

VIEWPOINT

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THE BUGABOOS OF WORKING CAPITAL ADJUSTMENTS

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The definition of working capital—current assets minus current liabilities—seems straightforward enough. How could such a simple accounting calculation cause controversy in the sale of a business?

Quite easily—and quite often—as it turns out. When the amount of working capital estimated at the time a deal is struck differs from the actual level of working capital available at the closing, an adjustment is made that either drives the purchase price up or down. Sometimes the variance is big enough to delay or endanger the deal, and sometimes the mechanics of measuring working capital become controversial long after issues of similar magnitude have been resolved, causing jitters on both sides.

The good news is that most problems regarding working capital adjustments can be resolved, provided the pertinent issues are brought to the surface before expectations about final outcomes become solidified.

SOURCES OF PROBLEMS

Disputes about working capital arise from a number of sources:

- **The definition of working capital.** Basically, working capital is the net amount of capital required for day-to-day business operations. It is not the capital invested in long-term assets, like a plant and equipment; it is the capital involved in various short-term items, like cash, inventories and accounts receivable.

Buyers and sellers often disagree on exactly what goes on the current assets and current liabilities sides of the ledger. For example, let's say the accounts receivable includes a large payment from one of the company's biggest clients. That payment is overdue, causing the buyer to believe it might not be paid. The seller, however, thinks the payment will be made based on past experience with the customer. If this payment is not included in the accounts receivable calculation, the working capital is going to take a major hit, a hit that comes straight out of the seller's pocket.

"The solution in this case is to set aside an escrow for late payment," says Russell Leblang, a partner at Landay & Leblang, a boutique law firm in Boston that does domestic and international corporate transactions. "If the customer eventually paid the bill, the amount would be counted back into working capital."

WHY THIS MATTERS:

- Working capital adjustments often cause conflict between buyers and sellers.
- Addressing this issue sooner rather than later can help avoid delays and/or nasty surprises at the closing.

Definition problems also can arise when a company has current assets that can't be turned into cash quickly or cash that is restricted and shouldn't be included in the working capital. According to Mark Tarallo, a partner in the Boston office of Holland & Knight, one of the nation's largest law firms, "Cash that is restricted in some way shouldn't be included in working capital."

Deferred revenues can also present a challenge when buyers and sellers are defining working capital. For companies that accept advance payments for goods or services to be delivered over a period of time, those funds are booked as deferred revenue, which is treated as a liability.

Of course, current liabilities drive down the amount of working capital, thereby reducing the purchase price. But in businesses with high margins, the cost of providing the product or service may well be significantly less than the deferred revenues. In such cases, sellers will argue that not all the deferred revenues should be included on the liability side of the ledger.

Finally, defining working capital is especially challenging in the case of a divestiture. A business unit that is being divested often doesn't maintain a complete and independent set of books; carving out the unit's working capital from that of the corporate parent can be tricky.

- **Timing of the calculation.** During the negotiations of the deal, the two parties agree on a targeted level of working capital based on a current balance sheet. In essence, they're looking at a snapshot in time of the company when they make this agreement. They also agree that the purchase price will be adjusted up or down based on the working capital shown on the balance sheet at the time of closing.

But what if the company being sold is involved in a seasonal business? In such cases, the balance sheet at the time the deal is struck may look significantly different than the balance sheet at the closing, causing surprises and unhappiness for one side or the other of the transaction.

- **Who will do the calculation.** "Each party wants to prepare the balance sheet that's used at closing because there is some

HERE ARE TWO REAL-LIFE SCENARIOS THAT ILLUSTRATE THE KINDS OF DISAGREEMENTS THAT CAN ARISE ABOUT WORKING CAPITAL ADJUSTMENTS:

A seller provided an estimated working capital calculation at closing that didn't reflect a reserve for a potential state sales tax liability. Based on the firm's history, the seller believed no such liability existed. The buyer's auditors, however, took a more conservative approach and concluded that a reserve for sales tax should be added to the liability side of the ledger, causing a material adjustment to the net asset value. An amount equal to the potential sales tax liability was deducted from the deal escrow – which the buyer was entitled to retain even though the liability might never have materialized.

A seller agreed, in a letter of intent, to provide "adequate working capital" to the buyer at closing. During the due diligence phase, the buyer learned that the seller consistently operated with working capital of negative \$1 million because customer prepayments yielded a large deferred revenue balance. The buyer insisted that the seller "make the deal whole" by providing positive working capital, which translated into a \$1 million reduction in the purchase price

advantage in putting that together," says Leblang. "And then there is a dispute method included in the agreement, no matter who prepares the final calculation of working capital. Most of the time, whoever prepares the final balance sheet sends it to the other party, who has a certain amount of time to lodge a complaint. The parties try to resolve the issue and if it can't be resolved, it goes to arbitration or a CPA firm that isn't aligned with either side is hired to do the calculation. Buyers usually win the battle over who will do the working capital calculation because they have the money and they say, 'We're taking over the company today and we're going to prepare the balance sheet.'"

AVOIDING SURPRISES

Issues with working capital adjustments often can be avoided if the matter is given adequate attention early in the negotiation process. "Working capital sometimes comes up late in the negotiation and people see it almost as a throw-away, but it can be a significant number," says Leblang. "So it is wise to think about it up front and figure out whether it's going to be an issue."

"A careful buyer should not gloss over this issue," notes Mark Tarallo. "The buyer should pay enough attention to it to make sure that it is getting adequate working capital to fund the operation of the business without having to pump money into it immediately after an acquisition."

Not tackling the issue of working capital adjustments at an early stage of negotiation creates the possibility of a free-for-all if a mismatch of expectations occurs down the road. Of course, often both sides are so focused on getting a letter of intent signed that they treat working capital as a minor issue and do not think it through up front. But as the potential problems with working capital adjustments show, this can be a dangerous attitude.

David Hoffer is a partner at Mirus Capital Advisors, Inc., a boutique investment bank that specializes in advising middle-market companies in strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and NASD/SIPC Member. For more information, visit www.merger.com.

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