

M&A; EXECUTION PROGRAM

PART 06 OF 12 · PART 2: WORKING CAPITAL & CLOSING MECHANICS

PART 6

NWC ADJUSTMENT: THE FOUR IMPACT CASES

A deep dive into the four working capital components that most commonly create disputes and surprises at closing: accounts receivable aging, inventory obsolescence, accounts payable stretching, and accrued liabilities — with a complete closing statement walkthrough.

IN THIS PART

- A/R aging analysis and collectibility adjustments
- Inventory obsolescence reserves
- A/P stretching and normalization
- Accrued liabilities completeness
- Construction WIP and under-billings
- The complete closing statement mechanics

THREE CASE STUDIES

Each session includes one fully worked case study with detailed calculations, negotiating dynamics, and CFO-level decision frameworks.

■ SESSION 6: THE FOUR NWC IMPACT CASES

Why Working Capital Causes More Post-Close Disputes Than Any Other Item

The NWC adjustment is the single most litigated element of M&A transactions. The reason is structural: the enterprise value is agreed weeks or months before closing, but the actual NWC delivered at closing is measured on a specific date using definitions that are often ambiguous. Small differences in methodology — how AR is aged, how inventory is valued, how accruals are estimated — compound into significant dollar amounts at closing.

There are four NWC components that generate the majority of disputes. Understanding the accounting standards, the practical measurement challenges, and the negotiating dynamics of each is essential preparation for any closing process.

Impact Case 1: Accounts Receivable Aging

Accounts receivable represents the most liquid component of NWC — but not all AR is equal. Older receivables have lower collectibility. The QofE and closing statement must include an appropriate allowance for doubtful accounts based on a rigorous aging analysis.

◆ AR AGING AND RESERVE ANALYSIS

AR AGING ANALYSIS & COLLECTIBILITY RESERVE

AR Aging Bucket	Gross AR	Reserve %	Net AR
0-30 days:	\$3,200,000	1%	\$3,168,000
31-60 days:	\$1,400,000	5%	\$1,330,000
61-90 days:	\$680,000	15%	\$578,000
91-120 days:	\$320,000	40%	\$192,000
121-180 days:	\$180,000	75%	\$45,000
180+ days:	\$94,000	100%	\$0

Gross AR Total: \$5,874,000

Allowance for Doubtful Accounts: (\$561,000)

Net AR for NWC: \$5,313,000

COMPANY'S STATED ALLOWANCE: (\$185,000)

REQUIRED ALLOWANCE (aged analysis): (\$561,000)

NWC SHORTFALL FROM AR: (\$376,000)

Seller understated bad debt reserve by \$376K
 → NWC is overstated by \$376K
 → Closing wire reduces by \$376K

Impact Case 2: Inventory Obsolescence

Inventory valuation under GAAP is at the lower of cost or net realizable value (LC/NRV). Many private companies carry inventory at cost without applying appropriate obsolescence reserves. The QofE team must perform an independent obsolescence analysis based on inventory turnover, slow-moving item reports, and market pricing data.

◆ AP STRETCHING ANALYSIS

AP STRETCHING DETECTION — DPO ANALYSIS

Historical DPO (Days Payable Outstanding):

Q1 (Jan-Mar): DPO = 42 days AP = \$1,820,000

Q2 (Apr-Jun): DPO = 44 days AP = \$1,910,000

Q3 (Jul-Sep): DPO = 43 days AP = \$1,865,000

Q4 (Oct-Dec): DPO = 61 days AP = \$2,646,000

(CLOSE OCCURS DEC 31 — AP ARTIFICIALLY INFLATED? NO.)

WAIT — Higher DPO LOWERS NWC (AP is a liability)

**Actually: if DPO suddenly DROPS close to closing,
it means AP was paid DOWN — inflating NWC artificially**

REVISED EXAMPLE — AP PAID DOWN BEFORE CLOSING:

Normal DPO: 43 days; COGS/day = \$52,000

Normal AP at 43 DPO: $43 \times \$52,000 = \$2,236,000$

Actual closing AP (seller paid down): \$1,420,000

AP understated vs. normalized: \$816,000

NWC OVERSTATED by: \$816,000

(Fewer liabilities = higher NWC = more \$ to seller)

NORMALIZATION: Add back \$816K to AP → reduce NWC peg

Impact Case 4: Accrued Liabilities Completeness

Accrued liabilities represent expenses incurred but not yet invoiced or paid. They include accrued wages, vacation/PTO liability, warranty reserves, customer deposits, contract completion costs, and many others. Under-accruing these liabilities inflates NWC. The QofE must verify the completeness of all accruals.

◆ ACCRUED LIABILITIES — COMPLETENESS

ACCRUED LIABILITIES — COMPLETENESS REVIEW

VACATION/PTO ACCRUAL:

Average headcount: 145 employees

Average hourly rate: \$28.50/hour

Average accrued PTO: 6.2 days = 49.6 hours

Required accrual: $145 \times 49.6 \times \$28.50 = \$204,948$ **Company's stated accrual: (\$148,000)****Shortfall: (\$56,948)**

WARRANTY RESERVE:

LTM sales subject to warranty: \$12.4M

Historical warranty claim rate: 2.3%

Required reserve: $\$12.4M \times 2.3\% = \$285,200$ **Company's stated reserve: (\$180,000)****Shortfall: (\$105,200)**

BONUS ACCRUAL:

Annual bonus pool (expected): \$380,000

6 months accrued (close = June 30): \$190,000

Company's stated accrual: \$0 (oversight)**Shortfall: (\$190,000)****TOTAL ACCRUAL SHORTFALLS: (\$352,148)****NWC OVERSTATED BY: (\$352,148)**0
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CASE STUDY 1

Riverstone Construction LLC*Under-Billings (WIP) — \$1M NWC Shortfall at Closing***Background**

Riverstone Construction uses the percentage-of-completion method for revenue recognition. The company has \$28M of backlog with several projects at various stages of completion. The QofE team identified significant under-billings (work performed but not yet billed) and over-billings (billed but not yet earned) that needed to be analyzed carefully to determine their NWC treatment.

◆ RIVERSTONE WIP ANALYSIS

RIVERSTONE — WIP / BILLINGS ANALYSIS

Project Analysis:

Proj Contract \$ % Complete Revenue Earned Billed To Date Under/(Over)

A \$4,200,000 72% \$3,024,000 \$2,600,000 \$424,000 (under)

B \$2,800,000 45% \$1,260,000 \$1,050,000 \$210,000 (under)

C \$6,100,000 88% \$5,368,000 \$5,800,000 (\$432,000) (over)

D \$1,900,000 30% \$570,000 \$720,000 (\$150,000) (over)

E \$3,400,000 55% \$1,870,000 \$1,504,000 \$366,000 (under)

Total Under-billings (asset): \$1,000,000

Total Over-billings (liability): (\$582,000)

Net WIP Position: \$418,000

NWC TREATMENT:

Under-billings (\$1M) = current asset IN NWC

Over-billings (\$582K) = current liability IN NWC

BUYER'S CHALLENGE — COLLECTIBILITY OF UNDER-BILLINGS:

Project A: 90 days overdue on billings — customer dispute

Risk-adjusted value of Project A under-billing: \$254,400 (60%)

QofE adjustment: (\$424K - \$254K) = (\$169,600) deducted

ADJUSTED NWC IMPACT: (\$169,600)

The Complete Closing Statement

The closing statement is the document that translates all of the NWC analysis into the final wire amount. It is prepared initially by the seller, reviewed and adjusted by the buyer, and then finalized through the post-close true-up process.

◆ RIVERSTONE — COMPLETE CLOSING STATEMENT

COMPLETE CLOSING STATEMENT — RIVERSTONE CONSTRUCTION

Agreed Enterprise Value: \$24,000,000

Cash and Cash Equivalents (closing): \$480,000

Less Funded Debt:

Equipment notes payable: (\$1,840,000)

Vehicle fleet financing: (\$320,000)

NWC Adjustment:

Closing NWC (estimated): \$3,840,000

NWC Target (Peg): (\$4,200,000)

NWC Shortfall: (\$360,000)

(AR reserve shortfall + inventory + WIP adjustment)

ESTIMATED CLOSING WIRE:

\$24,000,000 + \$480,000 - \$2,160,000 - \$360,000

= \$21,960,000

ESCROW / HOLDBACK: (\$2,400,000)

(10% of EV, released after 18-month NWC true-up)

NET WIRE AT CLOSING: \$19,560,000

ESCROW RELEASED AFTER TRUE-UP: \$2,400,000

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CASE STUDY 2

Summit Packaging Corp.

AP Normalization — \$680K Dispute Over Vendor Payment Timing

Background

Summit Packaging Corp. closed on a Thursday. The seller's finance team had delayed the weekly vendor payment run (normally Tuesday) by two days, reducing AP artificially by \$680,000 — which inflated NWC by the same amount. The buyer's closing accountants identified the payment delay in the bank statement review.

◆ AP MANIPULATION DETECTION

SUMMIT — AP MANIPULATION DETECTION

Normal weekly AP disbursement (Tuesday): \$340,000

Week of closing (Thursday close):

Tuesday payment run: SKIPPED

AP balance at close: understated by \$340,000

Following week would have been: another \$340,000

Total manipulation: \$680,000 lower AP = \$680,000 higher NWC

BUYER'S POSITION:

AP should be normalized to 42-day DPO average

Normalized AP: $42 \times (\$52K \text{ COGS/day}) = \$2,184,000$

Actual AP at close: \$1,504,000

Normalization adjustment: (\$680,000)

NWC adjustment to buyer: +\$680,000 credited back

RESOLUTION: Seller agreed to \$680K NWC downward adjustment

SPA rep confirmed: 'AP shall reflect payments made consistent with historical payment patterns'

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CASE STUDY 3

BioServ Clinical LLC*Deferred Revenue Classification — \$1.2M Debate at the Closing Table***Background**

BioServ Clinical provides laboratory testing services on annual subscription contracts. At closing, BioServ had \$1.2M of deferred revenue (cash collected in advance but not yet earned). The fundamental question: is deferred revenue a debt-like item (excluded from NWC, deducted from enterprise value) or a NWC liability? The answer depended entirely on the SPA definition — and the LOI was silent on this point.

◆ DEFERRED REVENUE — NWC vs. DEBT-LIKE

BIOSERV — DEFERRED REVENUE CLASSIFICATION

SELLER'S POSITION (NWC Liability):

Deferred revenue is a normal current liability
It is part of the operating working capital cycle
Included in NWC → offset by NWC peg → near-zero impact
Impact on price: ~\$0

BUYER'S POSITION (Debt-Like Item):

Deferred revenue = obligation to deliver services
at below-market cost (margin is zero on already-billed work)
It is an economic liability like funded debt
Excluded from NWC; deducted from EV directly
Impact on price: (\$1,200,000)

MARKET PRACTICE:

High-margin SaaS/subscription deferred revenue:
Often treated as debt-like (low cost to fulfill)
Low-margin services deferred revenue:
Often treated as NWC (high future cost to fulfill)

BIOSERV RESOLUTION:

Negotiated: 50% treated as debt-like (\$600K deducted)
50% treated as NWC

PRICE IMPACT: (\$600,000)

LESSON: Define deferred revenue treatment in LOI