Demystifying The M&A Net Working Capital Calculation

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Many negotiations take place in a business acquisition, but one that often causes considerable stress and confusion is the Net Working Capital (NWC) calculation. When a buyer submits a Letter of Intent (LOI) to a seller, they attempt to assign a price to the business. Usually, the seller will retain cash and cash equivalents and pay off any third-party debt on the balance sheet as of closing. The NWC language typically reads, *"The purchase price includes an assumed normalized level of net working capital (typically referred to as a Net Working Capital Target ["target"]) at closing."* The buyer and seller will negotiate the "target" and agree to a dollar amount. If the NWC comes in above the "target," the buyer will pay the seller the difference. The seller will pay the buyer the difference if the NWC falls below the "target." This seems pretty simple and fair, so why might the NWC calculation cause so much heartache and confusion?

Seller Not Following GAAP

One reason for the confusion is that the seller often uses cash or some other modified cash basis of accounting, and the buyer, bankers and investors require Generally Accepted Accounting Principles (GAAP). The change in accounting practices could significantly impact the components that make up the NWC calculation. More often than not, the seller does not fully understand the impact until the NWC negotiation begins.

For example, the seller sees that they get to keep cash at closing but do not realize that any cash they received for services not yet performed at close will be counted as deferred revenue on the balance sheet under GAAP. The seller is accustomed to treating that prepayment as revenue at the time of receipt. That GAAP correction could be several hundred thousand dollars and reduce the amount the seller ultimately receives.

Another common problem for the seller occurs when the seller is slow in entering accounts payable and underreports accounts payable. The seller will be surprised when two to three weeks' worth of accounts payable are added to the balance sheet at close to convert to GAAP. Other unrecorded expenses under the cash basis accounting that work against sellers are items like accrued annual bonuses, sales commissions, payroll, and employee benefit contributions. The buyer will assign those expenses to the period during which they were incurred (pre-close).

Other problems sellers may face are if their AR is aged or their inventory is old, and there are no reserves for bad debt or obsolescence on the balance sheet. The buyer may apply a value post-close to reduce the accounts receivable and/or inventory values, again reducing the final proceeds the seller receives.

It is usually not until after the buyer has done their financial due diligence and has made sure the financial statements reflect GAAP that they are in a position to recommend an appropriate "target" for NWC. Unfortunately, this usually happens near the closing date and the time in which the "target" is negotiated. If needed, the buyer will typically educate the seller on GAAP accounting during this negotiation. If the seller does not fully comprehend GAAP and its impact on NWC, it could be costly, leading to a stressful discussion.

Defining "Normalized" Working Capital

The next sticking point in the NWC calculation is defining "normalized." Normalized working capital is theoretically the current amount of working capital required to run the business at the current level of revenue. First, it can be interpreted as how the seller typically measures NWC, which goes back to the modified cash versus GAAP issue. Sellers may fight to keep doing it the way they always have because it is what they understand. To avoid an accounting nightmare of producing financial statements under GAAP and NWC using modified cash, I would strongly encourage the buyer not to give in. Keep the NWC calculation from switching back to modified cash.

The second component in determining the "target" is the number of months to be included in calculating normalized NWC. The standard choices are either trailing 3, 6, or 12 months. The best practice is picking a more extended period to smooth out abnormalities. Seasonality, rapid growth, and rapid decline can impact the NWC components. Let's use a seasonal landscaping business as an example. In the busy part of the year, accounts receivable might be $1 million, inventory $800k, prepaids $50k, accounts payable $150k, and accrued expenses $150k, for a total NWC of $1.55mil ($1.850mil – $300k). In the winter, accounts receivable might be $200k, inventory $100k, accounts payable $70k, and accrued expenses $40k, for NWC of $190k ($300k – $110k). If you picked the wrong period, that could cost someone over $1 million when the NWC is trued-up.

Redefining NWC Components

Another potential problem could arise if one of the parties tries to change the components of the NWC. For example, one party might try to exclude inventory or accruals from the equation for whatever reason. The beautiful thing about the NWC calculation is that following GAAP provides a well-documented standard that users of financial statements have widely adopted. The NWC fluctuations tend to counterbalance fluctuations in cash and debt levels. For example, let's say after an LOI is signed, the seller decides to stop replenishing inventory to save on cash. That means inventory will drop, and accounts receivable might drop because there is less to sell. The net result is that at the time of close, the seller will deliver a lower NWC, but, in this example, that drop is offset by a higher cash balance.

Another example is if the seller is crushing sales a month before close but has not yet collected accounts receivables. The inventory decreases but turns into accounts receivable at a higher value. In that case, the inventory drop is offset by an increase in accounts receivable. The result is a fair mechanism for both parties.

Asset Purchase Agreement

The Asset Purchase Agreement is the official document that defines the terms of the deal, including the NWC calculation. The buyer typically has 90 or 120 days post-close to deliver the NWC calculation true-up. The buyer needs this time to do a look back and to ensure they have all the revenue and expenses recorded in the correct periods and have properly valued the assets and liabilities that make up the NWC at close.

I have seen asset purchase agreements that say NWC will be "calculated as it has historically been or GAAP." That language is a train wreck waiting to happen. I strongly encourage the language to only reference GAAP because it eliminates confusion.

Conclusion

Introducing GAAP accounting to a business owner, especially late in the business acquisition process, can be very stressful. It takes a lot of patience to work through this negotiation, but transparency is the best policy.

To further discuss this information in more detail or to explore additional business strategies, contact Transaction Advisory Services Director Tim Moellering.

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