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INSIGHT: Protecting the Value of the Deal—How to Resolve Working Capital Disputes in Transactions


By Jeff Litvak and Jason Tolmaire

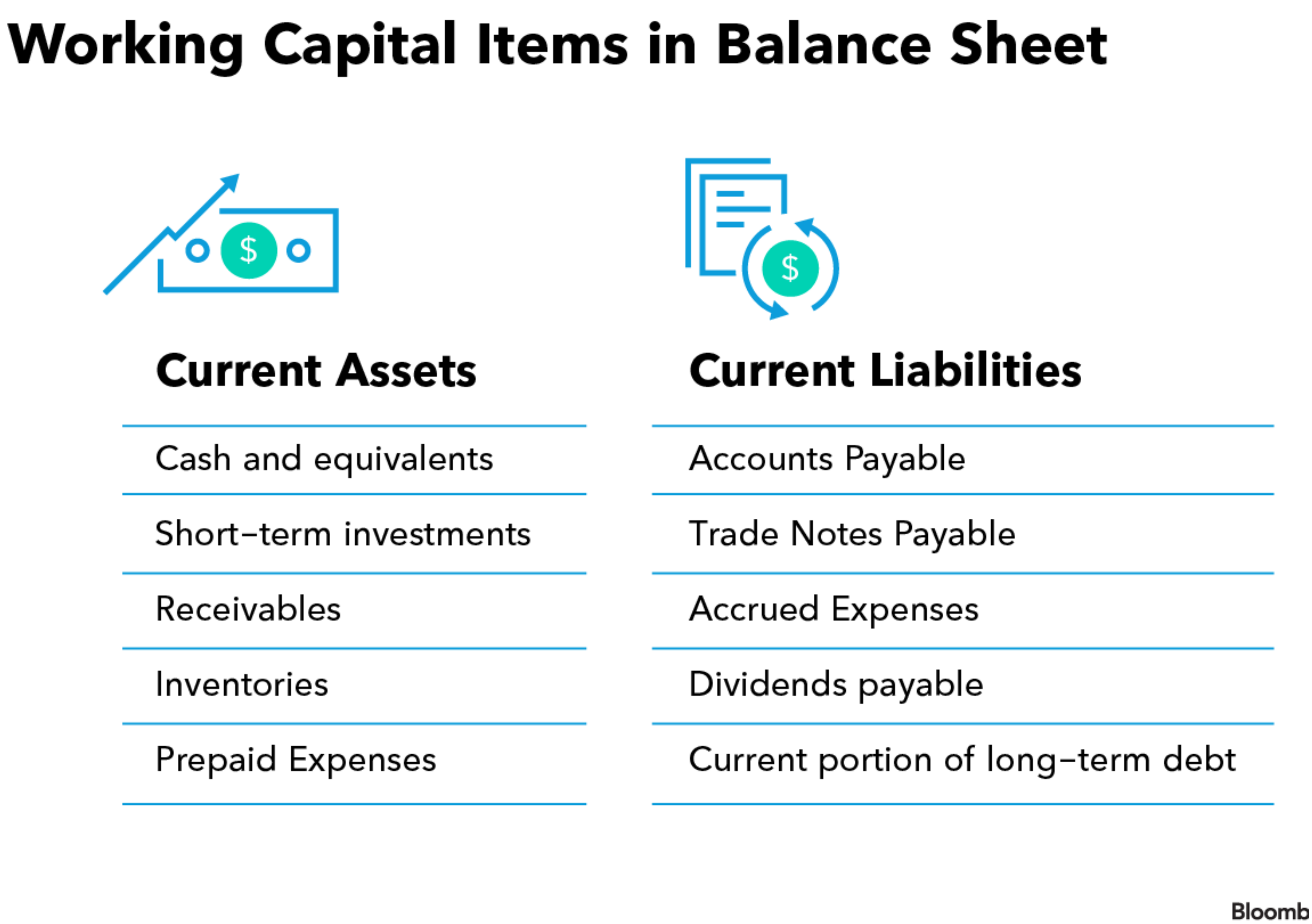
Jeff Litvak is a senior managing director in the Forensic & Litigation Consulting segment at FTI Consulting. He is based in Chicago and specializes in accounting, valuation, damage assessment and post-acquisition issues. Mr. Litvak was a co-chair of the AICPA Task Force which authored the Practice Aid for merger and acquisition disputes. He has presented in webinars and in other national forums on the subject areas of resolution of working capital and earnout disputes, the role of the neutral accounting arbitrator in resolving an M&A dispute. He also has determined indemnification damages and whether a Material Adverse Change (MAC) has been sustained.

Jason Tolmaire is a senior director in the Forensic & Litigation Consulting segment at FTI Consulting. He is based in Chicago and specializes in accounting, valuation, damage assessment and post-acquisition issues. Mr. Tolmaire has presented webinars on the topic of damages in post-acquisition disputes for Clear Law Institute.

In 2016 and 2017, over 80 percent of purchase price adjustments in M&A transactions involved working capital adjustments, according to SRS Acquiom's 2018 Deal Term Study. The purchase and sale agreement (PSA) commonly includes a purchase price adjustment provision to address differences between the target working capital expected by the buyer at the time the PSA is signed and the working capital received by the buyer at closing. Disputes often arise between the buyer and the seller as to the proper determination of the working capital based on the closing balance sheet. This article explains how working capital is calculated, how working capital is included in the purchase price, how disputes arise in the calculation of working capital, and how accountants can assist the buyer and seller in resolving working capital disputes.

Calculating Working Capital

Working capital, also referred to as net working capital, is the difference between current assets and current liabilities shown on the balance sheet. Working capital measures how well the business can support its short-term financial needs through various company activities, including revenue collection, debt management and inventory management. Examples of items typically included in current assets and current liabilities are shown in the table below:



Current assets are cash and other assets that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. The normal operating cycle is usually a year but can be longer in certain instances. Liabilities are classified as current when the liquidation of such liabilities is reasonably expected to require the use of existing resources properly classifiable as current assets or to create other obligations.

There are certain instances when some items will not be included in working capital. For example, when a business is acquired on a cash-free, debt-free basis, cash and the current portion of long-term debt will not be part of the working capital equation. There may also be instances when working capital may include deferred tax assets or liabilities. However, it appears that the majority of recent deals have excluded these tax-related items. According to SRS Acquiom's 2018 Deal Terms Study, 77 percent of the 2017 deals involving a working capital adjustment excluded tax-related items.

Working Capital and the Purchase Price

The price paid by the buyer in a merger and acquisition transaction represents the amount the buyer is willing to pay to acquire both a stream of earnings/cash flows and a measure of capital necessary (i.e., the working capital) to generate such cash flows. At the time the PSA is signed by the parties, a target working capital is estimated for the acquired business. The target working capital memorialized in the PSA ensures that the buyer receives the working capital it expected and, if it doesn't, provides an ability to be compensated for any difference via a purchase price adjustment. If there was no target working capital agreed upon by the parties, the seller could make significant adjustments to the working capital, leaving the buyer with less working capital than expected and no way to be compensated for the variance in working capital from the target. As an example, the seller could aggressively collect cash or receivables prior to closing, taking away current assets for the business that the buyer expected to have to pay upcoming liabilities.

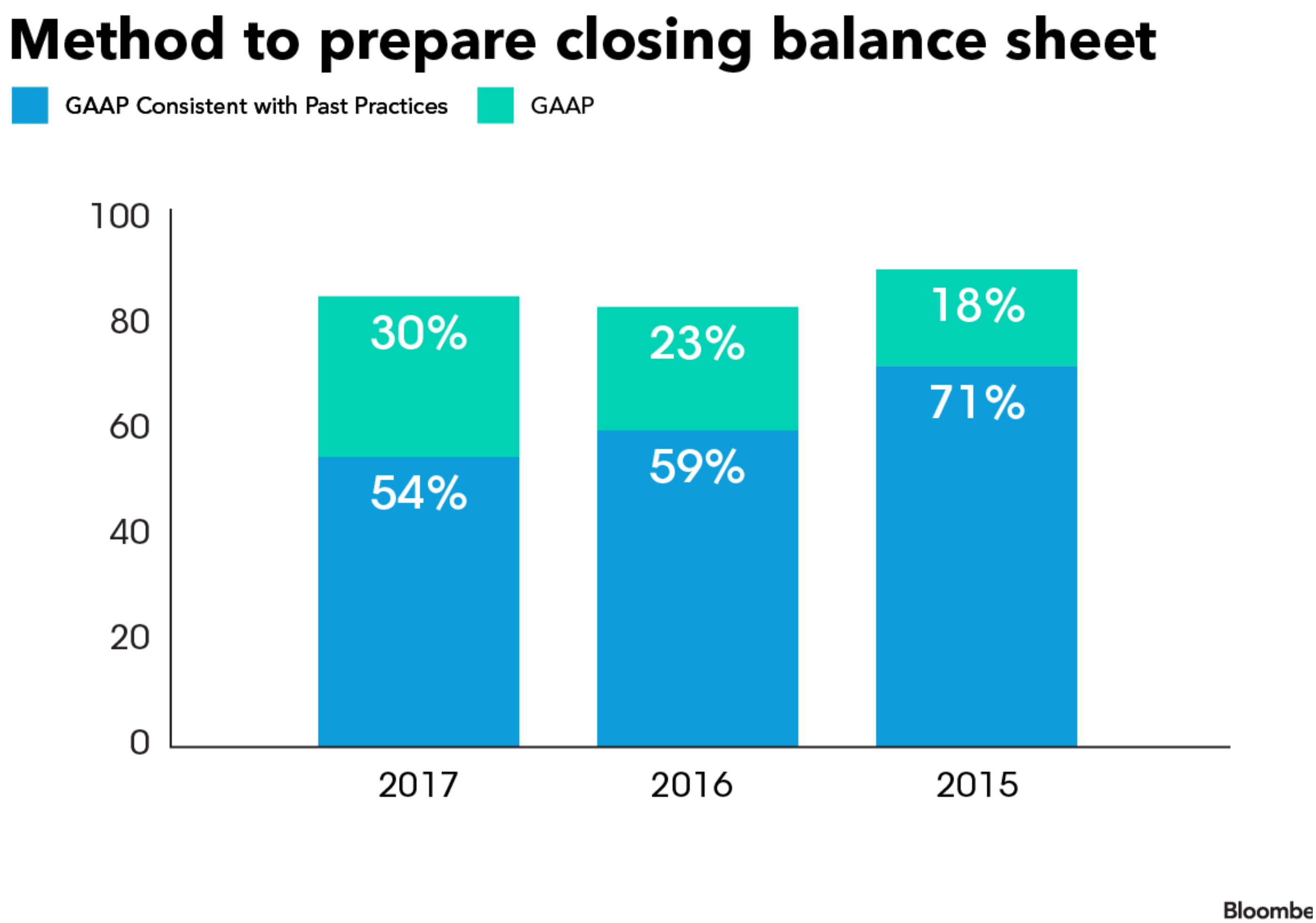
After the transaction closes, the buyer, who now has control of the business, prepares a closing balance sheet. The PSA allows the buyer a certain amount of time after the closing date to prepare the closing balance sheet, 30 days, for example. The actual working capital, calculated from the closing balance sheet, is then compared to the target working capital to determine if a working capital adjustment is necessary. The PSA gives the seller time to review the working capital calculation prepared by the buyer and make objections. If the parties cannot resolve the objections to the working capital calculation on their own, the PSA commonly contains language regarding how to resolve the dispute between the parties.

The PSA often contains language that the proposed working capital adjustment will affect the purchase price, either upward or downward, on a dollar-for-dollar basis. For example, assume a business is purchased for $50 million and the expected working capital is $5 million. If the actual working capital based on the closing balance sheet is $3 million, the purchase price is reduced to $48 million for the lower-than-expected working capital.

Working Capital Disputes

Disputes between the buyer and seller can arise based on 1) whether an account is properly included in working capital; 2) if properly included, whether the working capital item has been properly measured; and 3) whether subsequent events affect the presentation and measurement of financial statement items. The basis for determining whether a working capital item is properly included and measured is usually generally accepted accounting principles (GAAP). Based on a Wiley publication on Interpretation and Application of Generally Accepted Accounting Principles, GAAP establishes:

- "The measurement of economic activity,
- The time when such measurements are to be made and recorded,
- The disclosures surrounding this activity, and
- The preparation and presentation of summarized economic information in the form of financial statements."
- As shown in Chart 2, at least 80 percent of PSAs include provisions that the closing balance sheet should be prepared in accordance with GAAP over the past three years:



GAAP vs. Consistency is often the most hotly contested issue in a post-closing dispute. Consistency refers to how the company accounted for the financial statement item in the past. The seller generally takes the position that its consistent past practice results in a GAAP-compliant presentation. The buyer counters with the position that the seller's past practice is not GAAP-compliant and, therefore, results in an incorrect accounting treatment. Generally, if the seller's past practice or methodology does not result in a GAAP-compliant presentation, then GAAP would typically prevail over consistent past practice. However, this can change depending on the facts and circumstances of the practice in question. For example, certain accounting practices agreed to by the parties within the PSA may trump any GAAP presentation of those items.

The single source of authoritative GAAP to be applied to non-governmental entities is the Codification from the Financial Accounting Standards Board (FASB). The Codification references GAAP in the form of various accounting standard codifications (ASCs). Although GAAP is rules-based and provides the framework for accounting for transactions, there are significant elements fo GAAP that require judgment and interpretation in their application.

Examples of disputes around certain elements of working capital include:

Accounts Receivable

- The reasonableness of the methodology used to estimate the allowance for doubtful accounts
- If the seller is responsible for the collection of existing receivables post-close, what constitutes "best efforts" on the part of the seller?
- Are the receivables included in the estimated balance sheet prepared by the seller valid?

Inventory

- Different approaches to cost estimation when valuing inventory at the lower of cost or market
- Differences in accounting methods for inventory, for example, FIFO versus LIFO
- Reasonableness of the estimated reserve for inventory obsolescence

Accruals and Contingencies

- Whether any accruals and contingencies have been properly included and measured (e.g., benefits accruals, warranty accruals, and litigation)

Subsequent Events

In addition, parties have disagreements over what type of new information, if any, should be considered that becomes available after the closing date. This information is referred to as subsequent events. Under GAAP, there are two types of subsequent events:

- Type one subsequent events provide additional evidence about conditions that existed at the balance sheet date.
- Type two subsequent events provide evidence about conditions that arose after the balance sheet date.

The closing balance sheet should typically be adjusted for any changes in estimates that result from type one subsequent events but not for any adjustments that result from type two subsequent events.

Another issue relating to type one subsequent events involves the length of time after the closing date that the parties can consider subsequent information. The PSA usually calls for the closing balance sheet to be prepared anywhere from 30 days to 90 days after the transaction closes. The timing established by the PSA for preparing the closing balance sheet is usually the longest period that subsequent information can be considered. However, some parties have argued for a longer period, such as information available over any extension of time agreed to by the parties beyond what is established by the PSA or any information that becomes available prior to the final arbitration of the disputed items.

Working Capital Dispute Example

To illustrate the points made above, consider the following example of a post-closing dispute around working capital. The seller runs a services business that provides financial consulting advice for small-to-medium-size businesses and wealthy individuals. In determining the net realizable value of accounts receivable, the seller's accounting practice involved assessing the collectability of receivables based on past collection history to create the allowance for doubtful accounts. The net realizable value is the accounts receivable outstanding less any allowance for outstanding amounts deemed to be uncollectable.

The buyer purchases the seller's consulting business for $5 million. Post-closing, the buyer estimates the collectability of outstanding accounts receivable based on their age and determines that the allowance for doubtful accounts should be $100,000 higher. The buyer then seeks a $100,000 purchase price adjustment from the seller. The buyer's position is that the reserve for accounts receivable established by the seller is not GAAP and understates the risk associated with receivables greater than 90 days old. The seller counters that the company's past practice is in accordance with GAAP and adequately considers the risks of collecting all outstanding accounts receivable.

The determination of whether the buyer or seller's position will rule the day can be based upon the following considerations:

- What is the language regarding financial information in the PSA? For example, if it is GAAP consistently applied and both buyer and seller's method are determined to be GAAP, the consistency factor may allow the seller to prevail.
- Is there any information regarding generally accepted industry practice? If there are certain methodologies within the industry that would lean towards either the buyer or seller's methodology, the arbitrator may rule in favor of that party.
- What are the facts and circumstances around the receivables greater than 90 days? If both methods from buyer and seller are GAAP, can the buyer prove that the methodology employed by the seller would result in an underestimation of the amounts based on collection trends in the business?
- Is the seller's method in conformance with GAAP? If the buyer can prove it is not, then the buyer can prevail, as GAAP would typically prevail over consistency.

The Role of the CPA in Resolving Working Capital Disputes

The CPA can assist the buyer and seller in resolving disputed items around working capital in several ways:

The CPA as Arbitrator

In many instances, when the parties cannot come to a resolution on their own in working capital disputes, the PSA will call for the disputed items to be arbitrated by a neutral party. In arbitration, one or more third-party neutral arbitrators are engaged to act in a similar capacity to a trier of fact. The CPA as an arbitrator can assist the parties in resolving their disputes based on their understanding of GAAP and their experience with the financial reporting items at issue. As arbitrators, CPAs may set the agenda for the arbitration proceeding by identifying the documents to be filed with the arbitrator, establishing the time frame for their receipt, and holding hearings on the evidence. The CPA will evaluate the merits of each party's position and ultimately rule on the items in dispute.

The CPA as Mediator

In mediation, parties present their disputes before a mediator who, unlike in an arbitration, does not adjudicate the disputes. Instead, the mediator facilitates a discussion to resolve the dispute between the parties. In mediation, the CPA can act as a mediator and use their understanding of GAAP and the accounting practices at issue to assist the parties in resolving the dispute. The CPA can also assist one of the parties in presenting its position to the mediator.

The CPA as an Advisor to the Attorney as Mock Arbitrator

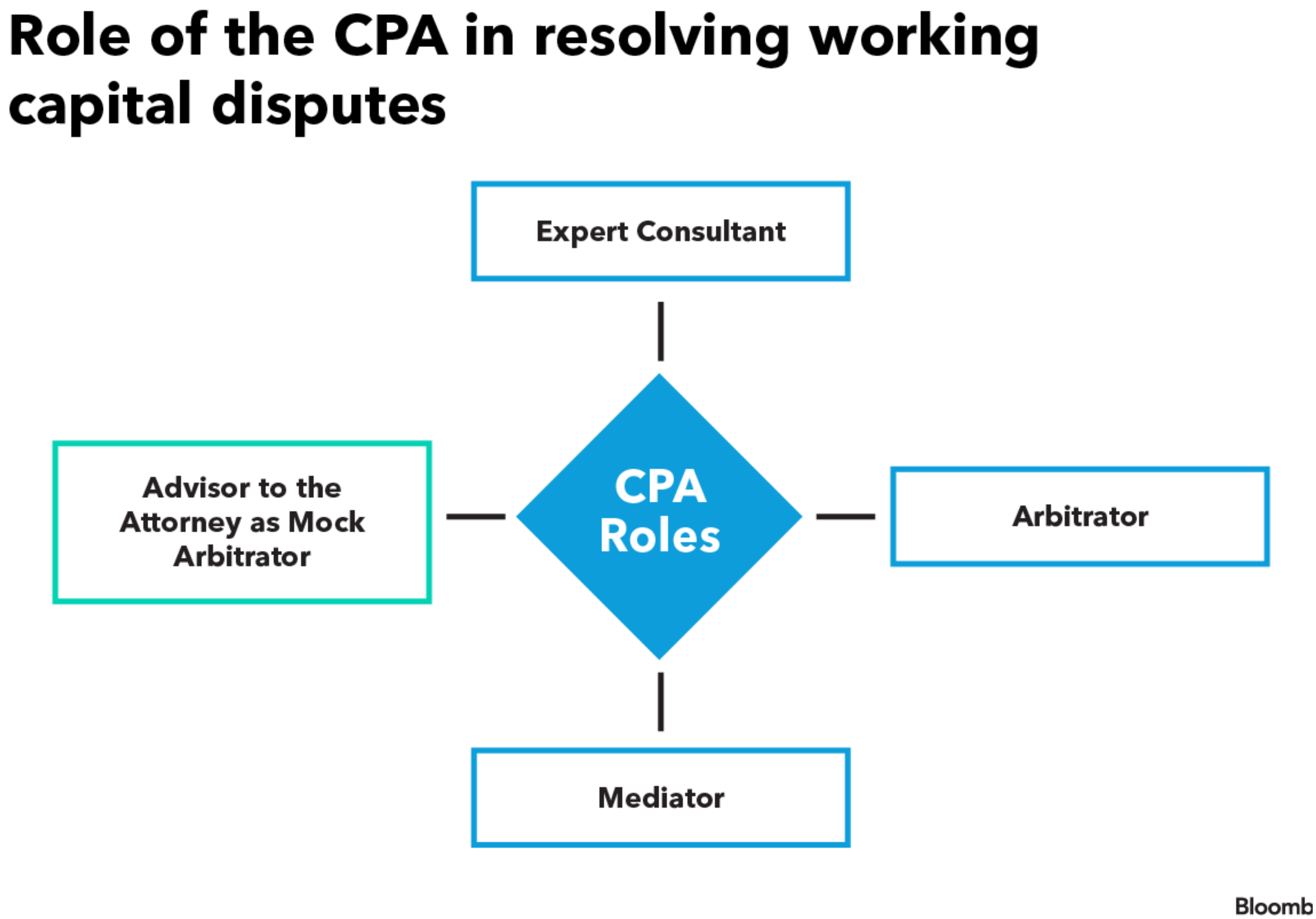
When the attorney acts as the arbitrator in a working capital dispute, the attorney may need assistance in understanding the accounting treatment at issue with the working capital items. The CPA can assist the attorney in ruling on the disputed items by providing the attorney with the necessary understanding of accounting based on a review of the PSA and the accountant's familiarity with the GAAP at issue in the dispute.

The CPA as an Expert Consultant

The arbitration process involves, among other things, requests for discovery, written statements, interrogatories and hearings or conferences. As a consultant, the CPA can help either of the parties with gathering information, preparing written statements and responding to interrogatories. For instance, the CPA can assist the seller in preparing a document request to obtain the necessary information from the buyer to support its claim. As another example, the CPA can also assist the parties in preparing its written statement, often referred to as a position statement, which summarizes the parties position and outlines the reasoning and basis for the respective position. While companies in these disputes turn to their own accounting personnel to prepare and respond to claims, the CPA as an outside accountant can provide unbiased advice in approaching these disputes and can also identify alternative strategic options.

Best Practices for Minimizing the Opportunity for Working Capital Disputes

While the risk of working capital disputes between the parties cannot be eliminated, it can be reduced based on the following actions:



- **The treatment of certain "questionable" items should be specifically addressed within the PSA.** Using the working capital dispute above, if the buyer believed that the collectability of receivables greater than 90 days would be problematic, the buyer could negotiate to have these receivables removed from working capital or structure the deal so that the onus to collect these receivables is on the seller. From the seller's perspective, if it anticipates a potential dispute around how the reserve for accounts receivable is established, the seller could seek to include language in the PSA that the seller's methodology is appropriate for purposes of the working capital calculation.

- **Use clear and unambiguous language within the PSA.** The language used within the PSA should strive to utilize industry or company-specific historical reporting periods and terminology, define terms when the possibility of ambiguity exists, and specifically state limitations on the buyer's operation of the acquired business.

- **Include exhibits and sample calculations within the PSA.** Incorporate a detailed, descriptive calculation as an example along with step-by-step instructions. Also, state the accounting policies to be applied as part of the calculation.

- **Have the closing date consistent with the closing procedures in place for the target acquisition.** If the closing date does not correspond with the normal month-end or quarter-end for the business, additional procedures may have to be performed such as pro-rating certain items that can lead to disputes between the parties. Also, if the target working capital is based on audited financial data and the closing date is prior to the completion of the audit, the PSA should address whether any adjustments should be considered for the unaudited data to make it consistent.

Conclusion

Working capital disputes generally arise based on the difference in the buyer's and seller's understanding around the accounting treatment of the elements of working capital within the confines of the PSA. Generally, the PSA will stipulate that the financial information is either in according with GAAP, past practices, or GAAP consistently applied. Any past practices that deviate from GAAP should be outlined in the PSA. When the disputes involve GAAP, the question becomes whether GAAP was properly applied for a transaction, based on whether an element of working capital was properly included, and if properly included was the element properly recorded.

While GAAP is rules-based and provides the framework for accounting for transactions, there are significant elements of GAAP that require judgment and interpretation in their application. The CPA can assist the buyer and seller in resolving their working capital dispute based on a review of the PSA and the CPA's understanding of the GAAP at issue. The CPA's assistance can come is various roles as either an arbitrator, mediator, adviser or an expert consultant.

The disputes between the parties around working capital center on whether an element of working capital has been properly included, and if properly included has the element of working capital been properly measured. The determination of whether an element of working capital is properly included and measured is based on whether the PSA indicates that the financial information of the target is prepared using the target's historical practices while controlled by the seller, GAAP, or GAAP consistently applied. GAAP consistently applied means that the GAAP used in developing the estimate of working capital prior to close should be the same GAAP used in the calculation of working capital post-close. The target's historical practices are usually identified in the PSA when they deviate from GAAP and include specific language as to how the target's past practice will be used to calculate the element of working capital.

There are ways to minimize the chance of working capital disputes. Buyers and sellers should seek to be as specific as possible with language in the PSA so that the language is clearly understood by both parties. Example calculations should be used when possible. If either the buyer or seller expects questions around any issues prior to the signing of the PSA, they should seek to incorporate language within the PSA to address those issues.

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