

Focus on Forensics

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Post-Acquisition Disputes and Net Working Capital

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The sales price for many businesses is an agreed-upon purchase amount, subject to adjustment for net working capital, or current assets less current liabilities. Typically, the seller performs the preliminary calculation of net working capital using their financial books, records, policies, procedures and staff. In most cases, the preliminary statement is prepared and submitted to the buyer at closing or within a few days after the transaction date. The buyer, however, is usually responsible for computing the post-closing net working capital statement. The buyer prepares this

computation using whatever financial books and records of the seller are available, interpreting the application of the seller's policies and procedures, and using buyer personnel.

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In short, the seller is responsible for preparing the net working capital statement before the sale and the buyer is responsible for preparing this information after the sale. Oftentimes, the seller and buyer disagree about the net working capital calculation to be used for the final purchase price adjustment – giving rise to post-acquisition disputes. A number of post-acquisition disputes could be avoided with some careful planning around common accounting trouble spots.

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Post-Acquisition Disputes and Net Working Capital (continued)



Common Trouble Spots

Accounting Policy Selection

Usually, net working capital statements generated in connection with the sale of a business are prepared and presented in accordance with generally accepted accounting principles (GAAP) as used and consistently applied by the seller. This is often a requirement cited in the purchase agreement. GAAP recognizes that the seller's management team has the responsibility for selecting appropriate accounting policies for the business. Accounting Principles Board Opinion No. 22 defines accounting policies as, "...the specific accounting principles and the methods of applying those principles that are judged by management... to be the most appropriate..." In addition, GAAP acknowledges the use of management estimates, which is often subjective.

Trouble frequently starts when the seller has not adequately apprised the buyer about accounting policies selected and the reasons therefore. In these cases, the buyer and seller are likely to select

differing accounting policies, apply independent judgment, and arrive at divergent estimates while preparing their respective net working capital statements. Simply put, the seller and buyer may prepare and report net working capital statements using inconsistent accounting policies and differing judgments

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Commonly, inconsistencies and differences arise between the seller and buyer from a handful of issues related to accounting policies. These issues generally can be classified into six areas: (1) cut-off; (2) liability, loss and asset value estimates; (3) allocations; (4) taxes; (5) disclosures; and (6) materiality.

Cut-off

Cut-off policies stop, or "cut-off," the collection of information used to prepare financial statements. In this instance, cut off applies to the time allowed to collect information, say two weeks, in order to prepare the current assets and current liabilities for the net working capital statements. Cut-off policies are designed to identify, capture, record and report economic activity in the proper period, taking into consideration practical limitations related to document collection and the need for timely information.

Cut-off is often a post-acquisition problem because the seller and buyer use different periods. The seller is often required to prepare the preliminary net working capital statement within a few days after the date of sale. As such, the seller's usual cut-off policies are ignored and the cut-off period is shortened. As a result, more estimates are used in an attempt to properly capture information. Later, when the buyer prepares their version of the net working capital statement, the cut-off period is extended using the seller's customary cut-off policy or another applied by the buyer after the purchase. A longer cut-off period may provide more accurate information, but it can differ from the estimates made in haste by the seller's staff. Therefore, current asset and current liability balances differ between the seller and buyer sometimes causing a dispute.

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Liability, Loss and Asset Value Estimates

As stated earlier, the preparation and reporting of the net working capital statements by the seller and buyer requires the use of estimates based on judgment. Among other items, estimated amounts in the net working capital statements may include current liabilities (e.g., accounts payable, accrued liabilities), loss contingencies (e.g., uninsured damage, litigation), and current asset valuations (e.g., pre-paid rent, allowance for uncollectible accounts receivable, reserves for obsolete inventory, impairment reserves). Estimates of net working capital accounts are determined at a point in time using significant judgment about expected actions to be taken to achieve a predicted outcome of uncertain future events.

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Post-acquisition disputes arise when the seller and buyer fail to adequately identify, understand and agree on significant estimates to be included in the net working capital statements and how they will be determined and reported. For example, at the time the seller prepares the statements, he/she may believe, based on the information they have or should have had at the time that certain products in inventory are likely to be profitably sold in the future. This judgment includes assumptions about future customer buying habits, marketing programs to be used, technological changes anticipated, competitor responses known or anticipated, and sales force performance. The seller may not believe it is appropriate, and therefore may not accrue, an estimate to record a reserve for future losses. Using its own judgment, different assumptions, and perhaps a little hindsight, the buyer subsequently may conclude that the same inventory is, and was then, worthless and should have been fully reserved on the date of sale.



Allocations

Allocations match revenue and expense generating activities to the entity/division/department actually earning the revenue or receiving the benefit from the expenditure. For instance, expenses incurred by a corporate holding company on behalf of a controlled group (e.g., facilities lease expenditures, insurance premiums paid, financing costs, employee benefits) might be allocated to members of the group based on an estimate of usage. In circumstances where a business is sold and it was previously reported by the seller as a division, segment, or part of a consolidated group, there may be elements of working capital that include allocations of revenues and expenses that should be considered by the seller and buyer when preparing the net working capital statements.

However, if the seller has not fully informed the buyer about significant allocations historically estimated and reported by the seller in current assets and current liabilities it is likely that a dispute will ensue regarding the appropriateness of including these items in the purchase price adjustment. In most cases, the seller will want to recover the allocated amounts, particularly expenses, because they represent estimates of actual expenditures that will ultimately benefit the buyer. Conversely, the buyer has an incentive to minimize the seller's expense allocations and increase revenue allocations to decrease the ultimate sales price.

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Taxes

Tax assets and liabilities may or may not be includable in net working capital related to the sale. That is the first issue to be addressed by the seller and buyer. Tax matters can be complex and require counsel from international, state and local, employment, regulatory, federal taxation and legal professionals. Similar to the GAAP matters mentioned earlier, management judgment is required to elect tax positions and prepare tax returns.

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Due to the complexities, the judgment involved and the high potential for adverse consequences, the parties will often initiate disputes over small matters. This is because of the potential involvement of third party regulators (e.g., IRS) in the resolution of most tax related matters and the associated risk of business and personal fines and penalties. In severe cases, it may also result in civil or criminal charges.

Disclosures

Even though financial statements prepared and reported under GAAP require footnotes for the reader, net working capital statements prepared in connection with a sale usually do not

include these disclosures. Regardless of whether footnotes to the statements are used, the seller should disclose any material information needed to read and fully understand the preliminary net working capital statement. Often the items getting the most attention from the buyer are related party transactions, off-balance sheet liabilities and adverse subsequent events. Therefore, the seller should be exceptionally diligent about transparency in these areas.

The big problem in this area is when the buyer later finds the seller's disclosures insufficient or omitted altogether. The resulting dispute centers on the trustworthiness and reliability of the seller. Therefore, the buyer may believe the only way to discover potentially important information is to start a post-acquisition dispute because they are unable to rely on the seller's disclosures and representations.

Materiality

Materiality as used in connection with the sale of a business is not the same as materiality used in the preparation of financial statements. Therefore, use of financial statement materiality by the seller and buyer is typically inappropriate. Materiality for the sale and purchase of a business is defined by what is important to the seller and buyer. As a safe harbor, each party should treat items as material if there is a strong likelihood that the opposing party might consider it important. Therefore, the parties may need to have a number of candid discussions to get a sufficient understanding of potentially important matters.

The determination of materiality by each party always includes an evaluation of monetary significance (i.e., the dollar amount each party believes would influence their decision-making) and/or percentage magnitude (i.e., the percent or ratio change each party considers critical). These are considered quantitative factors. Materiality also requires the parties to assess certain qualitative factors, such as the honesty, integrity and reliability of the other party.

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Disputes are created because the parties fail to discuss and agree on materiality for purposes of preparing the net working capital statement. Consequently, the buyer finds fault with a number of items immaterial to the seller's preliminary net working capital statement taken as a whole. A buyer may dispute individual transactions, line items, accounts, groups of accounts, or the classification of balances.

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Post-Acquisition Disputes and Net Working Capital (continued)

Avoiding Common Trouble Spots

Following is a list of a few items for parties to consider when preparing and presenting a net working capital statement in connection with the sale of a business to avoid common accounting trouble spots:

1. Reach agreement on how net working capital statements are to be prepared by the parties. It may be prudent to agree on items such as accounting policies and estimation practices to be used, including detailed methodologies and formulas.
2. Clearly identify significant liability accruals, loss contingencies, and asset reserves and consider using agreed-upon methods, formulas and assumptions to evaluate and compute these estimates.
3. Understand the seller's cut-off policies and agree to use a standard cut-off policy after the sale.
4. Identify any allocations affecting net working capital items and reach agreement on the appropriateness and methodologies to be used for the preparation of the net working capital statements in connection with the sale.
5. Identify and agree on the inclusion of any tax assets and liabilities in the net working capital statements prepared for the sale. Engage professional advisors and secure tax opinions for important or controversial matters.
6. Identify and require the full and complete disclosure of important matters related to reading and understanding the net working capital statements. These are equivalent to the footnotes required under GAAP for financial statements. Consider performing due diligence procedures to determine the completeness and appropriateness of disclosures. In addition, expect that the disclosure of internal accounting controls will become more important in the future.
7. Consider joint access agreements for the parties to have available any critical records (e.g., financial books and records), resources (e.g., key accounting personnel) and tools (e.g., software applications) necessary to prepare net working capital statements.
8. Agree to specific quantitative materiality thresholds for individual and aggregated items to qualify for dispute resolution (Note: It is generally impractical to identify all of the qualitative factors).•



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Mr. Preber is the National Litigation Consulting Practice Leader in Grant Thornton's Advisory Services practice. He is a Partner in the Advisory Services practice located in Phoenix and is the regional Partner-in-charge of forensics, investigation and litigation services provided in the western United States. Mr. Preber is a Certified Public Accountant, Certified in Financial Forensics and Certified Fraud Examiner with over twenty-five years experience serving as a litigation consultant, expert witness, forensic accountant and fraud investigator. He specializes in complex claims and events, with a particular emphasis on class actions, commercial disputes and fraud claims. He frequently speaks, writes and teaches on leadership, accounting and fraud matters.

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