Purchase Price Adjustments: Where to Focus

Ben Adams

The purchase price is not the entire story—an experienced team will also focus your attention on the many adustments that are made before cash proceeds.

Virtually every middle market business sale transaction contains elements of adjustments to purchase price based on unknowns as of the date of closing. Transactions are expressed in terms of enterprise value, or the total value of the business, inclusive of all operating assets and liabilities required to produce the company's profits. It is the future profits the buyer is purchasing. The buyer needs to assure itself it has the proper amount of assets to earn those profits and the seller wants to assure itself that it doesn't provide more assets than has been bargained. The amount that flows to the seller is often expressed as enterprise value, less debt, plus cash, plus or minus the amount of working capital relative to an agreed target. These may seem simple and self-evident, but they are the subject of much time and attention in every transaction.

If a transaction closes as of a specific date, the business changes hands, but there remains a lag between that closing date and the date when the parties have knowledge of the true final balances – the accounting lag, usually no more than 60 days. If a transaction is signed and committed to by the parties, but awaits closing until third parties grant approval, there is an additional lag. In some cases, this lag can be many months. In both cases, confirmation of amounts need to be made following the date of closing. Usually these are balance sheet measurements from which a "true-up" is made, comparing actual balances to the negotiated balances, often referred to as the target.

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What the targets should be and how they should be measured and compared can be tricky subjects, amounting to many dollars swinging between the parties. The purpose of this article is to give an overview of the issues and offer some perspective on how to think about these matters in light of a transaction.

What is Cash? What is Debt?

What is simple about these two measurements is that they are not measured against any target level. The balance is simply added to or subtracted from enterprise value. What actually constitutes these categories is less simple. Cash is not as simple as the amount in the bank, and debt is not as simple as the amount owed to the bank. There are nuances that can lead to these values differing dramatically from what is seen on the company's balance sheet.

"Cash" – as it is intended in the concept of a "cash-free, debt-free" enterprise value – is the amount of cash that has, as of that date, been earned by the business and has no operating purpose in the business. Occasionally, some cash does have operating purpose.

For example, the retail industry requires cash to operate. If a customer cannot