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Working Capital Adjustments

Working capital and other post-closing purchase price adjustments (which are in addition to any debt or net-debt adjustments to ensure that the buyer is purchasing the target on a "cash and debt-free basis") are found in a significant majority of all private transactions. They can also account for a significant portion of post-closing disputes in M&A transactions. One recent study found that more than a quarter of post-closing purchase price adjustments are disputed. Given the prevalence of these provisions and the potential for a dispute, material value often hinges on this one mechanism alone. In this article, the first of a two-part series, we examine these provisions and some of the issues faced when crafting them.

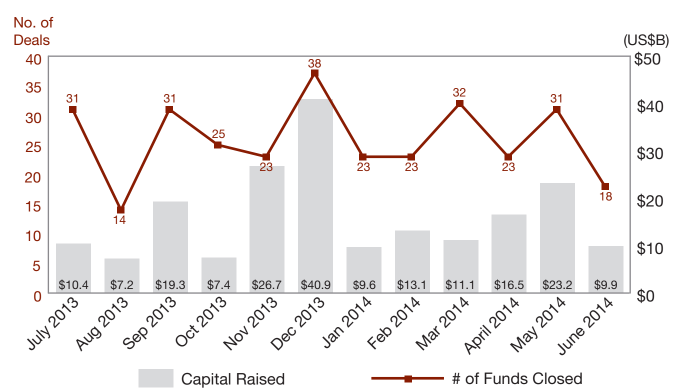
Working capital provisions are complicated to draft for a variety of reasons. First, these provisions are bespoke and must reflect multiple layers of unique attributes for the particular deal. These attributes include the specific nature of the target business, industry practice, applicable generally accepted accounting rules and also any additional special rules agreed to by the parties. Unlike other acquisition agreement provisions, "market practice" may not work or even exist. Second, the precision required to measure changes to working capital differs from the more abstract concepts common to acquisition agreements (such as materiality or material adverse change), and this need (and opportunity) for precision and detail provides a strong impetus for gaming by the parties. Finally, a successful working capital provision requires the close cooperation of not only the parties involved, but also their specialist advisors from two different professions, law and accounting. Implementing accounting principles in legal documents is not always an easy task and substantive issues can be lost in translation. Therefore, lawyers, clients and accountants must coordinate early and often.

Methodology

First, the parties must agree to the general methodology by which the working capital amount will be calculated. This methodology will be defined first by reference to the target's existing practices, including its existing accounting principles, methods and practices and applicable GAAP. The working capital calculation should, therefore, mirror the accounting methodology used in preparing the target business's most recently audited balance sheet, applied consistently and in accordance with GAAP. Reference to the audited balance sheet promotes precision in numerous ways, including that:

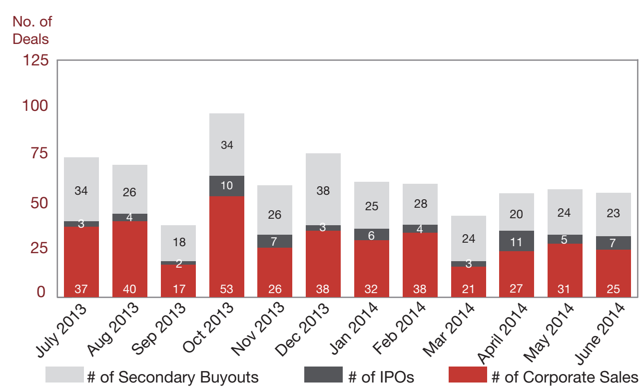
- The notes in the audited financial statements delineate the target business's accounting methodology, such as whether the inventory is calculated on a LIFO (last-in-first-out) or FIFO (first-in-first-out) basis; and

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits By Number



Source: Pitchbook

- This methodology has been validated by the target business's auditor. Because private companies are not subject to legal reporting obligations, the methodology used by management in preparing monthly and quarterly balance sheets for internal use is unlikely to be as clear and uniform as that of the auditors in preparing the audited financial statements.

This audited balance sheet approach also complements the audited financial statement representations and warranties, as collectively 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]." The seller and buyer can rely on an additional level of protection if the acquisition agreement stipulates that any changes in accounting methodology following the issuance of audited working capital financial statements will have no effect, even if required by GAAP, thereby ensuring a consistent, apples-to-apples comparison of working capital levels.

Special Rules

To further refine the baseline accounting methodology described above and to reflect any specific deal terms, the parties may agree on additional special balance sheet rules. For example, the parties might specify:

- A special inventory obsolescence policy or specified write-downs for obsolete inventory to supplement the accounting methodology's choice of whether inventory is calculated on a LIFO or FIFO basis; or

- An agreed-upon approach to liability reserves or other areas where GAAP allows for multiple interpretations and approaches. Under GAAP, a party may choose to reverse certain reserves despite not having made a cash settlement. Because liabilities decrease working capital, including a reserve in a given target working capital calculation reduces that amount. If, however, a party reverses a liability reserve that has not been paid, the liability will not be on the books at closing and the amount of closing working capital will thus increase. As such, a seller may desire to reverse reserves in order to manipulate the closing working capital calculation to its benefit. To deal with this possibility, the parties may specifically prohibit the reversal of reserves, except where the party can eliminate, through a cash payment on or before the closing date, the liability for which the reserve was created.

Line Items

In addition to defining the accounting methodology to be used, which line items constitute "working capital" must also be specified. A basic GAAP definition is current assets less current liabilities. The former includes cash and cash equivalents, accounts receivable, inventory and, in some instances, prepaid expenses, while the latter encompasses

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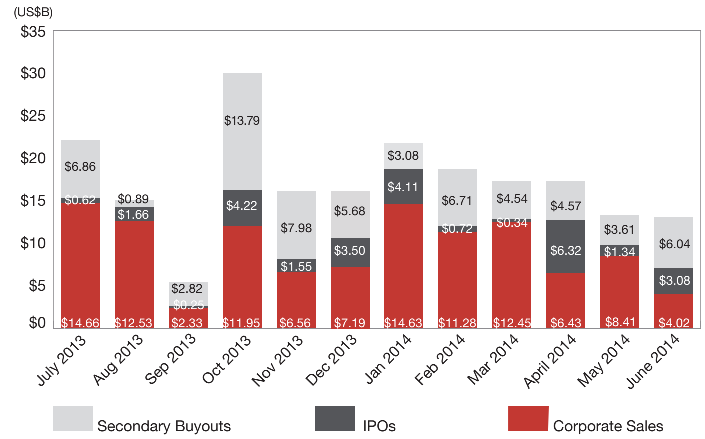
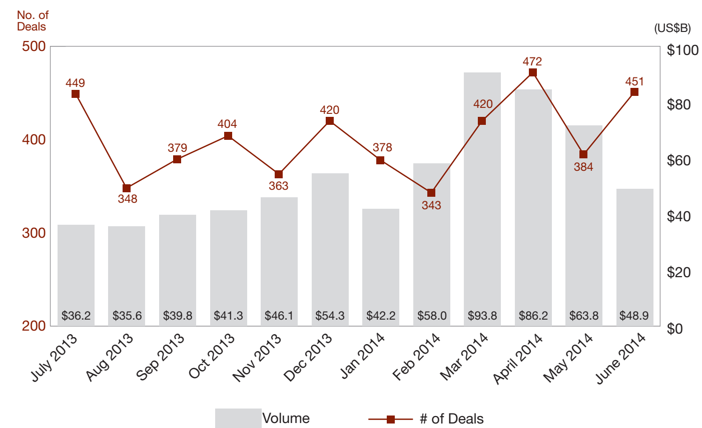


Source: Pitchbook

Global Sponsor-Related M&A Activity



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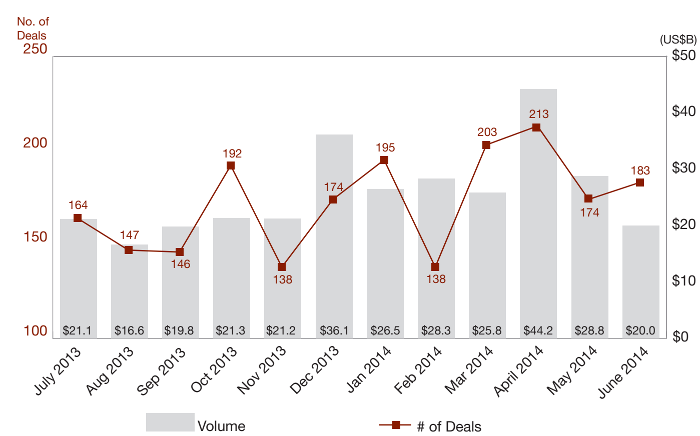
U.S. Sponsor-Related M&A Activity



Source: Dealogic

compensation and benefits accrued, accounts payable and income taxes and other liabilities accrued, all to be paid within one year of the balance sheet date. The target company's historical balance sheet and accounting due diligence report are an effective initial source for determining which assets and liabilities fall under the working capital definition.

Instead of utilizing the standard GAAP working capital definition, the parties should independently indicate which line items the definition will incorporate. The definition should explicitly note that the calculation will exclude those assets and liabilities which are not special balance sheet rules or enumerated line items. This framework helps maintain consistency, ensuring that neither party will include a category of assets or liabilities that does not explicitly fall within the ambit of the parties' definition of working capital.

The Target Amount

Once the accounting methodology has been specified and refined, the parties must set a target working capital amount, which represents the agreed normalized pre-closing level of working capital and the working capital at the transaction's closing date. This target working capital amount is measured against the closing working capital amount to see whether there has been an excess or shortfall, and whether there should be a corresponding increase or decrease in purchase price.

To determine this target working capital amount, the parties must decide what is appropriate depending on factors such as the target business's historical and projected growth and any seasonality or other industry trends that affect working capital. For example, with businesses subject to seasonal fluctuations, it may be sensible to use a working capital target calculated as an average over some period of time as opposed to using any given month or reference date because the chosen month/date could be a particular high or low point in the business cycle. In contrast, this trailing working capital average may not be ideal for a business that grew over its latest financial period because the working capital required to operate the business upon closing will be greater than the historical, trailing average, and projected future growth would determine the price paid by the buyer. In this event, the selection of a specified pre-signing balance sheet date or other reference point may be more apt. The accountant's input is central to determining the suitable target amount.

Part II of this series will feature a more detailed discussion of the issues related to specific line items.

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