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Post Closing Adjustments Redux

Avoid confusion and animosity after the sale.

by Jay Schembs

Nearly a decade ago, we published an IN$IGHT article addressing post-transaction adjustments with the objective of ensuring that when the parties have agreed on the "price" to be paid for the business, neither party has an advantage as to the specific date of closing. The premise of any adjustment mechanism as stated in that article remains true:

> *"The enterprise value of a business is generally predicated on a projection of its expected future after-tax cash flow, after accounting for investments in capital assets and working capital. In exchange for paying the enterprise value purchase price, a buyer should reasonably anticipate receiving all of the assets, net of operating liabilities, required to generate the expected future earnings and cash flow of the business."*

While typically representing a minor proportion of deal consideration, negotiations over post-closing adjustments can lead to confusion and vigorous debate, often when a seller has lost negotiating leverage and may feel the buyer is simply "retrading" the deal to reduce the purchase price. The concept of working capital adjustments may seem simple, but determining the target and consequently the closing measurement often cause significant debate.

The target to which actual closing working capital is compared is often calculated as the average of the actual working capital employed in each of the preceding 12 month-end periods using the financial statements prepared by the company. While this mechanism works under certain circumstances, deviation from the implied assumptions about the business can give rise to differences of opinion with regard to whether that establishes an appropriate target. Having a clear thought process and rationale can help reduce the extent of those differences and resolve this issue early in the process.

OPERATING CAPITAL VS. ACCOUNTING WORKING CAPITAL

Offers for businesses are most often expressed in terms of enterprise value on a "debt-free, cash-free" basis. The intent is to segregate capital structure decisions from operating decisions. Similarly, excluding cash and debt from working capital focuses on accounts that are absolutely necessary to the proper functioning of the business, such as receivables, inventory, and payables. The exhibit below illustrates the differences between an accountant's balance sheet and the working capital used for measurement in a transaction.

However, even this rather straightforward "rule" may not be appropriate. Take the situation where a manufacturer receives up-front cash deposits for new orders, resulting in offsetting cash and deferred revenue accounts. Cash is received as a deposit, but the work still needs to be performed, requiring cash outflows to cover labor and supplies. Should the cash deposit be included in working capital, which conflicts with our "cash-free, debt-free" formula? It depends – on whether this is a normal course of business, or an aberrant situation that could affect who gets the cash and who gets to complete the work.

ACCOUNTING VS. ECONOMICS

Working capital is a real economic concept; capturing it in financial statements is not always perfect – or practical. The GAAP standard is often misunderstood, as statements can be in accordance with GAAP even when each account is not. Further, internal monthly statements sometimes are not prepared to the same standard as year-end statements. Since working capital is measured over time, these discrepancies can also cause further distortions.

The devil of a specific company's working capital is in the details of its particular business model. For some perspective, consider the following situations:

- A distributor earns volume purchase discounts from suppliers throughout the year, but only books the rebate at year-end; and

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- The company also has a "use it or lose it" vacation policy with virtually all vacation taken in the summer, but does not book accruals related to these potential liabilities, instead expensing as incurred.

These examples pose interesting questions in the context of understanding a company's working capital. If the company is not building these accruals throughout the year, are

$000s	Accountant's Balance Sheet	Non-Operating Items	Transaction Net Working Capital
Cash	5,000	(5,000)	-
Marketable Securities	2,500	(2,500)	-
Accounts Receivable	25,000	-	25,000
Inventory	40,000	-	40,000
Prepaid Insurance	1,200	-	1,200
Current Assets	73,700	(7,500)	66,200
Revolving Credit	10,000	(10,000)	-
Shareholder Loans	5,000	(5,000)	-
Accounts Payable	12,000	-	12,000
Accrued Expenses	4,000	-	4,000
Current Liabilities	31,000	(15,000)	16,000
Working Capital	42,700	7,500	50,200

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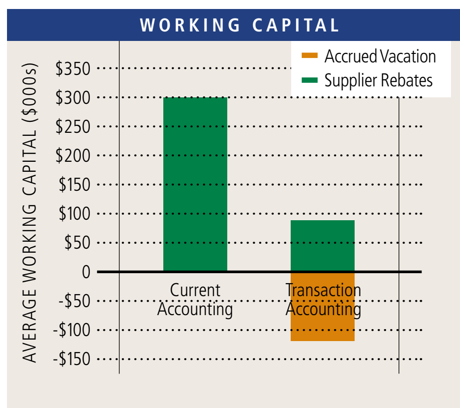
certain accounts not under or overstated? The exhibit in the next column shows the range of difference in average working capital over a twelve-month period for these specific accounts depending on the accounting methodology. Assuming the year-end procedures are employed at the date of closing, an unexpected adjustment could occur only as a result of accounting arbitrage.

A buyer will hesitate to agree to a specific target until after completion of financial due diligence. Anticipating this discussion in advance, and preparing the data in a complete fashion such that due diligence is likely to uncover anything new, helps the seller address this issue early along with all other economic issues.

SETTING THE TARGET

Once a defensible definition of working capital is established for the transaction, setting the target for an unknown closing date is the next challenge. The rule of thumb is to use the average of the most recent 12-month periods of actual working capital. That is a reasonable approach if the business is stable and seasonality is the only variable. What happens if the business model is changing, or the company is growing rapidly? In a stable no-growth business, the target (average of a season) is sufficient to support the next season. If the growth curve is not flat, an average of past periods will not support the future.



Returning to the premise that acquirers are paying for future performance, including the net assets necessary to support the future, the target should be in line with that premise. Since the future is unknown, this can lead to reasonable minds differing. The best defense is to have the issues clearly thought through and a position as to the right answer.

OTHER ADJUSTMENTS

Post closing adjustments need not relate solely to working capital accounts. Companies employing significant fixed assets and operating in seasonal environments (such as in agricultural or hostile weather settings) might show irregular capital expenditure patterns, which should be addressed in the context of post-closing adjustments. Another example is the business that undergoes periodic, but not regular, significant capital expenditures such as an information systems overhaul. Loading the cost of that totally in the arms of the buyer or seller, depending on the transaction date, may not be fair.

Our standard advice regarding post-closing adjustments is to deal with them in the context of the negotiation of all other economic components of the transaction. A strong intellectual basis and availability of data to support a definition of working capital and an appropriate target goes a long way. As with all elements of the transaction, once resolved, the seller can then focus his or her efforts on a swift process to close without reopening the economic debate late in the process when there is less tolerance by both parties. **ZS**

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

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