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INSIGHT
PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
FALL 2019

GAAP, The False Prophet: Avoiding Working Capital Accounting Arbitrage

How to protect against unintended consequences when a dispute occurs.

by Mark Working

Private business acquisitions nearly always express valuation in terms of a cash-free, debt-free value, subject to a target amount of working capital. The concept of a target amount of working capital and an adjustment mechanism makes conceptual sense: the date of close shouldn't introduce artifacts to a deal that are solely dependent on time and date, and both buyer and seller agree that neither party should be disadvantaged economically as a result of when a deal closes. We have written before on the challenges of determining an appropriate target (Reconciling Purchase Price and Working Capital," Winter 2006, and "Post Closing Adjustment Redux," Spring 2015), but this article is focused on how to protect against unintended consequences when a dispute occurs.

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COMMON LANGUAGE OF A WORKING CAPITAL TARGET

Working capital targets are common in purchase and sale agreements. Generally, a target is established by agreement between the parties, often as an historical average to take into account the cash cycle of the business, and typically is embodied in the agreement as a number. The reason for a specific number is to avoid having someone later rethink the basis for the target. Measurement of the target is defined in terms of specific asset and liability accounts, often accompanied by a schedule showing the calculation of the target and an example as of a specific date along with the implied adjustment (positive or negative). Further, a standard for measuring the amounts in the specific accounts is established, often relying upon GAAP or even more common, "GAAP as consistently applied" in the preparation of the company's financial statements. Buyers want GAAP so the numbers can be relied on as fairly representing the actual business performance. Most companies have external accountants who have audited or reviewed the financial statements and therefore can be comfortable with the standard.

This all seems fair, but…

A WORD ABOUT GAAP

GAAP is often thought of as an absolute accounting standard that eliminates individual judgement. In reality, GAAP is a set of principles practitioners agree to follow in order to prepare statements on a comparable basis, which accounting regulatory bodies think will fairly represent the economic performance of the business. There are many detailed principles, but they all emanate from several core principles, one of which is that practitioners are allowed to use judgement for practical reasons to deviate from principles when they in aggregate do not materially affect the interpretation of the reported results.

In terms of determining working capital in an M&A transaction, the key takeaway is that statements in their entirety can be in accordance with GAAP while individual accounts may not be. Some notable examples:

1. Certain accounts are not reconciled monthly, but instead are trued up at the end of an audit period. Frequent examples include vacation payable, bonus accruals, and 401K contributions, none of which may be material depending on the size of the business.

2. Reserves for receivables may not be recorded with accuracy at the end of each month, but are established through a rigorous process at fiscal year end.

3. Warranty obligations may be expensed as paid as opposed to the establishment of a reserve in every period.

4. Inventory counts and valuations may not be conducted monthly (or daily in the case of a mid-month close) and reserves for out-of-date or slow-moving items may not be rigorously applied, especially for companies with large SKU counts.

ACCOUNTING ARBITRAGE

The purpose of a target is to establish the amount of working capital a buyer needs to support the operations of the acquired business. It is not to deliver a dollar amount of working capital. To that end, sellers should ensure documentation doesn't allow accounting arbitrage, applying different standards to the closing working capital amount than those used to establish the target.

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Shortly after closing, the buyer calculates the actual amount of working capital as of the closing date (in accordance with the standards dictated in the purchase agreement). Especially with a mid-year closing, the buyer's accounting firm will likely "cleanse" the balance sheet to conservatively establish each account with the appropriate reserves and balances, all of which will be in "accordance with GAAP." If there is a disagreement between the parties, an accounting arbiter may be brought in to make a final determination.

This is where GAAP can become the enemy of the seller, as the buyer is trying to obtain a specific dollar amount of working capital, and the seller is trying to convince an accountant that GAAP doesn't matter and is not appropri-

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ate for the measurement. The actual language of the agreement is critical in determining the outcome.

SOME GUIDANCE ON DOCUMENTATION

- The target should be a fixed number, with a schedule provided illustrating how the target was determined. If an average of periods, a schedule should show the account balances in each period and how the calculation was made.
- The financial representation should be for the statements in totality, specifically calling out that judgments of materiality may have been made in individual accounts that could cause those entries not to be in accordance with GAAP. Therefore, the buyer doesn't get two chances to win the argument—first on a working capital adjustment, and if not successful, a GAAP compliance representation breach.
- The standard for measuring closing working capital should be that the closing balance sheet conforms exactly with the accounting policies and procedures used in preparing the statements when determining a target.
- If there is a dispute, the arbiter should be required to rule specifically in accordance with the language of the agreement and not any independent standard of presentation, regardless of GAAP conformance.
- The arbiter should rule separately in each individual account and not give an opinion as to the appropriate amount of working capital.
- Should an account balance be ruled to have changed, that change should be reapplied to all periods used to establish the target, including the immediately prior period, with the target being recalculated with these changes. For example, if a mistake is found where a double counting of an asset was recorded and that mistake had not been noticed since the previous audit, then the mistake should be fixed for all periods and the target recalculated.

PREVENTATIVE CARE IS BETTER THAN SYMPTOM TREATMENT

Post-closing working capital disputes can involve significant dollars, so deal documentation needs to have belts and suspenders. No claim is the best outcome, the odds of which greatly improve through good accounting practices. Before going through a sale process, the accounts should be scrubbed (and restated if necessary) for several years on a monthly basis. An outside accountant should be engaged to review policies and procedures to identify weak points. If there is to be a Quality of Earnings review conducted as part of the buyer's due diligence, a working capital account review should be considered as part of the scope.

No matter the amount of working capital in a business, unfavorable adjustments are always disappointing. It is best to head these off through preparation, but also to make sure documentation assures that fights, should they occur, are about shortfalls in value and not accounting arbitrage. **ZS**

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ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions through three service lines: sell-side M&A, acquisition and investment advice, and direct investing. For more information on Zachary Scott, go to **ZacharyScott.com.**

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