Issues in Negotiating Cash-Free Debt-Free Deals

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Most M&A deals are negotiated on a cash-free and debt-free (CFDF) basis. In simple terms, this means the seller keeps all cash and pays off all debt at the time of the sale of a business. Although this idea seems straightforward, defining the actual CFDF terms can be a contentious point of negotiation, and can significantly affect the economics and pricing of a deal. Most often, however, the specifics of the CFDF terms are not defined in the letter of intent (LOI). Therefore, during the due diligence process, both the buyer and seller identify CFDF items for further negotiation. For example, should the cash to be retained by sellers include restricted cash or cash received in the form of customer deposits? What should be included as debt to be paid off by the seller aside from bank debt? Should tax liabilities or bonuses be included as debt-like items? The earlier these issues are identified and addressed, the better. Failure to address these issues on a timely basis could delay closing, create tension between the parties or even result in a broken deal.

Why are deals conducted on a CFDF basis?

Most of today's deals are structured on a CFDF basis because valuations in M&A transactions are usually driven by an EBITDA methodology, which excludes the financial impact of debt and nonoperating assets. Since required operating levels of cash can be funded through a line of credit, most buyers and sellers view cash as a nonoperating asset that the seller will retain at closing. EBITDA-based valuations assume a debt-free basis, as evidenced by the exclusion of interest expense in their calculation. In other words, the valuation is effectively based on the buyer acquiring the business without its existing debt. Since most valuations assume a CFDF basis, the purchase price outlined in the LOI usually stipulates that the seller retains all cash and has to pay off all debt at close.

The problem is that this leaves a wealth of cash and debt issues to be identified, negotiated and written into the final purchase agreement. As you will see, there are a wide range of cash and debt issues to be considered.

The cash side — what cash does the seller keep?

Cash is often more than one homogenous amount shown on the balance sheet. Is cash the amount of cash on the books or the amount of cash in the bank? This can differ widely, as shown below.

Cash Book vs. Bank

US$ in thousands	Year-End	Interim
Operating account - per books	$ (1,532)	$ (1,346)
Outstanding checks	1,746	1,673
Deposits in transit	-	-
Operating account - per bank	**$ 214**	**$ 327**

A detailed review of the underlying cash accounts may identify cash items requiring further evaluation. Consider the following example.

Cash Summary

US$ in thousands	Year-End	Interim
Cash, as shown in audited financial statements	**$ 1,179**	**$ na**
Cash, as shown in internal financial statements	**(567)**	**(460)**
Cash detail per trial balance		
Petty cash	$ 5	$ 5
Operating account	(1,532)	(1,346)
Credit card	1	4
Payroll accounts	(30)	(41)
Escrow account	500	500
Deposit - workers' compensation	37	37
Foreign bank accounts	452	381
Total cash detail per trial balance	**$ (567)**	**$ (460)**
Reclassification of outstanding checks*	1,746	1,673
Total	**$ 1,179**	**$ 1,213**

** Often, this reclassification is only done at year-end.*

In this example, the buyer and seller could assume that very different amounts of cash are included in the deal. Cash is usually not defined in the LOI, but generally refers to all of the company's book or bank cash balances. If at close, the cash balance per the books is greater than the cash actually in the bank, what happens? What is the cash-free balance to be retained by the seller? Answering those questions requires addressing each of the following items.

- **Outstanding checks:** Sometimes outstanding checks are included as a reduction to the book cash balance. Sometimes they are reclassified to liabilities. Sometimes this reclassification is only done at year-end. So what is the cash balance to be retained by the seller? Very often, the outstanding checks, if not reflected within the cash balances, are treated as debt-like by the buyers. In other words, the seller sweeps all cash in the bank at close, but the transaction proceeds may be reduced by the amount of outstanding checks on the books when this debt-like treatment is agreed upon. Note that both parties should also be cognizant of outstanding check reclassifications when considering cash definitions and setting a net working capital target or peg because inconsistent treatment of amounts could be detrimental to one or the other party.

- **Restricted cash:** Less commonly, there may be significant cash balances included in restricted cash. Restricted cash may be required as collateral security for self-insured accounts, surety bonds, loan agreements or other reasons. Should the seller be entitled to this cash at closing and, if withdrawn or credited to the seller, what is the impact on the buyer after close?
- **Foreign cash:** Cash kept in foreign bank accounts raises additional issues. Repatriation of this cash ordinarily triggers additional taxes. Will this cash remain in foreign accounts, or will it be repatriated? Should the amount of cash retained by the seller be netted against any repatriation taxes, since the buyer will likely have to pay these taxes later? Buyers and sellers should consider the impact of foreign cash prior to close when there are large foreign cash balances.
- **Escrow**: While not very common, there may be escrow cash balances. For example, the company recently sold a division and may be entitled to additional proceeds if there are no warranty or representation claims. Who should be entitled to this escrow cash?
- **Held checks**: Held checks pose another potential issue, depending on how they are recorded in the financial statements. Payables may be understated if checks have been written and payables reduced on the books, but actual checks have been held and not yet released to pay creditors. Should the amount of held checks be treated as a reduction to cash or a trade liability?
- **Credit card payments in transit**: Customer payments received via credit card usually take a day or two before being fully processed by the bank. Should these in-transit items be considered cash to be retained by the seller, or a receivable amount to be included in the calculation of net working capital?
- **Petty cash:** Although petty cash balances are usually small, should the seller be compensated for petty cash on hand in a CFDF deal? This is relevant in a retail environment when there is cash held in cash registers in many locations — who keeps this cash? Most often, the seller receives this benefit unless the agreement or negotiations stipulate otherwise.

Treatment of each cash issue depends on specific circumstances and accounting classifications and treatments, which differ from deal to deal, and make determination of the final purchase price complex. Identifying items that require closer consideration early in the process allows for smoother negotiations and fewer obstacles to close the deal.

The debt side — what liabilities does the seller retain vs. the buyer assume?

There are many potential debt items to consider and the amounts involved can be very large, so analysis and discussion of debt issues is often more complex than cash concerns. Debt items requiring consideration fall into two categories. The first category includes interest-bearing debt, such as lines of credit, mortgages, capitalized equipment leases and shareholder notes, among others. The second includes less obvious and noninterest-bearing obligations that have characteristics similar to debt (such as payables with extended payment terms), or relate to obligations from nonoperational items (such as legal payments due). These debt-like items may artificially alter cash positions.

The example below presents the liabilities section of a sample balance sheet, and identifies the first category of debt items (interest-bearing debt).

Liabilities US$ in thousands	Year-End	Interim	Interest-Bearing Debt
Accounts payable	$ 5,355	$ 4,515	$ –
Line of credit	1,100	500	500
Accrued liabilities	3,434	4,648	–
Deferred revenue	3,612	3,267	–
Current portion of long-term debt	1,250	1,250	1,250
Total current liabilities	**14,751**	**14,180**	**1,750**
Due to affiliate	164	280	–
Note payable	1,584	1,522	1,522
Total liabilities	**$ 16,499**	**$ 15,982**	**$ 3,272**

For the second category of items, it is important to look at the trial balance-level detail to fully understand the individual items included as liabilities beyond just the interest-bearing debt. This detailed review may identify potential matters requiring further discussions and negotiations regarding items that are debt-like in nature. Consider the following schedules, which break down the accounts payable and accrued liabilities line item amounts, and identify possible debt-like amounts. Note the significant amount of debt-like items in the illustrations.

Trade Accounts Payable

US$ in thousands	Year-End	Interim	Possible Debt and Debt-Like
Trade accounts payable*	$ 3,046	$ 2,069	$ 135
Accrued inventory purchases	311	584	–
Outstanding checks	1,746	1,673	1,673
Warehouse fees	67	57	–
Outstanding freight bills	23	48	–
Other accrued purchases/services	162	84	–
Accounts payable	**$ 5,355**	**$ 4,515**	**$ 1,808**

** In this case, trade payables include $135,000 due to affiliates.*

Accrued Liabilities

US$ in thousands	Year-End	Interim	Possible Debt and Debt-Like
Customer deposits	$ 303	$ 1,249	$ 1,249
Accrued expenses miscellaneous*	210	359	125
Accrued interest expense	228	145	145
Accrued excess liability insurance	23	47	–
Accrued professional fees	49	35	–
Accrued vacation - salary	310	318	–
Accrued vacation - hourly	287	263	–
Accrued bonus	780	425	425
Accrued payroll	97	95	–
Accrued warranty	192	206	206
Health insurance (IBNR)	289	393	393
Accrued payroll taxes	46	36	–
401(k) employee contributions	56	59	–
Other accruals	112	97	–
Accrued taxes	452	921	921
Total accrued liabilities	**$ 3,434**	**$ 4,648**	**$ 3,464**

** Includes $125,000 of accrued severance costs.*

Following are some examples of debt-like items that should be considered in a CFDF deal:

- **Interest payable**: Interest payable is typically classified as an accrued expense instead of debt; however, a buyer would not likely want to assume this liability, as it relates to a debt instrument being paid off by the seller. It is also an amount owed to what may be the former bank; therefore, the balance will likely be paid off at closing with the loan payoff required by the bank.
- **Accrued severance**: Most buyers view severance liabilities related to preclose terminations as debt- like. The related expense is often included as an EBITDA addback, further indicating this as the seller's obligation. This is another example of a liability the buyer would not likely assume, but that goes unaddressed when the LOI is written.
- **Affiliate payables:** These liabilities are most often treated as debt, even though they are not likely to be interest-bearing. In some cases, affiliate debt is separately stated in the financials. However, in other instances, amounts due to affiliates or related parties may be embedded in trade payable accounts or accruals. From the buyer's viewpoint, these obligations are typically considered debt, and are often defined as debt through a blanket definition stating that all amounts due to affiliates and related parties are excluded liabilities.
- **Outstanding checks**: Outstanding and held checks are commonly considered debt-like items. Consideration of outstanding checks should be coordinated with the cash definition.
- **Customer deposits**: Does the business require customer deposits, and have orders on hand not

yet completed (e.g., an order that required 30 percent of the balance due upon order, 40 percent due upon shipment and 30 percent due 30 days after shipment)? Does the company collect deposits for the use of assets (e.g., gas cylinders or beer kegs) to be refunded when the asset is returned? These types of deposits can be considered debt-like items, as the customer either advances payment or "loans" money to guarantee the return of the asset. If the company collects customer deposits, the account balance is likely to fluctuate, but it remains a source of working capital and cash.

At close, the buyer will owe future obligations to customers who have paid deposits already collected, so should the seller get to keep the related cash? On one hand, this is a continuing source of funding and cash flow if the company is growing, and deposits roll over from customer to customer. On the other hand, if growth slows, cash balances can be depleted, as deposits are refunded (or obligations requiring cash outlay are performed) faster than new deposits are collected.

Additional complexity relates to fluctuations in the customer deposits balance. If deposits are deemed to be part of working capital, what should be considered a normal level for closing working capital? The buyer should also consider the treatment of deposits at exit, because the next buyer may have a different view of the treatment. Buyers and sellers should understand that in any event, the business in aggregate is worth less when the cash is separated from the liability (i.e., the seller keeps the collected cash, but the buyer is left with the liability). The collection of deposits may be a normal part of business operations; however, both parties should understand that assumption of this liability decreases the value of the acquired business. Conversely, there might be vendor deposits in prepaid expenses or a credit in accruals for which the seller may want offsetting consideration. Ultimately, customer or vendor deposits are a matter of negotiation between the parties, and relate to the valuation of the business.

- **Letters of credit**: Foreign purchases or self-insured medical or workers' compensation plans may require backup letters of credit. Buyers and sellers need to consider how these debt-like obligations will be treated at the close. While letters of credit are not debt, the buyer should consider the impact on credit availability when letters of credit are needed in normal business operations.
- **Deferred revenue**: Deferred revenue requires close attention. The seller may retain the cash, while the buyer must fulfill future obligations to perform services or deliver products. Therefore, fully evaluating deferred revenue requires considering the cost to the buyer of performing the related services after close. In technology deals where the deferred revenue is a result of an annual (or other period) subscription, the cost to service that revenue may be minimal. In that case, the seller might not be required to fund this liability. However, if the subscription services include, for example, ongoing customer service, customization and database management, there are real costs to the buyer to service the deferred revenue, and the buyer may request that all or a portion of the liability be funded by the seller. As with customer deposits, the buyer should consider that it may have to recognize and pay taxes on the deferred income, while never receiving the cash. The application of business combination accounting further complicates this, as the fair value of deferred revenue required to be recorded may be significantly less than its previous carrying value, leaving the buyer without the benefit of reporting all of the revenue the seller would have recorded.
- **Accounts payable extended terms or unusual payables**: Payables extended beyond normal terms could also be considered debt-like items. Vendors may extend terms for a variety of reasons, and may receive some form of guarantee or security on the extended payables. Accordingly, the amount of payables in excess of 60- or 90-days past due could be considered debt-like, and an adjustment negotiated. Other unusual payables, such as payables for capital expenditures, could be considered for adjustment.
- **Accrued bonuses**: Accrued bonuses are often only accrued at year-end, a large portion of which may be amounts due to the owners of the business. It may be difficult to normalize working capital for bonuses. Negotiations may lead to the seller being responsible for bonuses on earnings before close, with the buyer assuming the liability for bonuses on earnings after close. Formal bonus plans often require payment after year-end. The buyer may assume these, but may want a credit against the purchase price to fund the portion arising during the seller's ownership.
- **Royalty pass-through**: Occasionally, a company may collect and remit royalties on behalf of a third party. If the seller keeps all the cash, it might be reasonable for the buyer to treat this as

a debt-like item and negotiate an adjustment for unpaid royalties. On the other hand, unpaid royalties fund working capital needs, and so could be considered a normal part of working capital.

- **IBNR accrual**: At self-insured companies, the accrual for incurred but not reported (IBNR) health care costs is sometimes subject to further negotiations. While the IBNR accrual is likely a normal course item, the buyer could request that the seller fund any large outstanding claims incurred prior to closing.
- **Accrued transaction fees**: Most purchase agreements require the seller be responsible for their own transaction costs, which leads to an adjustment for accrued deal fees. These could include investment banking, legal and accounting fees, among others. Therefore, working capital and working capital targets should be treated likewise.
- **Gift cards**: This is another case where the seller retains the cash received from the sale of gift cards, while the buyer is responsible for settlement on gift cards redeemed after closing. Therefore, gift cards could be reviewed for consideration as a debt-like item.
- **Deferred rent**: If the seller has recently received significant rent concessions, or a long period of free rent, consideration as a debt-like item could be appropriate and consistent with the treatment in normalizing EBITDA. Additionally, deferred rent may arise from leasehold improvements financed by the lessor, but paid out by the lessee over the lease term. This arrangement has similar characteristics to a capital lease and could be treated as such.
- **Legal settlements**: Obligations remaining from legal settlements are usually considered a debt-like item. Often, an addback to adjusted EBITDA is made for legal costs or settlements, as they are considered nonrecurring.
- **Credit cards**: The use of company credit cards should be considered. In most instances, credit card payables of less than 30 days are considered a normal working capital liability, however, certain credit card uses could warrant additional examination. For example, if company owners use company credit cards to pay the owner's discretionary expenses, those obligations should be considered debt-like items. Sometimes a company may use corporate cards to extend cash flow by paying creditors at the end of their usual 45-to-60 day terms with the corporate card, and then taking advantage of the additional 30-day credit card terms. A buyer may wish to consider that use to be a debt-like item.
- **Earnouts**: If the seller has recently completed an acquisition, there may be earnout obligations due for meeting future sales or earnings targets. The liability on the books may not reflect the final obligations. Often, the adjusted EBITDA reflects the full amount of these pro forma earnings; therefore, the liability should be considered a debt-like item. Otherwise, the buyer may be paying for this segment of earnings twice — once in the EBITDA multiple, and again in assuming the remaining liabilities.
- **Unfunded pension obligations**: If the seller has a pension plan, especially a plan that was previously frozen, unfunded pension obligations should be considered as a debt-like item.
- **Off-balance sheet liabilities or liabilities that might not be recorded at the ultimate settlement amount**: Examples of these items that may bear consideration as debt-like items include: minimum purchase agreements where an obligation is highly likely, but not yet accrued, tier-based rebates, guarantees, transaction or retention bonuses, environmental liabilities and previously mentioned items, such as additional amounts on earnouts on prior acquisitions.
- **Other**: Depending on facts and circumstances, other liabilities that may bear consideration as debt-like items include:
  - Deferred compensation
  - Accrued commissions
  - Workers' compensation claims
  - Interest rate swaps
  - Derivatives
  - Noncompete payments
  - Unusual warranty claims
  - Any other debt-like obligations identified during due diligence

Tax liabilities are a separate category of issues that bear examination as possible debt-like items. Following are tax issues to consider:

- **Accrued income taxes**: Like bonuses, it may be difficult to normalize working capital for accrued income taxes. Negotiations may lead to the seller being responsible for income taxes on earnings before close, with the buyer responsible for income taxes on earnings after close, resulting in treatment of accrued income taxes as a debt-like item. Taxes get more complex when foreign taxes, property taxes and other types of taxes are in the picture.

- **Deferred taxes**: Deferred taxes are another account to consider. This can be complex, however, as deferred taxes may have enabled the seller to lower its taxes through the use of the cash method of accounting, bonus depreciation or other accelerated tax deductions. Depending on the deal structure, the buyer might have future obligations for additional taxes. Analysis of deferred taxes can become complex to the point that both parties agree to exclude deferred taxes from any further adjustment.
- **Sales and use taxes**: If there are significant accrued but unpaid sales and use tax balances, the buyer might want to treat some or all of these balances as debt-like, especially since the seller has already received the funds necessary to pay these taxes.
- **Unclaimed funds**: The seller may have a liability for unclaimed funds, such as outstanding uncashed payroll checks, or even greater hidden amounts related to very old checks already written off. As these liabilities are amounts possibly due to the state, there could be an adjustment to treat these as a debt-like item.

The transaction also may trigger taxes and deductions, operating loss carrybacks and complexities beyond the scope of this discussion, and it may not be clear whether the buyer or seller is entitled to certain deductions or responsible for certain obligations. Accordingly, the settlement of all pre-closing tax liabilities may be deemed the responsibility of the seller and post-closing tax liabilities the responsibility of the buyer, with tax obligations to be entirely excluded from working capital.

The final settlement

The schedule below illustrates a range of possible settlements after cash and debt issues are negotiated in a CFDF transaction.

Purchase Price and Closing Settlement

US$ in thousands	Version 1	Version 2
Purchase price	$ 45,000	$ 45,000
Cash credited to seller	1,213	1,213
Adjustment to cash, restricted cash	-	(500)
Adjustment to cash, imputed tax on foreign cash	-	(114)
Interest-bearing debt excluded	(3,272)	(3,272)
Debt-like items, accounts payable	-	(1,808)
Debt-like items, accruals	-	(3,464)
Due to affiliate	(280)	(280)
Deferred revenue at 50%	-	(1,634)
Cash Settlement	**$ 42,661**	**$ 35,141**

As this example illustrates, a large portion of the purchase price may depend on the final definitions of cash, debt and debt-like items. No single standard defines appropriate CFDF adjustments, and the LOI rarely addresses such complexities. Definitions in the purchase agreement will have the final say in how cash and debt-like items will be determined at closing, and will be resolved in any future disputes. Whether an item falls on the cash or debt side of the equation, there can be strong arguments from both the buyer and seller perspectives that will require analysis and negotiation. The earlier CFDF adjustment items are identified and discussed, the smoother the deal is likely to be. In some cases, these issues cannot be resolved. Even in those cases, the earlier adjustment items are identified, the earlier a final decision can be made, and the less time and effort the buyer and seller have to invest in a failed deal.

The final deal pricing is truly in the details. Knowing where to look for and resolve CFDF items related to the deal and its final pricing is vital to a successful transaction.

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