Advisory Alert: Pitfalls of M&A- working capital can hurt sellers

Introduction

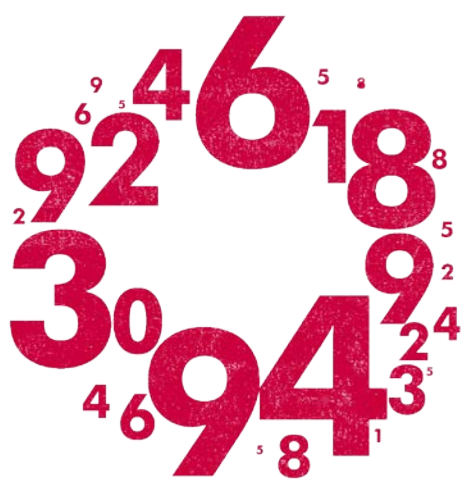
Working capital adjustments can cause material value change for buyers and sellers, but they are often not clarified or negotiated until it is fairly late in the deal process. In a typical deal, working capital is only mentioned in the letter of intent (LOI), and the terms are left for the buyer and seller to negotiate prior to close. Working capital sometimes can be complicated and tricky to determine and model. In this article we will explain the basics of the working capital adjustment from the seller's perspective, and discuss some pitfalls and takeaways.

Basics

Many transactions are closed on a cash-free/debt-free basis. In basic terms, this means that the seller keeps all cash (and investments) and pays off all debt (and debt-like items) at the time of the sale. Working capital, on a simplified basis, is often thought of as current assets minus current liabilities, excluding cash and debt-like items. In determining working capital for the purchase agreement, there are often further adjustments for non-business, related-party, tax and other items.

Based on historical working capital analysis that is typically performed during due diligence, a working capital target (or peg) is negotiated between buyer and seller. The peg is often determined based upon triangulation of working capital average levels and projected working capital levels at close. Setting the peg is a negotiated outcome, and practices vary widely. At close, the difference between the closing working capital and the peg is often a dollar-for-dollar adjustment to the total purchase consideration. As a result, the working capital adjustment can potentially be a significant component of the total consideration transferred between buyer and seller.

A few major considerations in establishing the working capital peg and mechanism are discussed below. There are many other potential considerations, and we recommend that you consult with your transaction service professional, as not all possible scenarios can be covered in a short article.



Revenue recognition: Revenue recognition in certain arrangements can be quite complicated and subject to significant

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ojel.rodriguez@pr.gt.com

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professional judgment. Many sellers believe that their accounting policies are in conformance with GAAP because they have audited accounts and/or they have never been challenged on their accounting policies before. In reality, we often find in due diligence that there is some divergence with GAAP even with audited financial accounts. Small differences can cause significant adjustments in working capital. For example, some companies use a bookkeeping convention of recognizing a full month of maintenance revenue in the month for which the contract begins; while consistent application of this bookkeeping may not materially change reported earnings, it may cause a significant increase in the value of deferred revenue when it is trued up at close. Revenue recognition is one of the most common causes of large unexpected adjustment to working capital.

Adjustments: As discussed, a peg is often utilized as part of the working capital mechanism, and there is wide difference in practice on setting and agreeing to the peg. A common approach is to reference the average level of working capital, after certain adjustments, in the most recent 12 months. Twelve months is a popular time frame because it is a relatively recent period, and it reflects a full year of working capital, averaging out many elements of seasonality. A little counterintuitive, but the seller will want a lower peg, as that is the reference amount that is subtracted from the closing working capital balance to determine the working capital adjustment. There are typically adjustments to the average working capital for one-time items that are uncommon, non-operational or nonrecurring in calculating the peg. An example of a typical adjustment to working capital is to exclude related-party balances, debt and tax accounts. The seller should make certain that significant one-time current assets are also adjusted out of the peg, such as non-recurring prepaid assets, employee receivables and unusually large receivable balance. Seller should also make sure to include in the adjustment any potentially missing accruals such as PTO, commissions, and bonus. It is up to the seller to identify adjustments that are favorable to the seller; these adjustments can decrease the working capital peg significantly. Failure to identify the adjustments will result in an artificially high peg and result in the seller paying the buyer for the difference.

Seasonality: Understanding the seasonality of working capital requires the buyer to complete a fairly granular financial analysis. The seller should not be surprised or alarmed at buyer concern and diligence surrounding working capital seasonality as this is one of the important risk areas for the buyer. Two most common seasonality drivers are customer billings and employee bonuses. For example, if a large percentage of customer renewals / billings occur in the fourth quarter of each year, then any transaction that closes at the beginning of the calendar year will see less cash flow from customers in the near term. Moreover, timing of annual bonuses can be a large cash outflow that the buyer needs to anticipate. For the most part, the risk to the buyer of not understanding seasonality is greater than to the seller. If the buyer does not properly understand seasonality, the buyer may find themselves needing to inject unexpected additional working capital into the business. The seller should be prepared to discuss seasonality and cash flow trends.

Seller takeaways

As shown, the working capital mechanism can result in considerable value transfer, and is subject to risk for both buyer and seller. The seller has considerable exposure with respect to revenue recognition and can mitigate this risk by making sure that its revenue recognition policies are in accordance with

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GAAP. Favorable adjustments to working capital should be identified by the seller.

While not always possible, negotiating the working capital mechanism and peg during the LOI process will reduce seller risk. Moreover, agreeing that past practices for accounting will prevail over GAAP in calculating the closing working capital will help the seller mitigate the risk of a large adjustment. However, to reasonably agree on a working capital mechanism and peg in the LOI will require substantial financial information to be disclosed to the buyer so that the buyer can get comfortable with the peg and seasonality.

Use of a transaction professional can be very helpful to the seller in navigating the working capital process. It is often helpful to a company to obtain a fresh, third party perspective on revenue recognition practices, seasonality analysis, commentary on the purchase agreement, and the final working capital calculation.

Adapted from:
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