Beware the Working Capital Adjustment Trap

By Stanley Veliotis and Mauro Viskovic

Here is a familiar story: An entrepreneur works for decades to build a successful business and has reached the point of successfully exiting from the business through a lucrative sale transaction. At the closing of the sale, the buyer pays the seller a substantial sum for the business. A bombshell arrives 90 days later, however, in the form of a demand to repay a large portion of the purchase price back to the buyer due to a "working capital adjustment." What happened? The answer is that the seller was a victim of the working capital adjustment trap. To explain how easy it is for an unsuspecting seller to fall into that trap, it is first necessary to provide some background describing the nature of and rationale for working capital adjustments in business acquisition transactions.

Defining Working Capital

Working capital is simply current assets (e.g., cash and cash equivalents, accounts receivable, inventory) minus current liabilities (e.g., accounts payable, other short-term debt, accrued expenses). When selling a business, the transaction is typically done on a "cash-free, debt-free" basis, meaning that the seller can withdraw all cash in the business immediately prior to closing. Notwithstanding this understanding, the buyer nevertheless expects that the seller will not diminish working capital. For example, the buyer wants to prevent the seller from accumulating extensive vendor payables up to the closing date, in order to maximize the balance of cash that the seller will withdraw prior to closing. As a result, a well-advised buyer will insist on a "working capital target," whereby the seller must ensure that—as of the closing of the transaction—the working capital of the acquired business will be within a defined range of a target amount.

The working capital target amount is often the working capital balance as of the end of the most recent fiscal period or, alternatively, an average of the monthly working capital balances over the past year or other period. Whichever methodology is used, the seller is basically promising to the buyer that the closing working capital balance will be equivalent to the agreed-upon target amount. Subject to exclusions for de minimis differences (e.g., an upward/downward range of 5%), if the closing working capital balance is greater than the working capital target, then the buyer owes a working capital adjustment payment to the seller. On the other hand, if the closing working capital balance is less than the working capital target, then the seller owes a working capital adjustment payment to the buyer. Although this mechanism may seem straightforward and fair, it is actually fraught with economic peril.

Example

Assume that the parties to a transaction agree to a working capital target of $5,000,000, based upon the acquired company's balance of working capital as of its most recent fiscal quarter end. Soon after the transaction's close, the seller prepares a closing balance sheet that results in a closing working capital balance of $4,950,000. Because the $50,000 shortfall is within the agreement's permissible range of the working capital target based on the seller's calculation of the closing balance sheet, the seller will not owe a working capital adjustment payment to the buyer.

The purchase agreement for the transaction, however, will typically provide the buyer and its accountants the right to review the seller's closing date balance sheet. At this point, the buyer's accountants complete their review and correctly note that certain GAAP protocols are not reflected in the closing balance sheet. They reveal that accounts receivable is not adjusted for a proper allowance for doubtful accounts and that inventory is not recorded at the lower of cost or market (LCM), in order to reflect obsolete inventory. These reductions in the value of accounts receivable and inventory result in the buyer arriving at a working capital balance of $3,900,000, further resulting in a working capital adjustment payment obligation of $1,100,000 from the seller to the buyer, as follows:

Working Capital Balance	
per Seller's Closing Balance Sheet:	$4,950,000
GAAP Adjustments:	
Allowance for Doubtful Accounts	($200,000)
LCM Reserve for Inventory	($850,000)
Closing Working Capital per Post-Closing Review	$3,900,000
Working Capital Target	($5,000,000)
Working Capital Adjustment due to Seller/(Buyer)	($1,100,000)

In response to the buyer's demand for $1,100,000, the seller will claim that this working capital adjustment is unfair because it is not an "apples-to-apples" comparison, as the target amount of $5,000,000 was calculated without regard for the allowance for doubtful accounts and the reduction for obsolete inventory. If the target amount was calculated using the same methodology that the buyer's accountants used, then the target amount of $5,000,000 would have been approximately equal to the buyer's calculation of closing working capital in the amount of $3,900,000.

Therein lies the trap. The purchase agreement merely defines "working capital target" as a numerical amount. There is no contractual basis for recalculating the target amount using the protocols that the buyer's accountants used to calculate the closing working capital. The end result is a substantial working capital adjustment payment obligation that the seller must satisfy.

The above scenario plays out too often in business acquisition transactions and can be financially devastating to a seller who has to make an unplanned payment. It can create tax problems if it is not resolved within the same tax reporting year or before the seller files the relevant tax returns. Also, this may create ill will between the buyer and seller, which can create tension when the seller is involved in the business post-closing, such as under a part-time consulting arrangement. In the worst cases, the parties may find themselves in arbitration or litigation to settle their differences (with escrow funds tied up), or may have to engage an independent accountant to settle the difference. In addition, the seller may feel let down by his accountant for not explaining clearly that the seller's financial statements did not comply with GAAP.

Avoiding the Trap

To avoid the working capital adjustment trap, the seller's financial advisors should be proactive and conduct—before the sales contract is signed—a thorough review of the financial statements of the business to ensure the financials, especially working capital, are fully compliant with GAAP. In addition, the seller's attorneys should mitigate this trap when negotiating the purchase agreement. Specifically, the definition of "target working capital" should not be just a numerical target amount and permissible deviation range. Instead, the definition should reference, in a schedule to the purchase agreement, the financial statements that were used to determine the amount of the target working capital. Furthermore, the definition must also provide that the financial statements used for the target working capital amount will be restated to use the same financial reporting methodologies used to calculate closing working capital in the event that the buyer's accountants use different methodologies.

Navigating the issues associated with working capital adjustments can seem like walking through a minefield. As such, business owners should seek effective and experienced accountants and attorneys to safely guide them. ■

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