How Much

Working Capital

Should be Included?

Tackling the Working Capital Calculation for M&A Transactions

Working capital, defined as current assets minus current liabilities, helps to reveal a company's financial health. If working capital is high, there is lots of gas in the tank, and the business can run smoothly. If, on the other hand, working capital is low, the tank is running dry and it may be a choppy ride. Buyers will need to infuse it with additional capital to shift it into gear and drive toward their goals.

Thus, although "working capital" may sound like accounting jargon that many would prefer to ignore, it is a critical aspect of every merger and acquisition (M&A) deal. Including it in the value of a company can make the difference of hundreds or even millions of dollars at closing, so it's an essential part of buy-sell negotiations. Despite its importance, discussion about working capital often surfaces toward the end of a transaction process.

While it may seem that analyzing financial statements would naturally produce a mutually agreed-upon company value, deal history shows it's almost always necessary to negotiate working capital. Agreeing on how to calculate it and how much the buyers need to operate the company is complex. To add to the challenge, the number does not remain static. It is a moving target from when the letter of intent is sent right up to a closed deal. The following provides a general understanding of working capital designed to help the seller's deal negotiating team maximize value.

Calculating Working Capital

We are focusing on the cash-free, debt-free definition of working capital, which parties use for most private market deals. This characterization is applicable when the seller agrees to extract excess cash and pay off outstanding debt before consummating the transaction. By focusing on a cash-free, debt-free deal, we can simplify the process of identifying current assets and liabilities on a Trial Balance or Balance Sheet. That's because it limits the number of terms people need to learn to understand the components of working capital.

Below are the terms to look for in financial statements. They will help those involved in an M&A transaction to set a target number for working capital during negotiations.

- **The Plus Side: Current Assets**

Current assets are those that businesses can easily convert into cash or value within a year, such as money due from customers. It also includes production components (raw materials, work in process and finished goods) and expenses paid ahead of time.

Key accounts to look for on financial statements include uncollected revenues (**accounts receivable**), services already paid for but not yet consumed (**prepaid expenses**), inventory, and income earned but not billed **(costs and estimated earnings in excess of billings)**.

When customers pay their bills, receivables become cash. Inventory will turn into sales. Prepaid expenses, such as prepaid rent on a warehouse, mean you won't have to pay for the rent sometime in the next year. Because these components represent future cash flows or provide value without requiring expenditures, it's important to be aware of them when considering a company's value.

- **The Minus Side: Current Liabilities**

Current liabilities represent money the business owes and needs to pay out over the next year. The main components of this category include money owed to suppliers (**accounts payable**), income received but not yet earned (**deferred revenue**), recognition of expenses not yet paid (**accrued expenses**) and billings for work not yet completed on contracts (**billings in excess of costs and earnings**).

The Final Equation

While it's better to leave the specific inputs to accountants and investment banking professionals, the working capital equation is relatively simple:

> **Working Capital** = Current Assets (accounts receivable, prepaid expenses inventory and costs and estimated earnings in excess of billings) - Current Liabilities (accounts payable, deferred revenue, accrued expenses and billings in excess of costs and earnings)

Working capital is a zero-sum game: sellers want to reflect the lowest possible value while buyers want to establish the highest value. Since savvy buyers will scrutinize the inputs to this equation, business owners preparing to sell their companies need to understand them fully. It will help them place a fair value on the value of their company's working capital and can have a significant positive impact on the final deal.

18 E COURT STREET

DOYLESTOWN PA 18901

215.489.8881