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Working Capital Adjustments in Due Diligence

BUSINESS ADVISORS, DUE DILIGENCE , TRANSACTION ADVISORY SERVICES
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During a transaction, efforts need to be made to evaluate the level of working capital sufficient to sustain current operations of the business. This is necessary because a buyer allocates value to the enterprise value of the business, and also requires the seller to deliver an amount as working capital.

Working capital is defined as current assets less current liabilities, and is a measure to evaluate the short-term health of the company, or the ability to pay upcoming commitments. This is easy enough to calculate on paper, but the number can be misleading if upcoming cash inflows and outflows aren't property accounted for. For example, if the receivable associated with a recent sale transaction isn't properly recorded, working capital will be understated. Although this would be beneficial to the buyer in that they would receive the future benefit, proper evaluation of working capital is crucial to the day-to-day operation of business. In the case of failing to record a future payable, this will overstate the calculation, causing a cash outflow to the buyer that would have otherwise been taken into account within the working capital considerations. In a company with tight cash flow requirements, this could become disastrous.

As part of a transaction, the buyer will often wait 90 to 120 days after closing of the transaction until making a final determination of the amount of working capital required by the business. By this time, most of the accounts will be closed and operating transactions can be identified. Once a final working capital number is decided upon, it is compared to preliminary figures, and any adjustment is made as needed in the form of cash due to or from the buyer. In anticipation of these adjustments, a holdback of funds is often requested by the buyer.

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