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Working Capital Adjustments in M&A: The Hidden Impact on Purchase Price

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Practices: Corporate, Finance & Acquisitions

Designed to ensure that a target business is delivered with an agreed-upon level of operating liquidity, working capital adjustments can materially affect transaction value depending on how working capital is defined, calculated and ultimately delivered at closing.

Understanding the Working Capital Adjustment

In a typical cash-free, debt-free acquisition, the parties establish a target level of net working capital, commonly referred to as the peg, generally based on the target company's historical operations. Net working capital typically consists of specified current assets, such as accounts receivable and inventory, less specified current liabilities, such as accounts payable and accrued expenses. Cash, indebtedness and other separately addressed items are generally excluded. The peg establishes the baseline against which closing working capital is measured. Any excess generally increases the purchase price, while any shortfall typically reduces it.

Accordingly, the negotiated peg and treatment of individual balance sheet items can directly affect the transaction's economics.

The Post-Closing True-Up

The initial purchase price is typically based on the seller's estimated closing working capital, subject to a post-closing adjustment based on the buyer's final calculation. Any difference between the estimated and final amounts may result in an additional payment to the seller or a purchase price adjustment in favor of the buyer. Clear procedures and deadlines for preparing, reviewing and challenging these calculations are essential.

Key Areas of Negotiation

Establishing an appropriate peg and defining the components of working capital are central to protecting the parties' economic expectations. Historical balances may not accurately reflect operating requirements due to seasonality, growth or unusual transactions. Particular attention should be given to inventory reserves, doubtful accounts, accrued liabilities, deferred revenue and transaction expenses. Differences in accounting methodologies, including the application of GAAP, historical accounting practices or other applicable standards, can materially affect the calculation. Parties should also ensure that liabilities are not counted twice through overlapping working capital, indebtedness or transaction expense definitions.

Practical Considerations

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Buyers and sellers should address working capital mechanics early in negotiations, supported by appropriate financial diligence and clearly documented calculation methodologies. Including an illustrative working capital calculation in the purchase agreement can clarify the intended treatment of key items. Careful negotiation of the peg, accounting principles and adjustment procedures can help preserve deal value, minimize post-closing disputes and avoid unintended purchase price adjustments.

If you have questions regarding working capital provisions, purchase price adjustments or other M&A transaction matters, please contact Karl Von Drathen or a member of Masuda Funai's Corporate, Finance & Acquisitions Practice.

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