Negotiating working capital targets and definitions

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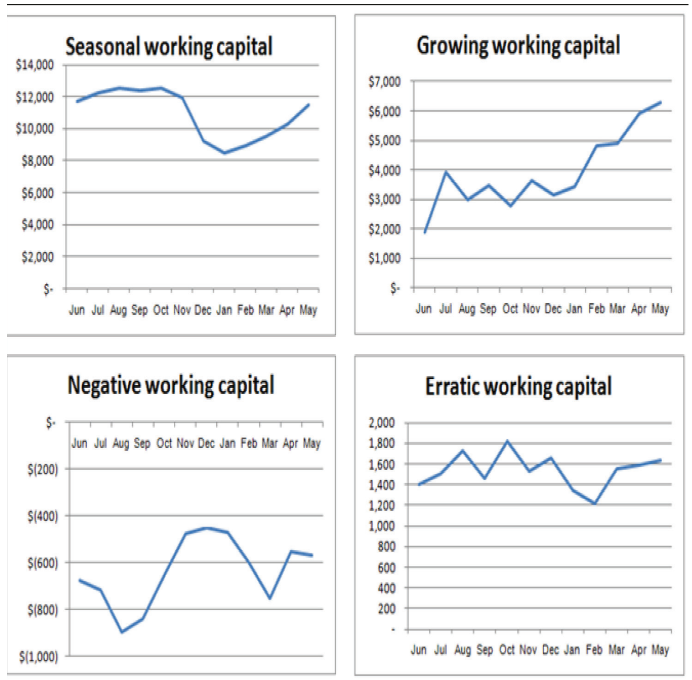
The textbook definition of working capital is the difference between current assets and current liabilities. This sounds easy, but when a company with significant working capital is being bought or sold, it is far from easy to settle on a proper working capital target and working capital definition in the purchase agreement. At the initiation of a deal, the letter of intent (LOI) usually has some general language that makes the deal based in part on the buyer receiving sufficient working capital to fund ongoing operations. At the end of the deal, very precise working capital targets and definitions are required for the purchase agreement. However, there are many working capital issues between the LOI and the final purchase agreement, some of which we will discuss within this white paper.

Working capital is critically important in the operation of a business and is often implicit in determining a company's value. A company needs cash to operate; it must fund its receivables from customers, carry inventories, prepay insurance, pay vendors and fulfill other obligations. Funding these working capital assets are the current obligations due banks, vendors, and other payables and accruals.

First, working capital can be far different from company to company, even those in the same industry. Working capital can fall into a number of the following categories:

- Seasonal working capital – In many businesses, especially those with highly seasonal sales, working capital may vary significantly. At the time of a sale, working capital can be very different than it was when negotiations began or when the LOI was executed.
- Growth working capital – A growing business often has increasing needs for working capital as sales grow.
- With business growth, receivables and inventories may increase each month, requiring working capital to grow as well. As the deal proceeds, working capital keeps growing.
- Negative working capital – If a company typically receives payment before a product or service is delivered, the company may operate with negative working capital. As the business grows, the company actually generates working capital. This is more common, for example, in software and publishing businesses where customers pay for services in advance. With negative working capital, there are often more discussions about some or all the cash being left in the business at the time of the sale.
- Erratic working capital – Notable instances where changes in working capital can be erratic are when customers change payment habits or terms, customer payments are large and infrequent, companies acquire inventory in large lots, or there are changes in payment patterns to vendors. Working capital targets are even more difficult to establish in these situations.

The following tables illustrate typical working capital trends seen in these categories:



Working capital amounts can be small at one company and quite significant at another. Looking at working capital as part of the total deal or in relation to sales, can show that it varies in importance from company to company. The following table shows several examples:

Working capital as percentage of deal value

US$ in thousands	Deal # 1	Deal # 2	Deal # 3	Deal # 4	Deal # 5
Purchase price	$96,000	$27,000	$41,000	$12,000	$30,000
Working capital (1)	22,000	1,000	6,000	(4,000)	13,000
% of deal value	**23%**	**4%**	**15%**	**-33%**	**43%**
Sales, LTM period	$81,000	$19,000	$25,000	$10,000	$43,000
% of sales	**27%**	**5%**	**24%**	**-40%**	**30%**

(1) Debt free, cash free working capital

The textbook definition of working capital is modified in most deals. The first adjustment is determining which current assets and liabilities are being acquired that will comprise the deal's working capital. Buyers and sellers often negotiate an acquisition on a cash-free, debt-free basis. In these cases cash, lines of credit and notes payable are all excluded. This is more complicated than it may seem. Are bank overdrafts included or excluded and what is done with loans due from owners, officers or employees? What happens with prepaid investment banker fees, customer deposits, deferred revenues and deferred taxes? The list can go on and on, so a close review of the details of the financial statements and trial balance accounts is needed. Ultimately, the purchase agreement will need to fully define the components of working capital, as the textbook definition of current assets less current liabilities is not enough.

A sample to illustrate the difference between the textbook definition and working capital as reported in a deal is shown in the following table:

Working capital, as reported			Working capital, as defined		
US$ in thousands		7/31	US$ in thousands		7/31
Cash	$	1,538	~~Cash~~	$	-
Accounts receivable, net		10,502	Accounts receivable, net		10,502
Inventory		8,824	Inventory		8,824
Prepaid expenses		1,240	Prepaid expenses		1,240
Related party receivables		189	~~Related party receivables~~		-
Notes receivable - current		959	Notes receivable - current		959
Income tax receivable		250	~~Income tax receivable~~		-
Deferred income taxes		2,529	~~Deferred income taxes~~		-
Total current assets		**26,031**	**Total current assets**		**21,524**
Line of credit	$	12,903	~~Line of credit~~	$	-
Accounts payable		7,787	Accounts payable		7,787
Accrued expenses		5,447	Accrued expenses		5,447
Accrued income taxes		762	Accrued income taxes		762
Long-term debt - current		5,525	~~Long-term debt - current~~		-
Total current liabilities		**32,424**	**Total current liabilities**		**13,996**
Working capital, as reported	**$**	**(6,393)**	**Working capital, as defined**	**$**	**7,528**

In looking at the balances in the financial statements, it needs to be understood that individual account balances shown in the financials are not one homogenous item. Each account may also have individual components that need to be considered separately. An account balance may comprise many different individual accounts, such as cash, which may include cash in the bank (which is really cash in the bank, net of outstanding checks and deposits in transit), cash at foreign subsidiaries converted into dollars, restricted cash and petty cash. For example, are all the accounts payable and accruals being assumed? Accounts payable may include some accounts that are not part of operations and should not be assumed, or may be inconsistent with other definitions. If the deal is cash free, should accounting reclassifications, such as bank overdrafts in current liabilities, be excluded as part of cash? For assumed accruals, does this include accrued interest, accrued income taxes and accrued legal obligations that the seller will be required to settle? How will accounts like accrued dividends or deferred taxes be handled?

The following table shows what might be found in accounts payable or accrued liabilities, and shows the additional review at account levels that may be needed to avoid post-closing disputes.

Sample of accounts payable detail			Sample of accruals detail		
US$ in thousands		7/31	US$ in thousands		7/31
Accounts payable aging	$	5,918	Customer deposits	$	2,532
Payables from post-cut-off checks		872	Accrued expenses miscellaneous		459
Accrued inventory purchases		469	Accrued interest expense		95
Held checks		301	Accrued excess liability insurance		147
Warehouse fees		57	Accrued legal & audit fees		71
Outstanding freight bills		48	Accrued vacation-salary		218
Other accrued purchases/services		84	Accrued vacation-hourly		253
Other		38	Accrued bonus		608
			Accrued payroll		395
			Health insurance (IBNR)		563
			Accrued payroll taxes		78
			401(k) employee contributions		19
			Other accruals		9
Total accounts payable	**$**	**7,787**	**Total accruals**	**$**	**5,447**

Customer deposits or deferred revenues can be especially difficult to determine as adjustments to working capital. A buyer would certainly want to be protected from a customer depositing $1 million the day before the deal closed and the seller keeping the cash in a cash-free transaction. In this case, it is possible that the seller would keep the deposit, and the buyer would have the future costs of meeting the deferred revenue services, but would not receive the benefit of the prepaid cash. Depending on how the valuation was determined, and the target working capital established, a post-closing adjustment inconsistent with how the target was established may make the deal unfair to one party or the other.

Next, the purchase agreement needs to define the accounting basis for working capital. This is often generally accepted accounting principles (GAAP) or "GAAP applied on a consistent basis." However, the definition of either GAAP or "GAAP applied on a consistent basis" creates possible contradictions. What if the company has not followed GAAP? Which has precedence, GAAP or "consistently applied"? What if both parties apply different, but acceptable, GAAP practices? Another complication is when a company follows GAAP in its yearend accounting, but does not maintain full accrual accounting on an interim basis. A different complication could be when a company has never closed its books on an inter-month basis, for example, July 15. How should accruals be computed, and what is GAAP at midmonth? An agreement also can allow GAAP exceptions or define a different accounting basis altogether, as may be negotiated by the parties.

Agreements also usually set working capital targets. Setting targeted working capital is generally based on an analysis of the business to identify the normal needs for working capital. Ultimately, the amount is negotiated between the parties, with the buyer often valuing the business based on an EBITDA multiple or expected cash flows of the business. In buying the cash flows, all of the assets that are used to create those cash flows would normally be acquired. This includes the fixed assets, workforce, name, technology, intangibles and goodwill as well as a proper amount of working capital. The approach to determining the target working capital should be consistent with the methodology originally used to value the business.

Factors to consider in establishing a working capital target include:

- What is normal for the industry?
- What is working capital as a percentage of sales?
- What special terms cause the company's working capital to vary from normal levels?
- How significantly does inventory vary on a month-to-month basis?
- Do seasonal sales affect working capital levels?
- Are the business and its working capital needs growing?

Another factor is for the buyer to consider the extent that working capital adjustments found in due diligence are negotiated and resolved prior to closing. In some cases, a buyer or seller may simply feel the inclusion of "GAAP applied on a consistent basis" will enable the respective party to be sufficiently protected. Working capital computations that are agreed to can include GAAP exceptions and can be negotiated in detail. Near the end of closing a transaction, after long discussions the parties may just choose not to keep negotiating and rather let the dispute resolution process resolve any issues after the close.

Due diligence working capital findings often include:

- Lack of sufficient receivable or inventory reserves (at least from the buyer's point of view)
- Missing accruals such as vacations, payroll, bonuses, warranty, sales allowances, IBNR medical claims, etc.
- Cut-off issues on an interim basis
- Individual accounts that should be excluded, such as accrued interest

The following table summarizes some working capital adjustments that might be found:

Quality of working capital		
US$ in thousands		7/31
Current assets	$	26,031
Current liabilities		32,424
Working capital, unadjusted		**(6,393)**
Additions		
Line of credit		12,903
Long-term debt - current		5,525
Deductions		
Cash		(1,538)
Related party receivables		(189)
Income tax receivable		(250)
Deferred income taxes		(2,529)
Working capital, trade		**7,528**
Due diligence adjustments:		
1. Excess and obsolete inventory reserve		(1,235)
2. Accounts receivable reserve		(419)
3. Warranty accrual		(250)
4. Accrued vacation		(220)
5. Repair and maintenace accrual		(95)
6. Worker's compensation accrual		(90)
7. Employee accounts receivable		(35)
8. Accrued interest		95
9. Health insurance accrual		125
Total due diligence adjustments		**(2,124)**
Net working capital, as adjusted	**$**	**5,405**
Net working capital as a % of revenue		*3.7%*

Sometimes due diligence findings are negotiated and incorporated into the target working capital amount, but often they are not considered in the target and become issues later in negotiations or after close in the computation of the final closing working capital.

The absolute amount of working capital, or the relative importance of working capital to the purchase price, may be a guide to the level that details are negotiated before the close. One business may have just a few hundred thousand dollars of working capital while another has many millions.

Fundamentally, working capital negotiation can create a feeling of unfairness between the buyer and seller. For the buyer, if they are already paying $80 million to buy a company, why should they pay any more for an increase in working capital? For the seller, since they will likely have to pay taxes on all the profits through the sale, why shouldn't they be entitled to keep all those profits? The growth in working capital is a proxy for the profits in the closing period. Both are reasonable positions and ultimately the purchase agreement negotiations will need to settle these issues. The early discussions during negotiating the LOI are at a very high level, with the parties agreeing that working capital is to be an amount that is sufficient or normal in relation to the business' needs or that the parties will later negotiate in good faith. This approach sounds great, but in practice, one party's sufficient or normal can vary greatly from the other party's.

The typical process from the LOI to arriving at an agreed-upon working capital definition and final adjustment is often as follows:

- The LOI has a very broad definition, for example, "The buyer will acquire a normal or sufficient level of working capital."
- The buyer analyzes working capital components and trends during the due diligence period.
- Due diligence reviews are conducted and identify additional potential working capital adjustments.
- More working capital discussions between the buyer and seller occur later in the process and a target working capital amount is eventually agreed upon.
- The initial purchase agreement is drafted and the parties further negotiate working capital definitions during drafts of the purchase agreement.
- Parties eventually agree upon definitions, targets and a dispute resolution process as part of the final purchase agreement.
- The buyer often computes the working capital adjustment post closing, the seller reviews the buyer's computation and agrees or doesn't, and then further discussions take place and a dispute process is employed if necessary.

Some other factors that may be negotiated in the purchase agreement to reduce the likelihood of future disputes include:

- Working capital can only be adjusted downward, not upward (favors buyer).
- A basket is created where working capital is only adjusted if it is a given amount above or below the target by a set amount, for example, $250,000.
- There simply is no working capital adjustment at all (likely favors seller).

The time and effort put forth to fully negotiate all the details of the working capital definition and adjustment also complicate the closing process. Negotiations can be bogged down if every aspect and definition of working capital must be negotiated. Most often what is good for the buyer is bad for the seller and vice versa, creating a difficult negotiation. Sometimes the final settlement is just left to resolution after the sale when dispute mechanisms are employed.

About the author

Robert B. Moore has a broad accounting and consulting background, specializing in financial management services such as mergers and acquisitions, due diligence investigations, business valuations, financial projections, obtaining financing, profitability analysis and improvement, and other corporate accounting and finance matters. He has worked with clients of all sizes, and his engagements have involved financial transactions, including debt financing, private placements, asset securitizations, portfolio acquisitions, loan workouts and company acquisitions and divestitures. Bob has extensive experience working as an advisor to management, bankers, buyers, sellers and attorneys as well as serving as an advisor or arbitrator in working capital disputes.

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