Working Capital Adjustments in M&A Transactions

Navigating a Minefield

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G&R Review

M&A transactions typically include a true-up for working capital as a component of the economic consideration. Buyers want to insure that they are acquiring a business on a going-concern basis that will be stocked with sufficient working capital to meet the immediate needs of the business, including obligations to customers and trade creditors. Sellers want to be compensated for earnings and profits they generate and for assets of the business that their efforts created.

These seemingly simple and straightforward desires can lead to complicated provisions that can end up in dispute in the implementation if not carefully drafted. This article will explore the various issues in drafting working capital adjustment provisions and potential problem areas.

Part – 1 - Components of Working Capital and Valuation Principles

Under Generally Accepted Accounting Principles ("GAAP"), the concept of "working capital" is simply the sum of current assets over current liabilities. However, in the context of M&A transactions, rarely is working capital defined in such a simplistic manner. Current asset components include cash, inventory, accounts receivable, and prepaid items. Current liabilities include accounts payable and accrued expenses. We will explore each of these items below.

Cash

Many deals are priced on a cash free/debt free basis. As such cash and cash equivalents are normally not included in the calculation of working capital. Nevertheless, depending on the nature of the business, Buyers may want to ensure that they will have enough operating cash on hand as of closing. This can be accomplished either by (a) requiring Sellers to leave a certain level of petty cash in the business for which they will receive credit in the working capital adjustment, or (b) Buyer immediately funding in cash on its own at closing such that the business can continue to operate. Normally (a) is the recommended approach as it is more seamless to the operation of the business.

Inventory

Inventory and accounts receivable are generally the largest components of current assets included in the calculation of working capital and each pose unique issues in their calculation. With respect to inventory, one of the key questions is whether the parties will agree to conduct an inventory at the time of closing to determine actual inventory on hand. If inventory is determined based on a perpetual system, it may be possible to roll the inventory forward from the last physical count. Buyer will need to diligence the accuracy of Seller's perpetual system and be comfortable with roll forward procedures in order to accept this methodology.

A physical inventory can sometimes be disruptive and impractical depending on the nature of the business. From a Buyer's perspective, without a perpetual system or roll forward procedures, not taking a physical inventory at closing creates risks that may not be able to be fleshed out through due diligence or a post-closing process. In this case, Buyers would in effect be relying on the recordkeeping prowess of the Seller and may have little recourse to challenge Seller's determination. A Buyer taking an inventory on its own days or weeks after closing and then using that inventory to challenge the closing figures will lead to inevitable disputes between Buyers and Sellers over the post-closing activities, the valuation, and inventory taking methodologies.

Valuation is another key issue in determining the inventory component. Whether inventory is determined on FIFO or LIFO, lower of cost or market and what will constitute slow-moving, obsolete or damaged inventory are all issues that should be specifically dealt with in the definitive documentation. Normally valuation methodologies can be set forth on a schedule to the purchase agreement. Failing to specifically define valuation methodologies is a recipe for future disagreements.

Finally, it is important to determine whether any adjustments are necessitated as a result of the nature and history of the Seller's inventory system. Normally a LIFO system reflects a more accurate picture of earnings and profits especially in an environment with ever increasing costs. The LIFO reserve account reflects the difference between the LIFO cost and FIFO cost of a Seller's inventory since the date that LIFO was adopted by the Seller. In an inflationary environment, this is normally a contra-inventory account and therefore reduces the value of inventory. Correspondingly, this will also increase the cost of goods sold and therefore reduce earnings and profits. It is therefore important to agree upon the affect of the LIFO reserve not only in the calculation of working capital – but also vis-à-vis the valuation of the business as a whole.

Accounts Receivable

Similar to inventory, determining the valuation methodology for accounts receivable is crucial to avoiding future disputes. Normally a business will carry a reserve for doubtful accounts (which should reduce the amount of accounts receivable included in working capital); however, the methodologies for including accounts in the reserve can differ widely. Buyers need to understand historical methodologies employed by Seller for compiling its accounts receivable reserve. The principles used in determining the accounts receivable reserve in calculating net working capital should be clearly set forth in the purchase agreement.

In certain transactions, it may be feasible to agree on a formulaic approach up-front so as to avoid any post-closing or calculation disputes. Such a formula would assign a certain percentage credit to the working capital depending on the aging schedule for the receivables. For example, all receivables less than 30 days old would receive 90% credit in working capital, 30-60 day receivables would be credited 75%, 60-90 day receivables – 50% and over 90 days – no credit. While a formula such as this brings certainty in connection with the net working capital calculation, it may or may not provide the Seller with adequate credit for its receivables depending on how the formula is structured.

A more typical approach is to value the outstanding receivables less an appropriate reserve for doubtful accounts. Reserves for receivables may be specific or general. A general reserve is established to account for the typical experience of the business with respect to un-collectibles. It is important to understand the historical methodologies for establishing these reserves so that as business metrics change, the necessary changes in the reserves can be monitored. For example, if a reserve is established based on a percentage of revenue, as revenues increase, the reserve should increase as well. Specific reserves for receivables are generally established once an account is known to be in trouble. At that point, the general reserve should be adjusted for such account and a specific dollar reserve set up to track the troubled account.

In the event that a formula is not used, the provision regarding working capital should deal specifically with the effect that post-closing collections of receivables will have on the calculation of working capital, particularly collections that occur prior to the time that any post-closing adjustment is finalized. Seller will want credit for post-closing collections, especially if those receivables were included in the reserve. Depending on the length of time post-closing, Buyer may take the position that the collection was due to Buyer's efforts and, as a result, should not be credited to Seller in working capital. From a Buyer's perspective, the purchase agreement should specifically provide that collections after closing, or a certain specified date, should be omitted from the net working capital calculation. Seller's may prefer to remain silent on this issue or provide that until working capital is finalized post-closing, that it will receive credit for all collections.

Accounts Payable

While inventory and accounts receivable are generally the largest asset components of working capital, accounts payable is the largest liability component. The struggle between Buyers and Sellers with respect to accounts payable is usually over the fact that Sellers desire to clear their plates of all payables and have Buyers assume all payables on the books as of Closing. Buyers only want to assume liabilities related to the acquired business and only those liabilities for which they receive credit in the calculation of the working capital.

Determining which payables to include in the calculation of working capital becomes more difficult when a

Buyer is not acquiring all businesses of a Seller. When divisions are split off or certain lines of business are sold and others retained, payables may apply to both acquired and retained businesses or one or the other. While cumbersome, the safest route from a legal perspective is to schedule the assumed and included payables in a schedule to the purchase agreement together with an allocation methodology. While dollar amounts may change up until closing, the vendors will at least be identified and the parties will have agreed on procedures to calculate this working capital component.

Prepaid Items and Accruals

The remainder of working capital is generally comprised of a miscellaneous hodgepodge of prepaid expenses, accruals and prorations. While the dollar magnitude of these items may be less than those categories of working capital discussed above, their value can add up and their calculation and inclusion can be as hotly debated if not well defined.

Items in this category may include employee related expenses (including accrued vacation, bonuses, and benefits), utilities, and other consumables used in the business, taxes, and reserves for maintenance and improvements.

Stay tuned for Part 2 of this article – "Revenue Recognition and Dispute Resolution Issues" - in the Winter edition of the *GR* Review.

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