

M&A Nuggets: Working Capital Requirement: The Seller's Scourge?

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By Glenn D. Solomon



One of the most befuddling concepts to a seller in a merger transaction is the working capital requirement. Buyers base their purchase price offers assuming that there will be a normal amount of working capital in the business at closing. To a seller, the concept of leaving any working capital in the business may seem illogical. As a result of these disparate views, an inordinate amount of time is devoted to negotiating the working capital requirement. However, the working capital process does not need to burden moving a deal forward,

There are two key steps in the working capital process. The first step is to establish the target working capital that will be required at closing. The second step is to determine after closing whether the target amount of working capital was left. An important part of determining the target working capital is the definition of working capital itself. In its most basic form, working capital equals current assets less current liabilities. However, sellers are often surprised when buyers propose to include in working capital certain current assets and current liabilities that the sellers have not historically included. Here are two key takeaways to be mindful of when negotiating the definition of working capital:

1. Purchasers prefer to base working capital on a strict GAAP (Generally Accepted Accounting Principles) standard. Sellers, however, often maintain books and records at least in part on a basis other than strict GAAP. Sellers should therefore negotiate for certain of their historical methods of accounting to be utilized to determine working capital, even if at variance from GAAP.
2. Although certain historical accounting practices may not be in accordance with GAAP, it is unusual for a seller's financial statements to be totally divergent from GAAP, that is, many accounting practices will be in accordance with GAAP. There are, however, different methods to account for certain items, all of which are consistent with GAAP. For example, GAAP recognizes several different methods to value inventory. For those items that it is agreed GAAP will apply to, sellers should insist that an agreement be made on which alternative allowed GAAP method is to be used.

The purpose of negotiating the finer details of the working capital target is to have a meeting of the minds between the buyer and the seller, the result of which is no adjustment, or a small adjustment, to the purchase price when actual closing working capital is compared to the target.