Purchase Price Adjustments: Where to Focus

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The purchase price is not the entire story—an experienced team will also focus your attention on the many adustments that are made before determining the amount of 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 receive change for a twenty-dollar bill, the customer may shop elsewhere. Therefore, cash in the register is required for the further operations of the business. Another example is that manufacturers sometimes require deposits in advance of making a product for a customer. When these deposits are a regular part of the business model, the deposits can be considered as cash with the liabilities remaining in working capital, but when an extraordinary or unusual event occurs, the liability for work to be performed is considered to be debt and the cash deposit is an off-set. That "cash" is actually there to pay for the cost of making the product. In both of these cases (and others), some amount of cash is not really "cash" for transaction purposes and may be included as working capital.

"Debt", on the other hand, is intended to mean amounts owed to third parties that are not part of the normal operating cash cycle. Loans are easy to establish, but every industry has its unique attributes and the definition of indebtedness in a purchase and sale agreement keeps getting longer and longer. Going back to our retail industry example, gift card liability is created because sometime in the past a customer gave the business cash and in return was entitled to a basket of goods from the company. Business owners love this arrangement. They are, in reality, receiving an interest-free loan from customers. Unlike a bank loan, not all gift cards are redeemed and, if they are, will be redeemed at different times, implying that the total outstanding liability might not be the real current liability.

Even operating liabilities (e.g., accounts payable) can sometimes be considered debt. If suppliers are extended beyond normal commercial terms, paying those liabilities is not within the normal cash cycle and therefore is debt for transaction purposes.

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More complexity can develop with deferred taxes in C corporations, and some don't think of that liability as debt. It is, but not completely. Rather than dig into this, we refer you to Deferred Tax Liabilities and M&A Transactions [Summer 2015].

The point of this is that determining the appropriate amount of cash and debt to be measured at closing requires an understanding of how the business works and each industry has nuances that should be considered.

Working Capital Targets

The first job is to define what is meant by working capital. It is intended to mean the assets and liabilities that flow through the cash cycle, purchases raw material, converts it to a finished product, sells it to a customer, and receives cash payment for the sale. The accounting definition is current assets less current liabilities. But, as we've already seen, it is not necessarily that simple. The definition needs to be precise and we would advise that it be a specific description of general ledger accounts.

How much working capital is needed? Working capital varies within a period because of seasonality, growth, and shrinkage of the business. Each has to be considered, including the basis for how the business is being valued by the buyer.

Seasonality of a business (both revenue and expenses) can result in different levels of working capital throughout the year. If not accounted for, a significant adjustment to the purchase price could be made that negatively impacts the seller or buyer, depending on timing. For more detail on the intricacies of seasonality in calculating a working capital target, we have previously written the article Reconciling Purchase Price and Working Capital [Winter 2006].

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Growth and shrinkage of a business also dictates the appropriate amount of working capital. When a business is growing or shrinking, its working capital typically changes. More narrowly, accounts receivable increase when monthly revenues grow and decrease when monthly revenues shrink. If a business is being valued based on the run rate of the sales level, then an average over time is not appropriate; a run rate of working capital implied by the run rate of the business needs to be determined.

Time to Closing

Between signing and closing a deal, a significant amount of time can occur as both parties complete their closing checklists. During this time, the seller is put in an odd situation. The buyer expects the business to continue to be operated as it would be normally. When new initiatives are involved that require investment, either in working capital or capital expenditures, another adjustment should be considered in order to balance the outflows and inflows between the parties.

An example is money spent on marketing of new products or in new areas that will be made today to stimulate future sales for a business. A seller would be incentivized to reduce marketing spend as it will not see the same benefit from this kind of investment during its ownership. On the other hand, it is in the buyer's best interest for that effort to continue. A fair adjustment that aligns the spending to the beneficiary can solve the problem.

For long periods between signing and closing, an alternative is to turn the company into a "lockbox" – no cash comes in and no cash goes out until the transaction closes. The value of the equity is determined at the signing and is adjusted for the changes in debt, cash and "investments" (as defined) made by the business, The seller remains responsible for taxes until closing and earns the cash profits until closing as they show up on the balance sheet and is reimbursed for investments whose benefit accrues to the buyer.

Measuring the Adjustments

In the United States, the gold standard for measuring amounts in differing types of accounts is GAAP – that is, Generally Accepted Accounting Principles. GAAP is utilized for defining the policies used to determine assets and liabilities. But "GAAP as consistently applied" (as defined by accounting firms) is anything but consistent and can vary between companies when they are believed to not materially affect the interpretation of the reported results.

Buyers will want to understand these differences and will focus on what the seller is missing. Are inventory counts and valuations carried out consistently? Are accruals being expensed for vacation, warranty and bad debt? We have written an article further outlining the intricacies of GAAP accounting, GAAP, the False Prophet: Avoiding Working Capital Accounting Arbitrage [Winter 2019]. Matching the precision in the establishment of the targets to measurement is essential.

Preparation Leads to Good Fortune

Waiting until it is too late is never beneficial. Whether a seller or a buyer, thinking deeply about the business and how it is represented in accounting is a prerequisite to a good (and fair) outcome. The purpose of these adjustments is not to make money on them, but not to lose money from them. An experienced team that encompasses operations, accounting, deal economics, and legal agreements gives the best opportunity to make good judgements on setting standards, minimizing disputes, and maximizing fairness.

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