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Working Capital Adjustments: At the **Crossroads** of **Law** and **Accounting**

BIGSTOCK

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Working capital adjustments are often some of the most highly negotiated provisions in a private company M&A transaction agreement. The provisions are complex and involve a blend of legal and accounting concepts and standards and can have an immediate impact. It is essential that deal team members understand not only the nuts and bolts of working capital adjustments but also the nuances thereof to avoid traps for the unwary. M&A lawyers must be fluent with the constituent elements of working capital in a particular business in order to properly understand their client's business objectives and to properly document the business agreement.

Working capital is often crucial to the operation of a business and can significantly affect valuation. Buyers often bid on an acquisition on a cash free, debt free basis, assuming an amount of working capital sufficient to operate the business at closing. The devil, however, is very much in the details.

This article will explore the various issues M&A counsel will face when drafting and negotiating working capital adjustments and highlight several potential "problem areas."

What Are the Parties Trying to Achieve?

Buyers typically want to protect against the depletion of working capital after signing and ensure that an acquired business has an appropriate amount of working capital. Adding additional working capital at closing will effectively serve to increase purchase price. Buyers also do not want to discourage sellers from operating in the best interest of the business. For example, buyers do not want the "cash free" nature of a transaction to provide a perverse incentive to discontinue making budgeted capital expenditures. Sellers want to preserve cash and reap the benefits of earnings sellers generated. As a result, the vast majority of M&A transactions include purchase price adjustment for changes in working capital measured against a target.

Components of Working Capital And Calculation Methodologies

A working capital adjustment is essentially a provision that tests closing date working capital against a negotiated benchmark or target working capital. The target is set at signing and actual working capital is determined after closing. If working capital is higher or lower than the negotiated benchmark, the purchase price is typically adjusted accordingly. This sounds straightforward; however, the components of working capital and the details of the adjustment and related dispute resolution mechanics often require a thorough understanding of the business. These provisions require not only a keen legal eye but also accounting acumen. Furthermore, when disputes arise, they are often resolved by accounting experts as opposed to judges. Accordingly, deal teams would be wise to involve both legal counsel experienced in such matters and accounting advisors from the outset.

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At its core, working capital is the difference between current assets and current liabilities. This, however, is the first trap for the unwary. The financial impact of the working capital and other purchase price adjustments can be significant. The definitions and methodologies used must be precise and work with potentially overlapping provisions, such as adjustments for debt, cash and seller transaction expenses.

Target

Before the parties negotiate the components of working capital and calculation methodologies, they need to agree upon a target working capital. Setting the target based on a specific historical date or set of financial statements is not necessarily appropriate. Ideally, the specifics of the acquired business and relevant facts should be taken into consideration before agreeing to a target. Target working capital may be influenced by many things, including anticipated timing between signing and closing, expected closing date and the industry in which the acquired business operates. Other key factors to consider in establishing a target include, among others, whether the acquired business:

- experiences seasonal shifts in working capital;
- experiences erratic changes in working capital or operates in a commodity driven business where commodity valuations may be subject to unpredictable swings; and
- is experiencing significant growth or, as a result of receiving payment prior to the delivery of product or services, operates with negative working capital.

A one size fits all approach does not work. Proper financial due diligence is key to avoiding pitfalls. The relative importance of working capital to purchase price should be a guide to the level of diligence and negotiation the parties believe is necessary. Among other things, working capital due diligence can uncover trouble spots including understated reserves, lack of sufficient reserves, or missing accruals (such as warranty, medical claims, vacations and bonuses), all of which result in higher EBITDA calculations, a multiple of which is often paid as purchase price consideration.

Definition of Working Capital

One of the biggest mistakes made in defining working capital is lack of specificity. To avoid inadvertent windfalls and post closing disputes, the parties to a transaction should define working capital precisely. The definition should at a minimum specify the particular accounts (encompassing all components of each included category of current assets and current liabilities, including general ledger account references) that are included in current assets and current liabilities and should also specify such accounts that are excluded.

Careful attention should also be paid to several items that should possibly be excluded or may be dealt with in other provisions of the purchase agreement. Such items include the treatment of cash and pre-paid expenses as well as the current portion of long-term indebtedness and other debt components (particularly if there are separate purchase price adjustments with respect to such items); bonus accruals; deferred revenue and/or liabilities; the treatment of income taxes (particularly in the event there is a standalone pre-closing tax indemnity or the seller gets the benefit of income tax refunds); employee liabilities; customer deposits; related party receivables; past due receivables (and the likelihood they will be received); whether the transaction is a carve-out, a stock deal or an asset deal (in which case, excluded assets and liabilities should likely also be excluded from working capital); any need for a physical inventory; and other current assets and liabilities that may or may not be reflected in the most recent balance sheet. The parties, together with their advisors, should work together to identify the specific assets and liabilities to include and exclude and determine whether any assets or liabilities should be taken into consideration in the target or the actual working capital but not in the other.

Calculation Methodologies

Purchase agreements often provide that closing date working capital will be determined in accordance with generally accepted accounting principles (GAAP) consistently applied. Such a standard, however, may not be sufficient to ensure an "apples to apples" comparison of closing date working capital to the target and, consequently, may not always be appropriate. Various alternative standards are often used, including that closing date working capital be determined:

- in accordance with GAAP applied in a manner consistent with the methodologies and procedures used to determine the latest balance sheet of the acquired business;
- in accordance with GAAP applied in a manner consistent with the historical practices of the acquired business;
- in accordance with GAAP applied in a manner consistent with the methodologies and procedures used to determine target working capital;
- by subtracting current liabilities from current assets (each as defined by reference to a list of included and excluded general ledger accounts); and
- in accordance with the methodologies, procedures and principles set forth in an exhibit.

The agreed-upon methodology should address instances where the acquired business's accounting practices (or certain of them) are not GAAP compliant or where accounting practices are GAAP compliant with respect to financial statements as a whole but not with respect to working capital (including materiality and conservatism issues). Although GAAP is often used in some form or fashion as a benchmark, GAAP is not a fixed set of rules. GAAP allows for flexibility, alternative treatments and the use of discretion.

Complications also arise when an acquired business follows GAAP in its year-end accounting but not on an interim basis, or when such a company has never closed its books on an intra-month basis and the transaction closes mid-month. How should GAAP be applied? What does "consistent" mean in such case? Counsel should also consider disregarding the impact of the consummation of the transaction at hand, regardless of past purchase accounting practices. Furthermore, the parties should address how post-signing/pre-closing events could affect the calculation of working capital. Should reserves be subject to adjustment as a result of such events or changes (particularly if such post-signing event is not one for which the target has previously accounted)?

The parties, consequently, often will be served best by carefully and robustly delineating the methodologies and procedures to be used. In many cases, the same methodologies and procedures that were used to calculate the target working capital should be used in calculating the closing date working capital, with such procedures specified in an exhibit to the purchase agreement. Taking such an approach and providing an illustrative calculation of target working capital—as opposed to merely defining target working capital as a number—will often reduce the likelihood of post-closing disputes, or, in the event of a dispute, provide the party tasked with resolving such dispute less room for independent interpretation and analysis.

Timing implications also need to be considered. For ease of calculation, closing date working capital is often measured at 11:59 p.m. on the day immediately preceding closing or at 12:01 a.m. on the closing date. Debt and/or cash, however, may be measured at a different time (e.g., at closing). In such instance, consideration should be given to the interplay between working capital and cash (for which the seller typically gets the benefit) when, on the closing date, cash is received in respect of a current asset. Consideration may also need to be given to the treatment of outstanding checks, wires and/or ACH payments issued by the acquired business but not yet cleared or settled.

Types of Adjustments and Procedures

Working capital adjustments may be two-way (i.e., up or down; this is most common) or one-way (only up or only down) or capped, banded, subject to a basket or dollar-for-dollar (most common). Adjustments also typically take the form of a single-step or two-step process.

The purchase agreement will typically provide that the buyer will have some number of days after closing to deliver a "closing statement" setting forth its calculation of, among other things, working capital and the components thereof. This is common in both a one-step and a two-step process. In a single step process, the buyer pays the purchase price on the assumption that closing date working capital equals target working capital and then calculates closing date working capital after closing. In a two-step process, one of the parties—typically the seller—will deliver an "estimated closing statement" shortly before closing, and the amount the buyer pays at closing will be adjusted accounting for deviations from target working capital (as reflected in the estimated closing statement). The second step follows the buyer's delivery of the closing statement. In such case, the buyer calculates the closing date working capital but compares such calculation against what was paid at closing and a true-up payment is then made by the buyer or seller, as applicable. Two-step adjustments are prevalent. They reduce the likelihood of large true-up payments, particularly in scenarios where a significant amount of time passes between signing and closing. Such a mechanism may, however, open the door for gamesmanship on the part of seller. In light of the foregoing, M&A counsel needs to consider the inclusion or absence of review and comment rights, interest payments, timing and escrows.

Review Periods

Appropriate review periods also need to be negotiated. Often the failure to timely deliver a closing statement will result in deemed acceptance of the seller's position and the failure to timely object will result in the deemed acceptance of the buyer's position. Accordingly, the parties need to consider such timing implications in negotiating appropriate review periods and ensure appropriate access to records. In addition, the purchase agreement should specify the requirements for a properly delivered closing statement and objection notice. The purchase agreement should also address whether undisputed amounts should be released from escrow or otherwise paid over prior to the final resolution of working capital.

Dispute Resolution

The purchase agreement should provide detailed procedures for addressing purchase price adjustment disputes between buyers and sellers. Typically, there is a period of time (e.g., 30 days) allotted for the parties to negotiate in good faith. After such period has expired, it is common for the dispute to be settled by a neutral accounting firm. The neutral can be named in the purchase agreement or can be selected pursuant to an agreed procedure. In either case, such neutral will typically be independent and not the accounting firm used by buyer or seller in the ordinary course. The parties should also determine whether the neutral should function as an independent expert and not as an arbitrator. If deemed an arbitrator, M&A counsel needs to determine whether there are unintended consequences regarding procedure and scope of review, including the implication that the neutral is to make decisions with respect to legal issues, such as liability.

The neutral should be required to make its determination solely based on the accounting methodologies and definitions specifically set forth in the purchase agreement and should not make any determinations with respect to matters not in dispute, including any independent evaluation of the appropriateness of target working capital. Furthermore, the parties should decide on the scope of permissible review and objection. The purchase agreement or engagement letter should also address whether the neutral will be entitled to review the parties' work papers or request additional information. Whether the neutral must resolve disputed items within the range asserted by the parties or whether some other procedure, such as baseball style arbitration, must be used (which, although less common, arguably disincentivizes overly aggressive positions) should also be specified.

Exclusivity of Remedy

Given the financial complexity involved, deal parties often prefer that all purchase price adjustment disputes, including whether the proper working capital calculation methodology was used, be resolved solely by the neutral and not in a court proceeding. Accordingly, such intent should be stated in the purchase agreement with precision and M&A counsel should carefully consider whether any other provisions, including exclusive remedy components of indemnification provisions, may allow a judge or arbitrator to decide such dispute.

Once the working capital adjustment, if any, is finally determined, the relevant amount will need to be paid to the applicable party. The purchase agreement will need to address the timing of such payment, the source of such payment and the rate of interest payable (if any). A portion of the purchase price is often placed into escrow to serve as a source of recovery for purchase price adjustments. Sometimes only one escrow is provided and payments therefrom serve to reduce proceeds available to satisfy indemnification claims. In other cases, there may be a separate adjustment escrow. Other possibilities include holdbacks, set-off rights (particularly if there is an earn-out) or simply an obligation to pay. Counsel should consider whether or not such arrangements constitute a cap on recovery and whether the mechanics provide an incentive to manipulate working capital estimates.