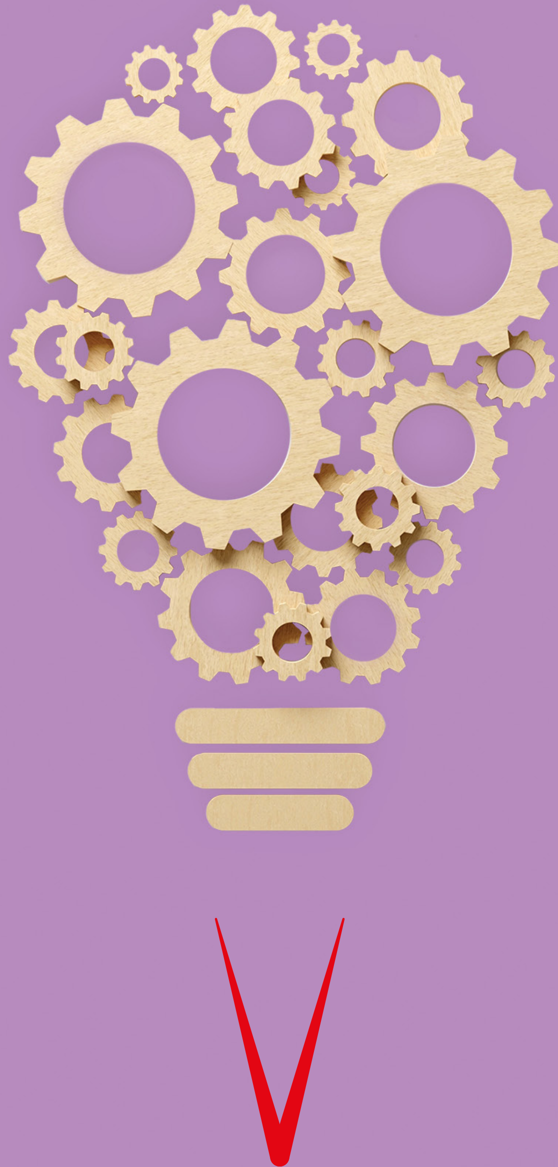

ICAEW CORPORATE FINANCE FACULTY

COMPLETION MECHANISMS

Determining the final equity value in transactions

BEST-PRACTICE GUIDELINE 64

Authors: Grant Thornton UK LLP

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INTRODUCTION

The objectives of this guideline are to set out the core principles behind equity value adjustments and completion mechanisms, and to advocate best practice.

The final consideration paid for the 'equity value' of a business is often substantially different from the headline price or 'enterprise value' initially agreed between the parties on a transaction. The basic principles behind equity value adjustments and the mechanics of these can be readily understood; however, the application of these principles to a specific transaction is often complex and subjective.

Despite the high monetary value often at stake and the potential for complexity, there is no set of published rules or standards for determining equity value adjustments in transactions. Given the many contentious areas and the absence of full consensus even on the core principles, a buyer's view of the final transaction price can be materially different from that of a seller. This can lead to protracted negotiations between principals and advisers causing delays, increased costs, sub-optimal outcomes and sometimes even aborted transactions.

Although the implicitly commercial nature of equity adjustments does not lend itself to an exhaustive set of rules covering every circumstance, this guideline considers some of the more contentious value-impacting items and the factors to consider in reaching agreement on them. As such, the guideline represents a step towards achieving better market consensus on the principles and mechanisms in arriving at final equity values on transactions. It is envisaged that this will generate value through more efficient transactions and increased trust and integrity in the mergers and acquisitions (M&A) market.

Section 1 Arriving at the equity value describes the key concepts of enterprise value and equity value adjustments including cash, debt and normalised working capital.

Section 2 Completion mechanisms covers the two widely accepted mechanisms by which to adjust the final price – completion accounts and locked box – together with other important aspects of the sale and purchase agreement (SPA) from which the final consideration is derived. In 2016, Grant Thornton UK LLP undertook a market practice survey of over 150 M&A professionals, covering equity value adjustments, SPAs, post-deal price adjustments and disputes. A selection of the key findings from this survey have been cited in this guideline.

1. ARRIVING AT THE EQUITY VALUE

ENTERPRISE VALUATION BASES FOR PRIVATE BUSINESS ACQUISITIONS

Typically, the headline offer price for a business will be linked to buyer expectations of the target's current and/or future profits and discounted cash flows. A frequently quoted measure of profits is earnings (often subject to normalisation adjustments such as for one-off income or costs) before interest, tax, depreciation and amortisation ('normalised EBITDA'), to which a pricing multiple is applied. The multiple and headline offer may be based on various factors such as risk and uncertainty, sustainability and expected growth of earnings, the buyer's cost of capital and required rate of return, competitiveness of the sale, anticipated synergies arising from the acquisition and recent, known valuations or price-earnings ratios of similar businesses.

For example, the headline offer, subject to due diligence, might be:

£500m, based on £50m normalised EBITDA for the last financial year and a 10 times multiple.

The £500m headline price is commonly referred to as the 'enterprise value'. While the scope of this guideline does not cover enterprise valuations, it explains the importance of understanding the basis of the enterprise value when considering the adjustments to derive the final equity value.

ENTERPRISE VALUE VERSUS EQUITY VALUE

A typical headline enterprise value is based on the underlying business, irrespective of the timing of the transaction and the level of funding required or existing in the business. Therefore, a buyer's offered enterprise value will typically be predicated on the following assumptions:

(i) the acquisition will be on a cash-free and debt-free basis; and

(ii) the business will be acquired with a normal level of working capital.

ENTERPRISE VALUE TO EQUITY VALUE BRIDGE

The assumptions above will require adjustments to the enterprise value to the extent there is cash or debt in the business and if there is a difference between the actual working capital and its 'normal' level at completion.

This can be expressed as an enterprise value to equity value bridge, as shown below, which also illustrates the material impact these items can have on the final price:

Enterprise value to equity value bridge		
Enterprise value (£50m x 10 multiple)		£500m
Plus cash		£20m
Less debt		(£80m)
Plus actual working capital	£60m	
Less normal working capital	(£70m)	
Working capital adjustment		(£10m)
Equity value		**£430m**

CASH-FREE

To the extent there is cash in the business, it will usually trigger an upward adjustment to the equity value unless the seller plans to extract it on completion. This adjustment enables the seller to benefit from surplus cash still within the business, which has accumulated under its ownership. If this adjustment were absent, the cash in the target could be viewed as effectively a windfall to the buyer over and above its valuation, which will not ordinarily have factored in a balance of cash on acquisition. In determining the basis of the cash adjustment, 'cash' needs to be defined.

It is customary to start with the cash book value per the accounts, rather than the bank account balance, provided it is subject to a full reconciliation to the bank statements and any reconciling items are bona fide. As the cash adjustment is then based on its book value per the accounts, this is consistent with the other aspects of the equity value adjustments, in particular working capital, which is discussed later.

In order for the seller to be fairly compensated for surplus cash left in the business, it will normally need to demonstrate that this is 'free cash' as opposed to 'trapped cash'. Whether or not the business' cash is free or trapped is the first of the contentious areas discussed in this guideline. Below are some examples of cash that might be considered by a buyer as trapped if they could not be readily extracted without harming the business.

- Cash in tills and petty cash.
- Cash held by overseas subsidiaries where there may either be a tax cost of extracting cash from the subsidiaries **(see sections International acquisitions and Taxation treatments)**, or where there are restrictions on the remittance of the cash from the overseas jurisdiction.
- Cash where its distribution may be limited by negative distributable reserves, which cannot be addressed via capital reorganisation.
- Cash held as security or deposit, for example on a leased property or to support guarantees, borrowings etc.
- Cash required to be ring-fenced for regulatory or contractual reasons.
- Cash held on behalf of customers or clients.

Careful analysis and consideration should be given to the nature of the cash in the target business. Whether or not the items noted above are ultimately considered as part of free cash, or are deemed trapped, will be dependent on the individual circumstances of the business and transaction.

Free cash will normally be adjusted for in the final equity value on a pound for pound basis, making it in a seller's interests to negotiate for the maximum amount to be designated as free. Cash defined as trapped may be excluded from the equity value or it may be appropriate to redefine it as working capital and make an adjustment to the extent that it is higher or lower than normal **(see section Normalised working capital adjustment)**.

Conversely, in some cases items that are not ordinarily classified as cash on the balance sheet might be considered as 'cash-like' for the purposes of the equity value adjustments. Some examples to consider are below.

- A financial investment not relating to the core operations of the business, which will either be sold at completion or which the buyer agrees will be acquired with the business but has not already been taken into account in the enterprise valuation.
- A deposit paid by the business which is no longer required and will be refunded at, or soon after, completion of the transaction.
- Tax losses **(see section Taxation treatments)**.
- Cash arising on exercise of share options **(see section Taxation treatments)**.
- Growth capital expenditure if it represents upside to the buyer (ie, is not taken into account in its enterprise valuation).
- Surplus property or assets held for resale.

There is no precise rule for how the above items should be treated and what value should be attributed to them. In assessing cash and trapped cash, consideration should be given to:

- the basis of the headline enterprise value and whether the item has already been factored into that valuation;
- the likelihood and sustainability of a cash inflow to the business on or soon after completion; and
- whether the cash could theoretically be paid out via dividend, as it is not necessary for the cash to be held in the business in order for it to operate.

DEBT-FREE

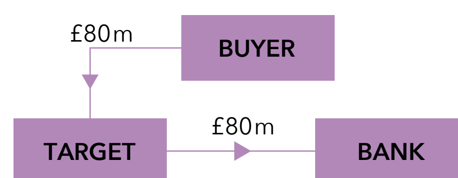
Many businesses are financed through bank loans or other forms of debt. The 'debt-free' assumption in a buyer's offer will typically mean that any debt in the target will be deducted when arriving at the equity value, on a pound for pound basis. Were this not the case, the buyer would have to fund and service the debt, which would normally be a cost over and above the headline enterprise value. The debt adjustment will usually need to take account of any redemption costs, accrued interest and of gross-up of capitalised loan costs, which have reduced the stated debt amount in the balance sheet.

Sometimes an offer is stated as assuming a certain level of bank debt. In these cases the implicit enterprise value may be calculated by adding back the level of assumed debt to the offer price.

Debt-free	
Offer amount	£420m
Add back level of assumed debt which will not be adjusted for	£80m
Implicit enterprise value	£500m

The above working can be useful to assess the underlying enterprise value and derive the implied multiple versus other valuations for similar businesses, so that comparable valuations can be benchmarked. A further consideration is that if the debt is different from the assumed level, it may be appropriate to make a corresponding adjustment to the equity value.

Loans are often repaid on completion of a transaction, as the buyer will usually have its own funding structure to put in place going forward. As the target business may not have sufficient surplus cash to settle the debt, at completion the buyer may procure that the target business settles the debt. This means the buyer lending an amount equal to the loan redemption value at completion to the target business (creating an inter-company loan owed by the target business to the buyer), which in turn repays the debt. Buyers should be aware that while the debt will be a deduction to the final equity value, the buyer will still need to fund its settlement at completion.

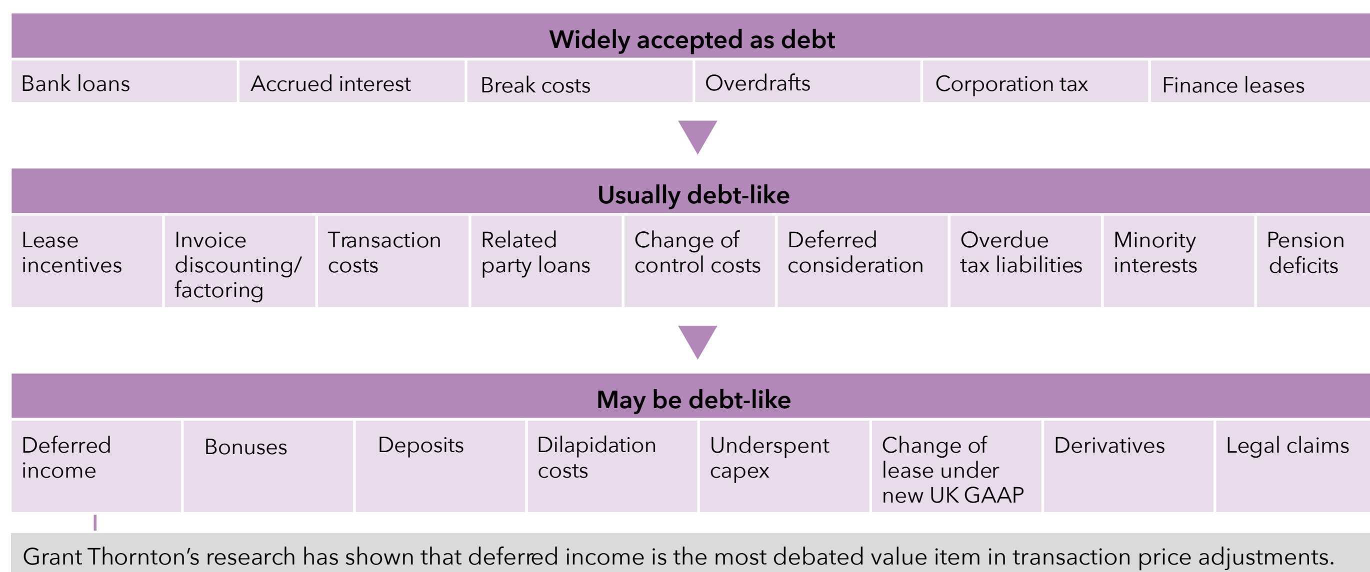


In practice the cash will not usually flow through the target's bank account as it will be paid by the buyer directly to the bank on completion.

Other forms of external debt or financing are usually caught within the definition of debt, such as overdrafts and hire purchase loans.

In addition to debt, the concept of 'debt-like' items frequently arises on transactions. These are liabilities not taken into account in the headline enterprise value and can be considered as a balance sheet deficiency, even though they are not actually financing debt. Debt-like items are a common area of debate and disagreement between buyers and sellers. A buyer may be incentivised to treat such items as debt-like given that this generates a pound for pound deduction to the equity value, whereas the seller will prefer them to be treated as working capital.

Examples of debt and potential debt-like items:



The classification of the above debt-like items as debt or working capital is highly subjective. Their treatment will depend on the nature of each specific item and will need careful analysis. One factor to consider is whether the item was factored into the headline valuation eg, whether the cost associated with the liability falls above or below the EBITDA or is reflected in the discounted cash flow that formed the basis of the enterprise value. Where the cash cost is not taken into account as part of the enterprise value, this is a potential indicator of a debt-like item. Another factor to consider is the likelihood and timing of the item resulting in an actual cash outflow.

An area of frequent, and often material, disagreement is deferred income liabilities; where cash has been received in advance of recognising the income. Buyers may take the view that this cash should be 'left behind' by treating the deferred income as debt-like because the buyer will need to deliver the service and the business had not 'earned' the cash under the seller's ownership. Sellers may view this as a working capital item if it is a normal feature of the business' cash cycle. Again this issue must be considered on a case by case basis by assessing the fact pattern, including the cash cycle of the business and the basis of the enterprise value. In some cases a compromise may be appropriate where an element of the deferred income is treated as debt-like (sometimes its associated delivery cost) and the balance as working capital. The question of deferred income is particularly pertinent to transactions involving technology businesses that apply a software subscription model with cash received in advance.

NORMALISED WORKING CAPITAL ADJUSTMENT

As presented in the **section Enterprise value versus equity value**, a common assumption of a buyer's offer is that the business will have a normal level of working capital. This assumption will trigger an adjustment to the equity value to the extent working capital at completion is not 'normal'. If there is no working capital adjustment on a transaction this could present the following two problems:

- sellers may be incentivised to manage down the working capital (eg, delaying a supplier payment), thereby increasing the upward equity value adjustment for cash, with no offsetting downward working capital adjustment; and
- completion may occur at a high or low point in the working capital cycle. This could be due to working capital seasonality or due to the timing of payments and receipts around completion. Again this would result in a cash swing and adjustment, with no offsetting working capital adjustment, which could create a sub-optimal outcome for either party.

The two key considerations in determining the working capital target are (i) the definition or composition of working capital and (ii) establishing what is a normal level of working capital for the business being acquired.

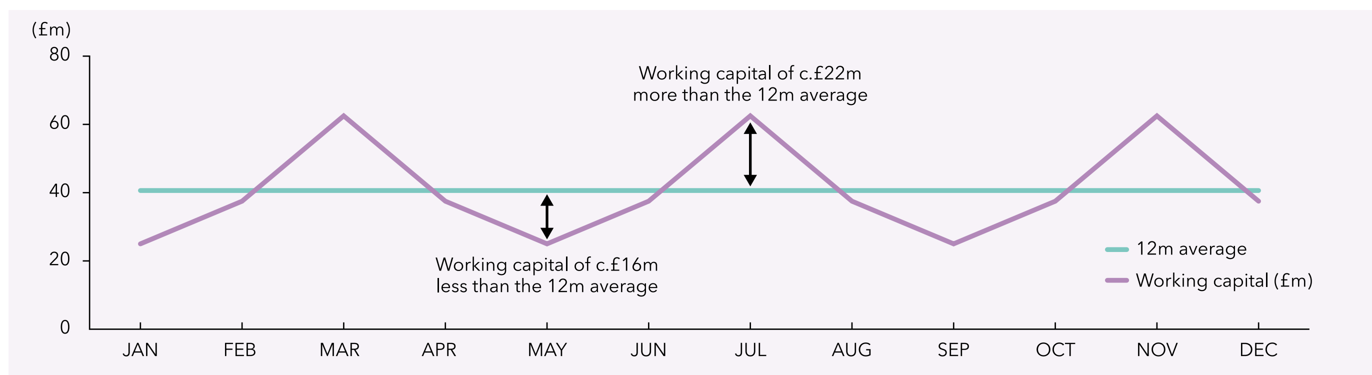
DEFINING WORKING CAPITAL

In the context of equity value adjustments, working capital does not have a legal definition and is not defined within UK GAAP or IFRS. In transactions, working capital is generally considered to be current operating assets (excluding cash) such as stock, trade debtors and prepayments, less current operating liabilities such as trade creditors, accruals and payroll liabilities. Any current operating assets or current operating liabilities determined to be cash, cash-like, debt or debt-like should be excluded from working capital to avoid double counting.

NORMAL LEVEL OF WORKING CAPITAL

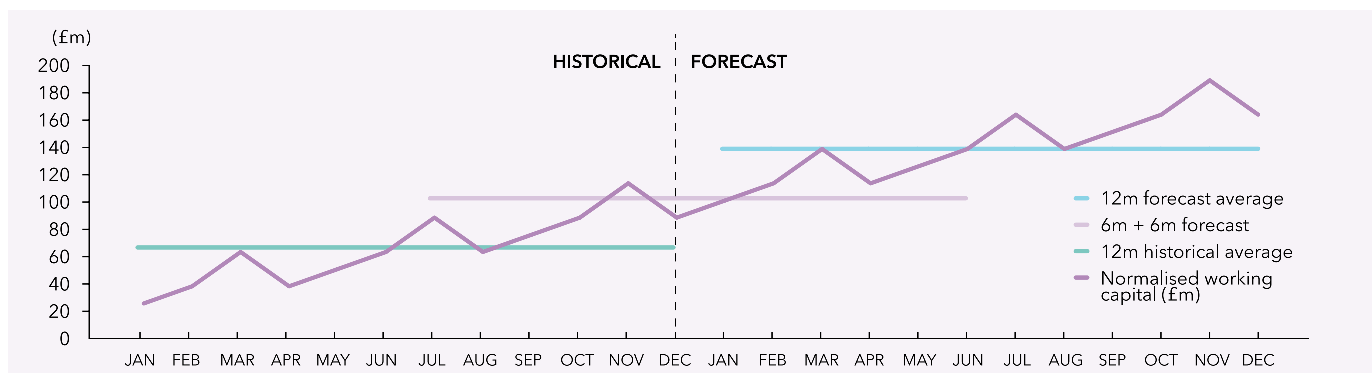
Some businesses will have a positive working capital cycle ie, debtors exceed creditors meaning there is a working capital requirement, while others will have negative working capital and some may oscillate between the two. Working capital may also increase or decrease over time and some businesses will experience significant swings in working capital due to seasonality.

The assessment of the normal level of working capital is a highly subjective area. Typically in assessing what is normal, working capital will be measured over a certain period of time and an average taken. For seasonal businesses, it may be appropriate to use a reference period which fully averages-out monthly fluctuations, for example 12 months.



In the example above using a £40m normal working capital target, if completion takes place in May the working capital is lower than average (and therefore cash will be higher). The working capital adjustment therefore reduces the equity value by £16m, which enables the buyer to be compensated for funding the subsequent increase in working capital up to its average level. In July the position is reversed: the buyer will pay an additional £22m for the excess working capital, which can be expected to be converted into cash over the following month. Buyers should be aware that in cases where there are peaks in working capital over and above the average, short-term funding facilities might still be required.

The reference period for calculating normal or target working capital may also have a significant impact on its value. The chart below shows a business with growing, positive working capital, where a buyer will prefer a more recent or future working capital reference period as it gives a higher target.



Agreeing the working capital reference period is another subjective area of equity value adjustments. Cases can be made for various positions and this area should be given careful consideration on each transaction. One methodology is to align the working capital reference period to the EBITDA period that underpins the enterprise value, with the rationale that the working capital target represents the requirements of the business at the level of earnings used for the headline price.

In addition to considering the reference period, normalisation adjustments to working capital may be appropriate, for example, if one-off items have occurred during the reference period which distort the reported level of working capital. Since the monthly management accounts will not be audited, adjustments may also be required to present the monthly working capital in accordance with GAAP.

INTRA-MONTH CASH

Management accounts are typically prepared on a monthly basis, whereas working capital and cash flows of a business fluctuate on a daily basis. Consideration may need to be given to intra-month cash when assessing the working capital target and ongoing funding requirements, as these may not be fully apparent solely from analysis of month-end or year-end balance sheets and cash flow statements.

FIXED ASSETS AND NET ASSET ADJUSTMENTS

Fixed and non-current assets are material items on many businesses' balance sheets. However, in the majority of transactions, fixed assets do not directly feature in the calculation of equity value adjustments. There are a number of possible reasons for this:

- fixed assets by their nature do not constitute a short-term cash funding requirement or surplus in the way that the cash, debt and working capital variances discussed previously do;
- in calculating the enterprise value, buyers will often assume the fixed assets are sufficient to support the level of trade and earnings on which the enterprise value is based;
- fixed assets include the non-cash item of depreciation; and
- fixed assets may include intangible assets such as goodwill, which are typically already priced into the headline enterprise value.

Notwithstanding this, capital items can still have a bearing on equity value adjustments. For example:

- The business may be deemed to be underfunded where it has withheld capital expenditure, leaving the buyer with a cash requirement not factored into its enterprise value. This may treated as a debt-like item in some cases.
- Conversely, there may be a surplus fixed asset on the balance sheet or the seller may have recently invested in a large new capital project but the buyer may not have priced the resulting earnings increase into the enterprise value, potentially triggering an upward adjustment to the equity value.

On property and investment fund transactions, full net asset value (as opposed to net debt and normalised working capital) adjustments are more common. In these cases, it is important to ensure there is no significant net working capital balance (where a working capital target may be appropriate) and that non-value adjusting items are carved out of the adjustment. The value attributed to fixed assets will normally be specifically referenced in the SPA at an agreed amount, to ensure other non-cash items relating to fixed assets such as depreciation, impairment adjustments and intangibles do not impact the price adjustment.

OBTAINING CLARITY ON THE EQUITY VALUE EARLY IN THE TRANSACTION PROCESS

Increasingly, sellers are requiring buyers to provide further clarity on equity value adjustments prior to signing exclusivity. This is becoming common-place in sale processes, where sell-side advisers may issue a paper setting out their assessment of the enterprise to equity value bridge (usually using a locked box mechanism which is discussed in **section 2 Completion mechanisms**) and require bidders to submit their assessment of this at the time of their final offers. This enables sellers to have greater certainty on the basis for and consistency of bidder offers before granting exclusivity to the preferred bidder. It may also enable the seller to achieve more favourable equity value adjustments due to these being put forward and agreed in principle during a time of competitive tension.

Even in off-market transactions, sellers may be advised to require a potential buyer to agree to an illustrative enterprise to equity bridge prior to granting exclusivity. Some buyers will prefer a degree of ambiguity to remain at the offer stage in order to negotiate the equity value adjustments later in the process. Others will see the increased clarity at the time of the offer as beneficial to an efficient process, though they will usually stipulate that it is subject to their own due diligence.

The example below illustrates that due to the subjective nature of equity value adjustments, a lower headline offer may still equate to a higher equity value.

	Offer 1	Offer 2
Enterprise value	£500m	£450m
Working capital adjustment	(£40m)	(£10m)
Net debt	(£60m)	(£20m)
Equity value	£400m	£420m

ACQUISITIONS OF PUBLIC COMPANIES

Offers for public companies are usually based on the quoted share price. Theoretically, since the share price reflects the equity value, it should already take into account the equity value adjustments discussed previously. However, as we have seen, equity adjustments can be highly subjective. In addition, the process of a public company acquisition cannot include a completion mechanism except, to a limited extent, through 'contingent value rights'. Parties to an acquisition of a public company may therefore consider back-calculating the implicit enterprise value, based on their interpretation of what the equity adjustments would be as if using a locked box mechanism (discussed in **section 2 Completion mechanisms**), as shown below:

	Buyer view	Seller view
Equity value eg, quoted share price plus offer premium	£400m	£400m
Add back notional net debt and debt-like items	£70m	£20m
Add back notional working capital adjustment (excess) / shortfall	£30m	(£20m)
Implied enterprise value	£500m	£400m
EBITDA	£50m	£50m
Implied multiple	10	8

The example above shows that due to different buyer and seller interpretations of theoretical working capital and net debt adjustments, the implied enterprise value and, therefore, earnings multiple may be materially different, even though the equity value is the same.

IMPLICATIONS OF BUYING LESS THAN 100% OF THE SHARE CAPITAL

The equity adjustments discussed previously and enterprise to equity bridge examples have assumed a 100% share acquisition. If the acquisition is of less than 100%, it may be appropriate to calculate the equity value of the acquired shares on a simple pro-rata basis based on the proportion of shares actually being acquired. This is because the buyer will be acquiring that proportion of interest in all the assets and liabilities of the business, many of which feature in the equity value adjustments. Buyers however may require a further discount to reflect the reduced control and other factors.

In some transactions it is envisaged that the remaining portion of shares will be subsequently acquired under an option agreement. It may be advisable in this scenario to ensure all the equity value adjustment bases for the remaining shares are agreed within the option agreement and are on a basis consistent with that used for the initial portion of the acquisition. Care should be taken around the treatment of funding and trading between the buyer and seller and the business in the interim period.

TRADE AND ASSET ACQUISITIONS

Equity values relate to acquisitions of shares. Where the acquisition is of the trade and assets of a business (rather than of its shares) or of a sole trader/partnership, the equivalent of the equity value adjustments will depend on which assets are acquired and which liabilities are assumed as part of the transaction. While the items being acquired/assumed can to some extent be cherry-picked, from a practical perspective it may not be appropriate to leave all net debt and working capital items outside of the transaction.

For example, while trade debtors at completion could theoretically be left behind, a buyer may prefer, from an operational perspective, to acquire the debtors rather than the seller retaining these and collecting debts directly from the customers who by then also have a relationship with the buyer. Therefore, while the principles of equity value adjustments are generally valid for trade and assets transactions, careful consideration should be given to the practical aspects of acquiring each individual category of asset and liability.

INTERNATIONAL ACQUISITIONS

Acquisitions of businesses operating across multiple countries can present a number of additional factors potentially impacting on the equity value adjustments. The list below is not intended to be exhaustive but sets out some common areas to consider:

- working capital cycles may vary by entity and jurisdiction, with changes or differing growth rates by country impacting on overall working capital trends;
- foreign currency movements may impact working capital trends;
- there may be certain debt-like items relevant in some jurisdictions which are not identified simply by making inquiries at a group level;
- certain jurisdictions may have different regulatory requirements possibly impacting cash and debt;
- a business with cash held in overseas subsidiaries may present issues for trapped cash (**see Cash-free and Taxation treatments sections**); and
- while the fundamental principles of equity value adjustments are jurisdiction-neutral, market practice may differ in other countries.

TAXATION TREATMENTS

The tax aspects of the transaction pricing mechanism should be considered in conjunction with the tax warranties and tax indemnities. The enterprise value will typically be adjusted in respect of tax liabilities or assets contained in the balance sheet, together with any further tax liabilities or assets arising on completion of the deal. To provide comfort on the robustness of the balance sheet tax position, a buyer will normally seek tax protection in the form of a generic indemnity, which provides pound for pound redress to the extent unprovided historical exposures arise. To the extent any higher-risk tax exposures which are not provided for have been identified in the due diligence, these are sometimes dealt with by means of a specific adjustment to price, or otherwise by means of specific indemnities that are subject to fewer limits or restrictions.

TAX LIABILITIES: DEBT-LIKE OR WORKING CAPITAL?

Equity value adjustments typically include a number of tax-related liabilities. The corporation tax creditor itself is almost invariably treated as a debt-like item, given the extended time differences between the point of accrual and taxation due payment dates, the fact that it relates to profits earned under the seller's ownership and because the corporation tax costs fall outside the EBITDA on which the enterprise value is often based.

Tax laws typically require corporate taxes to be calculated as accruing evenly over a fiscal period, which leaves room for uncertainty where the date of completion and/or the locked box does not coincide with a fiscal period end. To resolve this, the usual approach is to assume a hypothetical period end at the relevant date. However, various 'one-off' items, for example non-trading structuring transactions, may trigger immediate tax costs which rightly fall wholly to either party's account. Specific accounting policies may be required to address these, which will need to interact appropriately with the tax indemnity.

VAT and payroll tax liabilities are usually considered elements of working capital, in view of their closeness to the cash cycle and the associated income or costs being within EBITDA. However, an accumulated liability in this category, for example an amount owed to a taxing authority resulting from ongoing underpayments, may be deemed debt-like.

TAX: CASH-LIKE ITEMS

A seller may seek to include various tax 'assets' in the equity value. The extent to which a buyer will be willing to pay for these items will vary from item to item. A straightforward corporation tax debtor in the form of a tax repayment agreed with a tax authority, or an agreed tax credit claim, may be relatively uncontroversial. Whether or not tax losses are given value will depend on the prospect and timing of their use. However, it is not typical to attribute full value to tax losses in UK transactions.

TAX: DEFERRED TAX

Deferred tax is frequently excluded from the equity value adjustments on the basis that it does not reflect real cash ie, there is no associated short-term cash inflow or outflow. Accelerated and decelerated capital allowances are likely to fall into this category. In some cases further analysis/ breakdown of the actual deferred tax items may be merited from the perspective of either party, in case adjustment is appropriate.

Grant Thornton's research has shown that deferred tax is typically not deemed to be an adjusting item.

TAX ITEMS ON COMPLETING THE TRANSACTION

Depending on the tax analysis, upward equity value adjustments may be appropriate to reflect the tax benefit of events around completion of a transaction, such as settlement of debt interest, payment of bonuses and deal fees and the exercise of share options.

FREE CASH: TAX ASPECTS

The quantum of free cash in the business may be impacted by tax considerations. A withholding tax on payments of dividends from subsidiaries, typically those located overseas, can reduce the quantum of cash that can be extracted. A seller and buyer may have different structures and view these items differently. A seller may argue that a focus on extraction of cash by way of dividend is misplaced, and that a buyer could repatriate funds via repayment of existing downstream balances without tax consequence. The achievability of this will depend on how the acquisition is funded and also the extent of debt pushdown to all cash-holding subsidiaries. Furthermore, in some territories local tax or regulatory issues can prevent large-scale cash repatriation in any form.

TAX CONSIDERATIONS IN TRADE AND ASSET TRANSACTIONS

An acquisition of trade and assets will involve differing approaches in some respects (**see section Trade and asset acquisitions**). Although there are some notable exceptions, in most territories, including the UK, historical tax liabilities are not inherited with assets. However, both the seller and buyer may suffer necessary tax impacts of achieving the asset transfer, such as capital disposal taxes for the seller, transfer taxes for the buyer and potential taxable credits on initial recognition of assets for the buyer. These items in some cases become value-adjusting.

2. COMPLETION MECHANISMS

PURPOSE OF COMPLETION MECHANISMS

A mechanism must be selected in order to effect the equity value adjustments and finalise the consideration payable by the buyer. There is more than one way of doing this and the outcome can be different depending on the mechanism used.

Caution should be exercised where it is proposed that no completion mechanism is applied on a transaction. It is likely that one party will suffer value loss in this situation, as areas which may materially go to value will not be taken into account.

There are two widely accepted mechanisms for adjusting the consideration: completion accounts or locked box.

COMPLETION ACCOUNTS

With completion accounts, the final equity value adjustments are based on the actual balance sheet of the target entity prepared after the transaction as at close of business on the date of completion. It is important that the completion accounts are drawn up to this point, even if completion is mid-month when management accounts would not normally be prepared. This ensures all transactions prior to completion are captured. In practice it may be possible to roll forward or backward from the nearest month-end accounts to the date of completion.

Under a completion accounts mechanism, the SPA will set out the initial consideration payable at completion. This will often be based on an estimate of the completion accounts balance sheet (which may be included in the SPA to show its format), and will be subject to a 'true-up' adjustment post-transaction.

SPA CLAUSES ON BASIS OF PREPARATION, PROCESS, ACCOUNTING POLICIES AND DISPUTE RESOLUTION

As a minimum, the completion accounts show the net assets of the acquired business as at the date of completion. Typically, they will comprise a closing balance sheet, and will usually include a profit and loss account showing the results for the period from the latest set of historical financial accounts up to the completion date.

Completion accounts are bespoke to a transaction and therefore the basis of their preparation should be prescribed in the SPA. The hierarchy normally used for the basis of preparation is:

- specific accounting policies
- consistency with last accounts
- applicable GAAP.

SPECIFIC ACCOUNTING POLICIES (SEE OVERLEAF)

CONSISTENCY WITH LAST ACCOUNTS

If the target business issued financial statements within the last year, including notes to the financial statements, these accounts can provide a convenient reference point for basis of preparation of the completion accounts. The notes to the financial statements will normally include accounting policies on treatment of material items, which can be adopted in the completion accounts where appropriate. There will normally be a separate warranty in the SPA that the last accounts were prepared in accordance with GAAP.

APPLICABLE GAAP

Items not covered by specific accounting policies or the last accounts should be accounted for in accordance with the selected GAAP, which should be clearly defined in the SPA, including the effective date (particularly given the significant changes to UK GAAP in recent periods). Where there are differences between the GAAP adopted in the last accounts and GAAP selected for the completion accounts, the impact of adopting a different GAAP on certain balances should be identified and the appropriate accounting treatment agreed and prescribed in the SPA. In such cases it may be advisable to prepare proforma completion accounts under the new GAAP using historical figures, so that the impact of changing GAAP is clear to the parties.

SPECIFIC ACCOUNTING POLICIES

It is normally advisable that the parties agree specific accounting treatment of certain items to be adopted in the completion accounts, which takes precedence over the last accounts, for example:

Circumstance	Considerations	Example items to consider agreeing a specific accounting treatment in the SPA
No accounting policy stated in statutory accounts or stated policy does not provide adequate detail	Consider items not covered by a specific accounting policy, particularly if the item was not material to the last accounts but has since become material	• Revenue • Holiday pay accrual • Staff bonuses • Restructuring provision • Contract provisions
No balance in statutory accounts as item did not exist	Consider changes in factual circumstances that may introduce new items into the completion accounts that were not relevant to the statutory accounts	• Treatment of leases (eg, if a lease has become onerous or a rent-free period has now expired) • Impairment provision • Revaluation of property • Deferred tax • Other provisions (eg, litigation, environmental)
Accounting estimate is subjective	Key balances may be reliant on significant judgement eg, provisions for assets with doubtful recovery, revenue recognition on complex long-term contracts	• Bad debt provision • Contract revenue and provision methodology • Ongoing litigation provision
Specific commercial treatment	Parties may agree a specific treatment for items which may not necessarily be in accordance with the last accounts or GAAP	• Provision for capital expenditure below budget • Provision for off-balance sheet liabilities
Foreign currency balances	Material items may fluctuate based on underlying currency or entire last accounts may be in foreign denomination	• Agree basis and source of exchange rate to be adopted and treatment of any hedging arrangements

CONSOLIDATED ACCOUNTS

If consolidated completion accounts are required, but these have not historically been prepared for the acquired group of companies, the following should be considered:

- the method of consolidation and which business is to be treated as the parent;
- which business' accounting policies and treatments are to be adopted in the consolidated accounts (subject to the specific policies stated);
- it may be helpful to specify consolidation policies or adjustments, such as treatment of inter-company loans; and
- pro forma consolidated accounts may usefully be appended to the SPA showing treatment based on historical figures.

POST-CLOSING: COMPLETION ACCOUNTS PREPARATION AND REVIEW

Subject to what is set out in the SPA, either party may prepare the draft completion accounts and it may be a matter of practicality as to who is best placed to do so given ease of access to accounting records and personnel, and how much time it is reasonable to allow for the preparation of the first draft. It is most common for the buyer to prepare the completion accounts, as it is the owner of the business at that time.

The recipient may wish to have a similar amount of time to review the draft completion accounts as the preparer has to produce them, depending on access to data and other practical considerations.

Typically the draft completion accounts will become final and agreed at the expiry of the review period, unless a dispute notice is issued by the receiving party noting the particular figures that they dispute, the reasons for the dispute and the amount of any proposed adjustment to the completion accounts.

In order to narrow the scope and focus of negotiations and any subsequent disputes, it is recommended that items not specifically notified as disputed are deemed (through SPA clauses) to become final and agreed. Consideration should also be given as to whether it is appropriate to impose a de minimis value for individual items or the net value of items that may be disputed, to ensure parties' costs are proportionate.

ADJUSTMENT TO THE INITIAL CONSIDERATION BY REFERENCE TO A COMPLETION STATEMENT

Typically the initial consideration will have been calculated by reference to the estimated completion position. The consideration is therefore subject to a post-completion 'true-up' adjustment, to reflect the final agreed values as shown in the completion accounts.

The selected price adjustment mechanism will drive the form of the completion statement. For example, the initial consideration may be adjusted by the amount that actual working capital exceeds, or is short of, the target or normalised working capital.

A pro forma or example completion statement may be attached to the SPA. An example is shown below.

Completion accounts: estimated balances	Total	Net debt	Working capital	Non adjusting
Fixed assets	£70m			£70m
Free cash at bank	£28m	£28m		
Stock	£30m		£30m	
Trade debtors	£30m		£30m	
Prepayments	£15m		£15m	
Accruals	(£10m)		(£10m)	
Trade creditors	(£25m)		(£25m)	
VAT creditor	(£8m)		(£8m)	
Short-term borrowings	(£12m)	(£12m)		
Long-term bank loan	(£40m)	(£40m)		
Pension liability	(£35m)	(£35m)		
Net assets	£43m	(£59m)	£32m	£70m

If any calculation is required of the post-completion adjustment to consideration, particularly if the SPA includes a formula, consider including a worked example in the SPA to avoid ambiguity that could lead to disputes.

Grant Thornton's research has shown that completion accounts are the leading cause of disputes. One in ten completion accounts results in an expert determination.

TYPICAL DISPUTE AREAS

Set out below are some typical reasons for disputed items in completion accounts and earnout accounts (see page 14), and examples of potential actions to avoid such disputes.

Reason for dispute	Potential mitigating actions
Basis for preparation of completion accounts (particularly if a hypothetical consolidation is being produced that has no historical precedent)	Attach a pro forma example showing how the last accounts of each entity would be consolidated under the completion accounts methodology, including consolidation adjustments
Accounting treatment of an individual item (such as accruals or deferred income)	Include a specific accounting policy by reference to an agreed formula or basis for estimation
Provision for a liability of uncertain amount	Consider agreeing a specific provision in advance, or require third party evidence to be produced to support any movement since the provision in the last accounts
Errors in price adjustment such as double-counting items in completion statement	Include example workings in pro forma attached to the SPA to track from completion accounts to completion statement, ensuring each item is included once (see example above) and specify no double counting
New provisions in completion accounts that did not feature in last accounts	Consider changes in factual circumstances of the business since the last accounts were produced, for example, review management accounts/ disclosure for any items not represented in the last accounts Consider a specific accounting policy for any major new items (eg, new contracts)
Unexplained/unexpected difference between an account balance in last accounts and in the completion accounts (eg, bank loan balance), which may reflect a change in circumstances since the completion date that provides further information about the position at the balance sheet date	Consider requiring evidence supporting any material movements in key account balances Specify information cut-off date in the SPA
Revenue recognition being too aggressive/ prudent	Consider specifying a particular policy or formula such as percentage recognition of profits by reference to the stage of completion of a contract
Bad debt/stock provisions too aggressive/ prudent	Consider specifying a particular policy or formula such as a percentage provision by reference to age of debt or stock
Items included in cost of sales for the purpose of calculating gross profit or gross margin for earnout purposes	Include a clear definition of any accounting term on which the completion mechanism depends such as 'gross profit', including all of its component figures and calculations (particularly if it includes an apportionment of overheads)

COMPLETION ACCOUNTS DISPUTE RESOLUTION

Any items not agreed within the specified negotiation period (which can be mutually extended) may be referred to an independent expert to determine. Parties typically agree a process for selecting an independent expert, which is jointly appointed by them. The ICAEW President's Appointment scheme is typically specified within the SPA as a back-up option if the parties cannot agree upon an expert.

The parties should consider the desired scope of the independent expert determination, including limiting the determination to items that remain in dispute after the negotiation period. Parties will generally allocate costs in respect of an independent expert 50:50 unless the expert determines otherwise.

It is important to specify the cut-off date for information to be taken into account in the preparation, review and determination of the completion accounts, as new information may become available after the first draft is prepared that could be more advantageous to one party. Typically cut-off dates are the date the draft completion accounts are provided to the other party, or possibly, the end of the review period.

LOCKED BOX

With a locked box mechanism, the final equity value adjustments are applied to a balance sheet prepared at a date prior to completion, which is termed the 'locked box balance sheet'. Locked boxes are now commonplace in Europe. This may be because locked box mechanisms lend themselves well to multi-bidder sale processes: they avoid time being spent post-transaction on completion mechanisms and bring certainty for both parties on the final equity value at completion.

Grant Thornton's research has shown that the use of locked box has risen over the last five years.

The seller will typically provide a warranty to the buyer as to the accuracy of the locked box accounts. If the locked box is subsequently found not to be accurate the buyer may be able to make a warranty claim for any losses suffered as a result. This is arguably not as protective as a completion accounts mechanism, where a pound for pound adjustment is normally made for the actual values of assets and liabilities at completion.

The term locked box refers to a key feature of this type of mechanism, which is that no value is permitted to leave the business between the locked box date until completion of the transaction – the 'box' is thereby 'locked'. The agreed equity value adjustments discussed in **section 1 Arriving at the equity value** are applied to the assets and liabilities at the locked box date and there is no further true-up to take account of their values at completion.

LEAKAGE

The term 'leakage' is used to refer to extractions of value by the seller or connected persons, such as dividends during the post-locked box period (unless mutually agreed). Such items diminish the balance sheet value in the period between locked box and completion which, unadjusted, would mean the buyer receiving less value than they have paid for. The buyer will typically receive protection via the SPA against leakage to the seller or connected persons. There are other forms of potential value extraction by the seller or connected persons that are less overt than dividends and are usually also included in the leakage provisions. If, within an agreed timeframe post-transaction, the buyer identifies leakage they can require the seller to reimburse them.

A further concept termed 'permitted leakage' is also usually documented in the SPA. The intention of permitted leakage is to carve out certain items from the leakage protection. This covers known leakage both parties are aware of prior to completion, which is then factored into the calculation of the equity value at completion. Permitted leakage can also cover transactions between the business and the sellers such as agreed salary or management fees payable to the seller in this period.

The date of the locked box should be considered carefully. Due to the absence of a post-completion adjustment mechanism, a buyer should carry out sufficient due diligence on the locked box balance sheet to be comfortable that it is accurate. The locked box date should not be too close to the completion date so as to allow time for the seller to prepare it and for the buyer to review it prior to completion. It is also advisable that the locked box date is not too far in the past, as this would increase the risk of leakage and the risk of actual profits being materially different from the value accrual (see below). If timing permits, it may be advantageous to use the balance sheet from the statutory financial statements as the locked box, though buyers should be aware that the accuracy of that balance sheet will be subject to audit materiality.

VALUE ACCRUAL

The final important feature of the locked box mechanism is how to deal with the value movement in the balance sheet due to trading between the locked box and completion date. By applying the equity value adjustments at the locked box date, the economic risks and returns effectively transfer to the buyer at that date. From a seller's perspective, they may still be managing the business to generate profit and will have capital tied up until the completion date when the consideration is paid. Sellers may therefore expect to be compensated for this via an upward adjustment to the consideration (assuming the business is profitable). This adjustment is often referred to as the 'value accrual'.

One approach which is often used to calculate the value accrual is 'cash profits', which can be viewed as an approximation of the movement in value which would have been realised had a completion accounts mechanism been applied. Under this method the value accrual is calculated as:

profits before depreciation and amortisation, after interest and corporation tax charges.

Capital expenditure is also normally included in the cash profits calculation (excluding any amounts already treated as debt-like items), though parties sometimes agree to exclude capital expenditure that is agreed as being over and above a normal maintenance level.

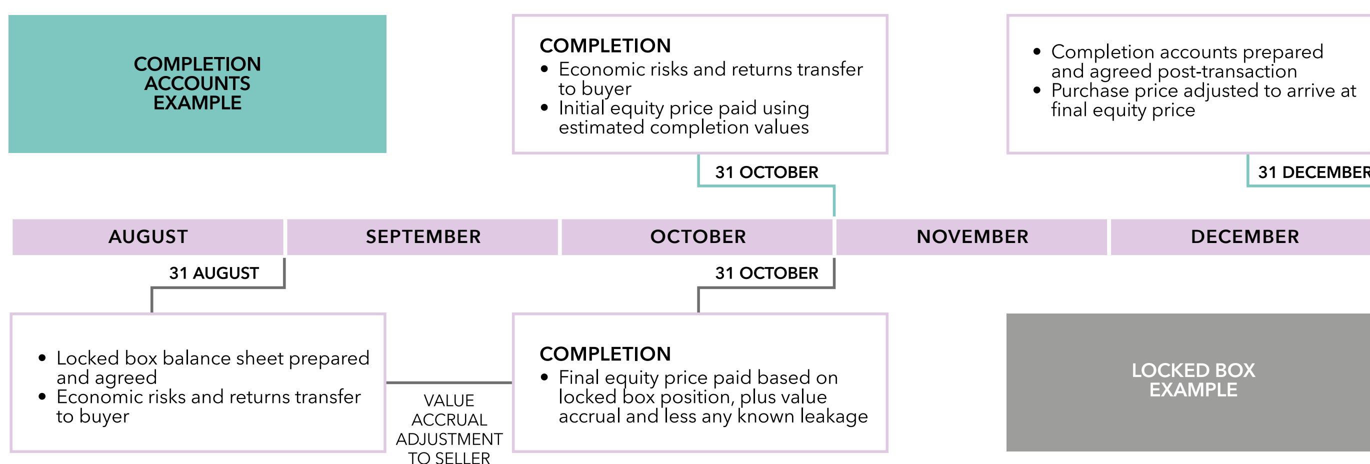
Grant Thornton's research has shown that the 'cash profits' type adjustment is the most commonly used.

As the profit up to the point of completion cannot be known with certainty prior to completion, this calculation normally comprises actual results so far as available and projections for the remaining months. If the timing of completion is uncertain a daily rate is normally agreed for the final part of the period.

An alternative basis is an interest-based value accrual applied to the equity value using an agreed rate of return to the seller for the post-locked box period. Buyers and sellers sometimes disagree on the rate to be used, varying from an equity-return-based rate to a lower, debt-return-based rate.

Grant Thornton's research indicates that, where this basis is used, the interest rate is more commonly based on an equity return rate.

COMPLETION ACCOUNTS VERSUS LOCKED BOX SUMMARY



	Completion accounts	Locked box
Point at which equity value known	Post-completion	At completion
Equity adjustments laid out in SPA	Yes	No – final consideration stated in SPA
Balance sheet date on which equity adjustments are applied	Completion date	Locked box date pre-completion
Protection for buyer	Completion accounts process	Locked box warranty and leakage provisions
Risks and rewards transfer to buyer	At completion	At locked box date pre-completion
Adjustment for value accrual between locked box and completion	Not required	Various methods available with 'cash profits' the most common
Can be used for trade and asset transactions	Yes	No

HYBRID MECHANISMS

Completion accounts and locked box are the generally accepted mechanisms, but in some cases hybrid mechanisms are used.

One such example is where a locked box is envisaged but one party still desires an element of post-transaction true-up ie, in respect of the actual profits to completion or the cash, net debt or working capital movements. There is limited rationale for bringing this true-up into a locked box mechanism, as the parties may be better served by applying a completion accounts mechanism if one party is not satisfied with the fixed equity value pertaining to a locked box mechanism.

Another example is where the business is not capable of preparing completion accounts as at the date of completion, in particular if completion is mid-month and the accounting systems of the business do not enable the accounts to be prepared reliably on that day. In some instances the parties may agree to a completion accounts mechanism based on the nearest month end date pre-completion, with leakage and value accrual adjustments similar to a locked box, or with completion accounts prepared to the nearest month end date post-completion, with equivalent leakage protection for the seller and a negative value accrual. In many cases it is preferable to avoid this added complexity by applying more resources to preparing completion accounts to the mid-month completion date or, if possible, ensuring completion takes place at a month end.

OTHER ADJUSTMENTS TO THE CONSIDERATION

RETENTION

The initial amount of consideration may be paid net of an amount retained by the buyer, to be released subject to confirmation of the price adjustment once the completion accounts and the completion statement are agreed between the parties. The buyer will then pay the balancing figure once confirmed.

ESCROW

Completion mechanisms may entail a claw-back of consideration paid by the buyer. In order to protect the buyer and ensure the seller is able to make the repayment on the due date following completion, certain of the completion funds paid by the buyer may be placed into an escrow account in the intervening period from which the price adjustment can be funded. Any balance remaining after finalisation of the completion statement would be returned to the seller.

Price adjustments may be subject to an upper or lower limit, and an amount held in escrow can provide a ceiling on funds to be paid/repaid following completion.

DEFERRED CONSIDERATION

Consideration for the acquired business may be split over time, with an amount due on completion (subject to post-completion true-up adjustments as stated before) and a further amount deferred to a later date. The deferred element of consideration is commonly contingent on certain conditions being met, for example the former owners remaining in the business to ensure a smooth transition, with no consideration payable to sellers that have left.

Deferred consideration may be contingent on the business meeting certain performance targets in the period post-acquisition (sometimes called an 'earnout'). This provides an incentive for former owners not only to remain in the business post-deal, but also ensures they retain a financial interest in its continuing success.

EARNOUTS

In order to determine whether contingent consideration is due, earnout accounts must be produced for the earnout period so the results of the business can be compared with the agreed targets. The basis for preparation of earnout accounts is subject to similar considerations as completion accounts, to try and instil a mechanism that will minimise the chance of disputes arising. This includes agreeing the specific accounting policies, with the reference accounts to provide a consistent basis for items not covered by specific policies (which may be the same historical accounts as those used as the basis for the completion accounts), and the relevant GAAP to apply where no specific accounting policies have been prescribed and no precedent treatment exists in the reference accounts.

Similar to completion accounts, the format for earnout accounts and the formula for any calculations should be agreed pre-completion, and it is usually advisable to attach a pro forma and/or worked examples to the SPA to minimise the scope for disputes.

Comparing performance pre- and post-deal

Earnout accounts often have additional risk factors making them particularly prone to disputes, due to the scope for change in the business between completion and the earnout date. For example:

Changes to the type of business	Changes in relation to suppliers, customers and products or service lines within the business leading to changes in financial performance and position such as revenue streams, direct and indirect costs, margins and working capital profile
Synergies and cost efficiencies	New systems and processes implemented or changes in key personnel within the business may increase margins and overall profitability, albeit with upfront costs
Integration of the business into a wider group	The business may be integrated and subsumed into a wider business with overlapping operations and shared service functions that now report as one unit
Changes to reporting requirements	The business reporting regime may have changed from a local GAAP to IFRS (or vice versa) on acquisition, or there may have been changes to GAAP
Changes to accounting policies	If the business has joined a new consolidated group, it may have to change its accounting policies post-deal to align with group policies

Ideally buyers wish to incentivise sellers by agreeing a fair reward by reference to post-deal results within the seller's control. However, in practice there will likely be difficulties in making an accurate like-for-like comparison of results before and after the sale, due to changes post-deal such as those given above.

The parties could either try to set performance targets anticipating and taking into account the likely impact of expected changes on post-deal performance, or prescribe the basis of preparation of the earnout accounts such that the impact of post-deal changes outside of former management's control is excluded.

Both options are likely to involve significant uncertainty arising from predicting future changes. The difficulties that may arise in the latter option depend on how feasible it is in practice to isolate the results of the acquired business from the new group, and separate out the performance of the comparable pre-deal business from the impact of post-deal changes on performance and reported results.

The more specific policies for dealing with post-deal changes that can be agreed in advance and enshrined in the SPA, the narrower the scope for disputes. This may include agreement of particular product lines to be included in the earnout results, or an agreed percentage uplift on certain costs to anticipate post-deal efficiencies that are not to be reflected in the earnout results, or an agreed treatment of costs anticipated to benefit from efficiencies.

Measure of performance

EBITDA is a commonly used measure of earnout performance, as it does not consider the impact of interest costs, taxation and depreciation charges, which are arguably not core to operational performance, and may be outside the seller's/former management's control. It also avoids potential disputes over which categories of cost should be included in direct cost of sales ie, affecting gross margins, and which are to be treated as overheads.

If another measure of performance such as 'gross profit' is to be used, it is recommended that any such term is tightly defined in the SPA including all component parts and the basis for calculating any apportionment of overheads to costs of sales. Other measures are sometimes used eg, sales volumes, that are less prone to accounting subjectivity.

Materiality

Reward structures often include critical targets below which there is a significant drop in consideration or none at all. If the actual results fall just below such targets, this is likely to provoke disputes over even the smallest item in the earnout accounts, as an immaterial adjustment to EBITDA that takes the result just above a critical threshold could have a significant impact on the consideration payable.

Designing the reward structure to allow consideration to be payable on a sliding scale – for example, allowing some consideration to be paid for reaching 80% of the target up to a maximum consideration if the target is attained, as opposed to an 'all or nothing' approach – may reduce the incentive to dispute immaterial amounts affecting the results when close to the target threshold.

Extra consideration should be given to accounting policies for items that may have been too small to feature in the statutory accounts (where audit materiality applies) but that may have a material impact on the earnout consideration. Imposing a de minimis limit on items that can be disputed may also reduce the extent of disputes.

ACCOUNTING WARRANTIES AND INDEMNITIES

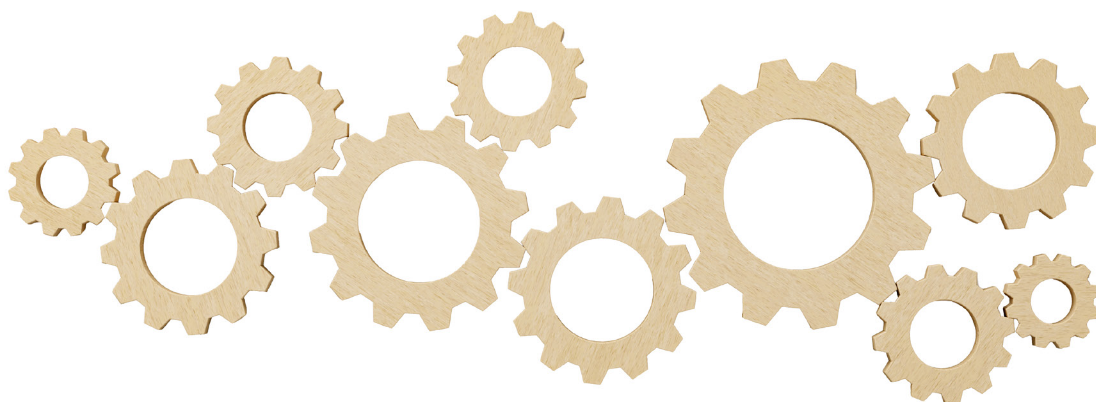
The buyer will want the seller to warrant that the last accounts fairly reflect the financial performance and position of the acquired entity for the relevant period. The level of assurance that can reasonably be obtained depends on the type of accounts.

- Financial statements: these can be warranted to show a true and fair view of the financial position and the results of the business for the period then ended (consider whether audited or unaudited).
- Management accounts: these can be more appropriately warranted to reflect the transactions of the business with reasonable accuracy – note that management accounts are not required to be GAAP compliant.

Accounting warranties may also be sought on certain items where large swings in value can occur due to changes in circumstances, such as contingent liabilities with respect to ongoing or pending litigation or claims, including property-related disputes or environmental claims.

A warranty will also typically be sought that no material adverse change has occurred in the period since the last accounts in relation to the trading and financial position. In addition, warranties will typically be sought on tax and pension liabilities.

All warranties are subject to fair disclosure of any factors which the buyer has been made aware of during due diligence that may have a material impact which would otherwise give rise to a warranty breach.



CLOSING REMARKS

This guideline illustrates points on which a buyer's view of the final transaction price often differs from that of a seller. It aims to promote trust and integrity by demystifying the core principles behind equity value adjustments and how they are applied. It also provides guidance to help parties reach agreement on the more subjective and contentious areas, thereby creating value through more efficient transactions, and fewer disputes.

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As co-head of Grant Thornton's pre-deal Sale and Purchase Agreement (SPA) Advisory practice, Patrick O'Brien specialises in advising buyers or sellers on transaction equity value adjustments and on the financial aspects of SPAs. This includes assessing and agreeing working capital and net debt adjustments, completion mechanisms, locked box and leakage provisions, earnout adjustments and accounting warranties. Patrick has over 14 years of transactions' experience, having acted for shareholders, private equity firms and corporate clients on hundreds of UK and cross-border deals. His background prior to specialising in SPA Advisory was financial due diligence and he is a Fellow of ICAEW.

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