The McLean Group
INVESTMENT BANKING

Valuation Vantage©

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The McLean Group's Valuation Practice

As a core competency and complement to its mergers & acquisitions (M&A) practice, The McLean Valuation Services Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes.

Working Capital – An Important Detail Not to be Overlooked

Merger and acquisition (M&A) transactions almost always include a provision for a working capital adjustment as part of the overall purchase price. Typically, a buyer and seller agree to a target working capital amount which is documented in the purchase agreement. Buyers want to ensure that they are acquiring a business with adequate working capital to meet the short-term operating requirements. Sellers, on the other hand, want to get compensated for business that they have already performed and not give away excess working capital at closing.

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Contingent Consideration: Is it Purchase Price or Compensation Expense?

Depending on how an acquisition is structured, contingent payments made to employees as part of the sales price of a business may be treated as compensation expense or included in the purchase price (ASC 805).

It is important to analyze why certain provisions are included in the agreement. The intent behind formulas used to determine the amount of additional consideration may shed light on how payments

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A working capital adjustment, as detailed in the purchase agreement, will call for the buyer to pay the seller (on a dollar-for-dollar basis) any excess in the closing balance sheet that is above the target. On the flip side, the seller will receive less for any shortfall in the closing balance sheet that is below the target. Escrow accounts are typically used to reserve for working capital adjustments.

Due to the necessity and often the significance of working capital provisions included in purchase agreements for M&A deals, it's important for a seller to be aware of how her company's balance sheet will affect the potential consideration she will receive in a transaction. Excess working capital balances (or deficiencies) affect the equity value of a business. A buyer will typically value a target's business on an enterprise value basis first. This valuation can be achieved via a discounted cash flow analysis or by applying valuation multiples to the company's financial metrics (such as an enterprise value/EBITDA multiple). The enterprise value is generally referred to as the "Base Purchase Price" in the purchase agreement. Next, after any interest bearing debt has been subtracted, the buyer will usually include an upward or downward adjustment for the working capital, referred to as the "Working Capital Adjustment."

The purchase agreement generally states that the closing balance sheet will be delivered within one to three months after the closing date with the assistance of an independent accounting firm. The closing balance sheet is prepared in accordance with Generally Accepted Accounting Principles ("GAAP") and is typically equal to current assets less current liabilities. However, in many transactions, the calculation of working capital can be much more complicated as the buyer and seller may disagree on what should or should not be included in the working capital calculation. In addition, there are some areas in GAAP that require judgment (such as the allowance for doubtful accounts) that can potentially cause a difference of opinion on the treatment of some accounts.

In a business valuation, if it is for a company to determine the strike price of its options or for a purchase price allocation, the process includes an analysis of working capital levels. The working capital analysis affects the reconciliation of the company's balance sheet to the net equity in the business. Whether the working capital analysis is taken into account as part of the reconciliation from enterprise value to equity value (as excess working capital or as a working capital deficiency) or if it is taken into account as part of the discounted cash flow analysis, an understanding of the working capital requirements is essential in a business valuation.

Therefore, a valuation needs to assume that a buyer will require a certain working capital amount. To estimate the target working capital, a company can analyze a number of different factors, such as:

- The company's historical working capital levels (as a percentage of revenue or other metric);
- Working capital levels of comparable public companies, or
- A rule-of-thumb for the number of days of operating expenses for the company's industry.

To provide more background on the last factor, companies in certain industries tend to peg working capital levels to a target number of days of operating expenses. For example, in government contracting M&A transactions, buyers typically require working

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capital equivalent of 30 to 60 days of operating expenses. If the company's days sales outstanding ("DSO") generally run at the higher end of the range for the industry, a buyer would most likely increase the working capital target.

Understandably, the enterprise value (or base purchase price) is the primary point of emphasis when analyzing a business valuation. However, the company's working capital will also play a role in the final determination of the equity in a business and the ultimate consideration paid to the seller. Therefore, it's important for business owners to be aware of how working capital factors into the equation. ◆

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should be handled for accounting purposes.

As stated in EITF Issue 95-8, contingent consideration may qualify as a compensation expense if an arrangement is forfeited because of employment termination. To help clarify some issues that arise when determining how to handle contingent consideration, as outlined in ASC 805, contingent payments may be classified as compensation expense if:

- Payments are affected by the termination of employment.
- The duration requirement of the key employee coincides with the duration of the contingent payments.
- The compensation awarded to the key continuing employee is not at a reasonable level in comparison to fellow employees' compensation, not including contingent payments.
- The non-employed shareholders receive less on a per share payment basis than shareholders who are employed after the transaction.
- Selling shareholders who become cotinuing employees receive greater benefits than those who are not selling shareholders.

It is essential to understand why contingent payments are structured as part of the transaction. Subjective views regarding the agreement's intent may make it difficult to decide how to treat contingent consideration. This subjectivity arises from the terms in the agreement that involve a selling shareholder becoming a continuing employee post-acquisition. Typically, the purpose of a contingent payment is to resolve disagreements regarding purchase price or compensation expense issues specifically related to a key continuing employee.

As noted in a speech by the SEC, "a contingency arrangement that is tied to employment [can be] treated as purchase price." However, the SEC continues to stress that the specific facts and circumstances are critical to understand and that it is important to "carefully consider the factors relative to your particular arrangement." ◆

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Spotlight on Court Cases

Murphy Case Highlights Discounts for Lack of Control and Marketability
Murphy v. U.S., 2009 WL 3366099 (W.D. Ark.) (Oct. 2, 2009)

In this case, Mr. Murphy owned interests in a publicly traded oil company, a timberland and farmland company, and a bank. The owner formed a family limited partnership ("FLP") to centralize management and protect family assets (worth $135 million). When Mr. Murphy died, he owned a 95% limited partnership interest in the FLP and the IRS issued a notice of deficiency for $34 million, alleging that the estate undervalued various assets and that the FLP assets were includable in the estate under 2036(a)(1) and 2036(a)(2). The court agreed that a bona fide sale was in accordance with section 2036. Both experts began examining the appropriate discounts for lack of marketability, control and rule 144/blockage discount.

Both the estate's expert and the IRS expert agreed that a rule 144/blockage discount would apply, but disagreed on what it should be. The court found the estate's expert was more credible because he analyzed the size of the block relative to the daily trading volume, volatility of stocks and the price change in the stock under recent and preceding market conditions. In addition, the IRS did not consider SEC sales restrictions.

Both experts determined appropriate lack of control discounts using data from closed-end equity funds. The court decided that the estate's expert was more credible because he looked at funds that were similar to the FLP's equity category. In addition, the estate's expert included a 5% discount for cash, claiming that an investor would have no control over how this cash could be invested. The estate expert's final discount for lack of control was a weighted average of 12.5%. In contrast, the IRS' 10% lack of control discount was rejected by the court.

Restricted stock studies were used to compute the discount for lack of marketability of 32.5%. The court agreed with the estate expert's opinion since he compared the data to three studies (FMV Opinions, management planning, and Silber) to the holding period, relative risk, distributions policy, and transfer restrictions of Mr. Murphy's interest. Based on the analysis, the holding period of Mr. Murphy's interest was longer than that of the restricted stock studies. In conclusion, the court found the fair market value of Murphy's 95% LP interest to be $74.5 million and mandated a full refund to the estate.

Practice Highlights

- Brian Sullivan presented "Valuation Issues in a Down Market" to the California Society of CPAs.

- Andy Smith presented "Best Practices in Fair Value Accounting" at the Colorado Society of Certified Public Accountants' Annual SEC/PCAOB Conference in Denver.

- Shari Overstreet and Andy Smith presented "Business Valuations for Lawyers and Litigators" and "Best Practices in Fair Value Accounting" for several accounting, law and consulting firms in Austin, Texas.

The McLean Group is a national middle market investment bank providing mergers & acquisitions (M&A), capital formation, market intelligence, business valuation, litigation support and exit planning services in 29 offices in the US and Canada. The McLean Valuation Services Group performs business valuation services for transaction, financial reporting and tax purposes. The McLean Valuation Services Group has dedicated business valuation offices in the following locations:

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