the non-current (or long-term) portion, comprising indebtedness not due within the twelve month period. Because most private deals are conducted on a debt-free basis, the purchase and sale agreement should provide that the relevant party repay debts with the purchase price proceeds at closing; outstanding debt reduces the equity value. The effect on the working-capital computation is that indebtedness will be paid at closing, and the closing calculation must exclude the current debt portion. This avoids double dipping relating to the repayment of indebtedness. To maintain consistency between the target and the closing calculations, the target working-capital calculation must exclude all repaid indebtedness.

Unfortunately, the debt-free concept is not always as clear cut as it sounds. It is common for some debt to remain outstanding after closing. Low interest-rate industrial revenue bonds and capitalised leases are two examples. If the purchase and sale agreement does not provide for a separate retained indebtedness-adjustment to the purchase price, the parties normally take the main amount of retained indebtedness into account in arriving at the purchase price. The agreement should also include the accrued interest portion of the retained indebtedness as a current liability for working-capital purposes, to reflect accurately the cost of the business between signing and closing.

The long view

Special balance-sheet rules treat liabilities customarily treated as long-term, under Gaap (and thus not part of a Gaap working-capital definition) as liabilities in the working-capital

calculation. Deferred revenue is a good example. Deferred revenue arises when a customer pays in advance for services or goods. If the customer needs the service or good more than one year after the date of the calculation of working capital, Gaap treats the portion of the prepayment attributable to the period after the one-year anniversary as a long-term liability. The typical working-capital definition would not pick up the portion of deferred revenue that is classified as long-term. Unless the purchaser deducted deferred revenue in setting the purchase price, or created another adjustment mechanism, the working-capital adjustment should include all such revenue, no matter how classified, as a liability. It must match the cash with the assurance that the revenue created will be performed.

Taxes

Taxes also create the need for special balance-sheet rules. One of the trends, at least in the pre-credit crunch, seller-friendly environment, is for the seller to include a current asset in the closing working-capital calculation for any tax benefits created by the repayment of debt, the cash out of options, the payment of bonuses and other payments made at the closing. The seller argues that it should have the benefit of these deductions because it is funding the payments by reducing its equity purchase price. If the target is a taxpayer and the

deductions simply reduce taxes, the issue is unclear because pre-closing taxes are generally the seller's responsibility. Problems arise if the target is not a taxpayer, or if the deductions exceed the pre-closing income. A purchaser would be reluctant to pay cash for these deductions, because the benefits that it derives from them are not known at closing; further, the purchaser cannot draw on the benefits immediately, if at all. If the target business has net operating losses that eliminate or delay the purchaser's ability to use the deductions, or if the post-closing capital structure is highly leveraged and future interest deductions will provide a tax shield, no purchaser would want the excess deductions to increase the purchase price. A purchaser could agree to provide a separate post-closing adjustment for tax benefits when they are realised. But this approach means that the seller remains interested in the buyer's affairs. The calculation is complex and vulnerable to attack. To avoid confusion, the balance-sheet rules should address whether working capital will be determined with or without consideration of the transactions outlined by the sale and purchase agreement.

Another tax area that requires special balance-sheet rules is deferred taxes. The parties will generally exclude deferred taxes from their calculations because deferred taxes are the result of the difference between tax and financial accounting, and

are not normal working-capital items. As with the tax benefits described above, deferred taxes may not be realised in the future.

After the parties have determined the line items, accounting methodology and special balance-sheet rules for calculating the target and closing working capital, they should attach a mock working-capital calculation to the purchase and sale agreement. It will be an excellent reference point if disputes arise, particularly because business people often find visual representations more accessible than prose.

Working-capital adjustments can be ambiguous. Creating a precise formulation of the working-capital adjustment is challenging and time-consuming. But it diminishes the likelihood that the parties will dispute the working-capital adjustment – and the memory of both parties will be of happy faces at deal closure.

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