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Business Combination Series

A Tale of Two Closings: Completions Accounts versus Locked Box Method

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Preface

Welcome to our 'Business Combination' series, a comprehensive exploration of the International Financial Reporting Standard that governs accounting for business combinations, IFRS 3. In this series, our objective is to provide clear guidance on IFRS 3, titled 'Business Combinations,' offering financial professionals, stakeholders, and decision-makers practical insights into the accounting rules that shape the treatment of mergers and acquisitions in the financial world.

Business combinations are transformative events with distinctive features. IFRS 3 serves as the guiding framework for recognizing and measuring assets and liabilities in these transactions. This standard has been in place for over a decade and has undergone thorough evaluations by the International Accounting Standards Board (IASB).

Each episode in this series is carefully curated to unpack the complexities of the business combination, presenting concepts in a clear and actionable manner. From the basics to advanced techniques, we will explore various aspects of deal structures, delving into real-world case studies, tax issues, contract issues, regulatory issues, and practical applications. Our goal is to equip you with the tools and knowledge necessary to make informed financial decisions, whether you are involved in mergers and acquisitions, real estate transactions, or any other financial deal.

The research underlying this report was run by the dedicated team of Helios Financial Group M&A practice, led by Asad Khan, a partner.
Valuable perspectives and advice were offered by a distinguished panel of academic and industry experts. Including, various articles, publications, books and research materials.

The report also benefited enormously from the contributions of HFG's global network of industry experts. It drew on HFG's indepth analytical expertise, our work with leading preferred acquirer organizations, distinguished lawyers, esteemed tax advisors and our understanding of deals space around the world.

The authors would like to thank the external and internal advisers for their contributions. In addition, the authors would like to thank Ammad Ahmed and Waqas Ahmed for their help in art directing, producing, and disseminating this report.

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1. This report was not commissioned or sponsored in anyway by a business, government or other institution.
2. Debra C. Jeter, Paul K. Chaney (2018), Advanced Accounting
3. Grand Thornton, Insights into IFRS 3
4. PWC Insights, Business Combinations
5. By reviewing this paper, no individual is endorsing its conclusions. All errors remain our own.

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In the dynamic and intricate space of deal planning and execution, executives navigate through a challenging business landscape. An alternative approach to finalizing deals, known as the "Locked Box" mechanism, offers an expedited and simplified path to deal completion. This method is notably favored by private equity sellers, driven by their keenness to swiftly conclude transactions, maximize value, and sidestep subsequent adjustments. Notably, this approach is gaining traction in corporate-to-corporate deals, underscoring the enduring relevance of Locked Box closing mechanisms.

The adoption of the Locked Box mechanism hinges on two primary factors. Firstly, it instills a heightened assurance regarding the predetermined price for the target business at the point of completion, allowing the seller to reallocate capital for reinvestment purposes. Secondly, it eliminates the necessity for a post-completion "true-up" process, an aspect often prone to disputes. By doing so, it frees up management bandwidth, curtails expenses, and reduces uncertainties surrounding subsequent adjustments in the purchase price.

THE TRADITIONAL APPROACH

In customary practice, the agreed equity purchase price is set at the contract signing and disbursed upon completion. Typically, this valuation is based on a multiple of EBITDA or discounted cash-flow assessment, with adjustments for net debt, working capital, and other relevant factors, all referenced to the balance sheet at the transaction's close. Despite thorough due diligence and a comprehensive sale and purchase agreement, this final phase can often feel prolonged and occasionally concludes with one party feeling that they have left some value at the table.

Between the agreement signing and the transaction's finalization, the business's value is prone to fluctuations. Variations between projected and actual net debt and working capital are commonplace. Consequently, a true-up process is engaged after the completion to reconcile and concur on adjustments to the purchase price. Regrettably, this phase often leads to disagreements and takes a toll on management resources.

Furthermore, the inclusion of a true-up phase elevates the intricacy of the sale and purchase agreement. Both the buyer and seller advocate for clauses and definitions that bolster their negotiation position, augmenting the agreement's complexity. These negotiations can incur supplementary costs, and, surprisingly, they may result in a loss of value during the process, catching the involved parties off guard

TYPICAL DISPUTE AREAS

Set out below are some typical reasons for disputed items in completion accounts and earnout accounts, 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)	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)

HOW "A LOCKED BOX " TRANSACTION WORKS

The Locked Box transaction model deviates from conventional methods, whereby, the Equity Price is fixed in the SPA at the Signing, calculated based on the historical balance sheet (the "locked Box Balance Sheet") at a pre-signing date (the "Locked Box Date), and this valuation remains static. However, the buyer is obligated to compensate the seller for anticipated changes in net debt occurring between the Locked Box date and the completion, known as the 'value accrual.'

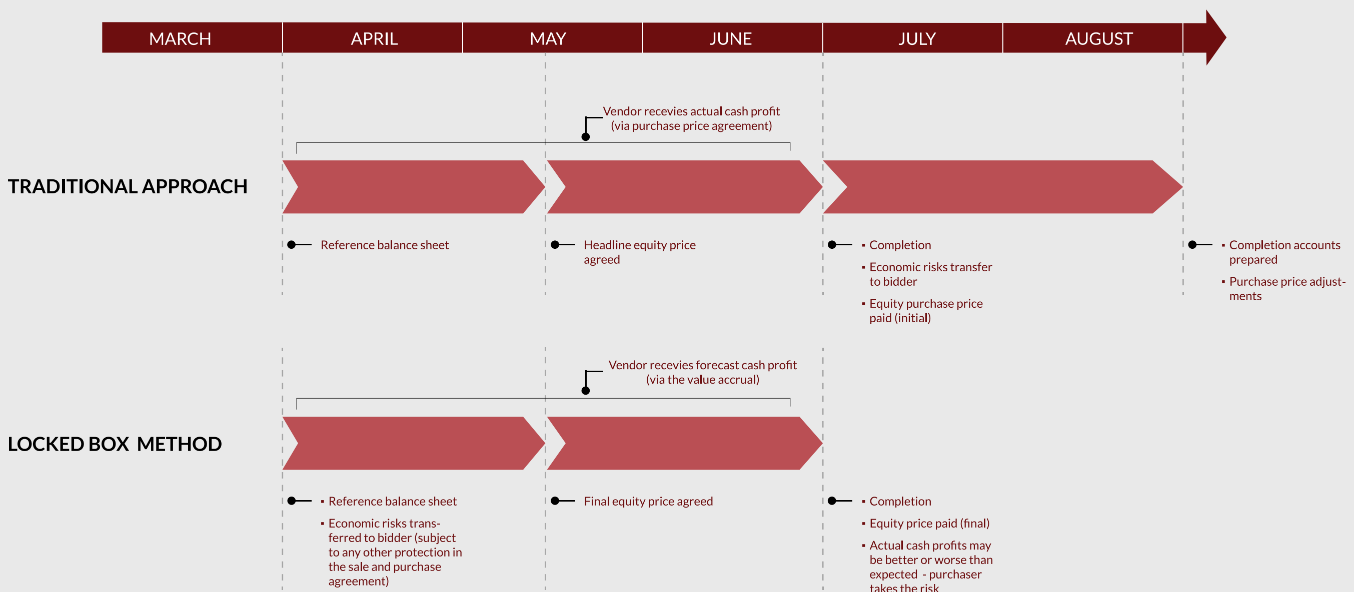
Notably, the sale and purchase agreement does not allow for post-completion adjustments or net debt true-ups, aside from potential claims underwarranties. Commencing from the Locked Box date, all economic risks and benefits flowing from the target company's performance effectively passes to the buyer.

HIGH NOTE

A LOCKED BOX: THE EQUITY PRICE IS CALCULATED BASED ON A DEFINED HISTORICAL BALANCE SHEET DATE AGREED BY THE PARTIES - THE "LOCKED BOX DATE" - AND THIS PRICE DOES NOT CHANGE.

The appropriateness of employing a Locked Box approach hinges on specific circumstances surrounding the transaction. The buyer must seek assurance on two critical fronts. Firstly, the integrity of the Locked Box must be robust, ensuring no unauthorized alterations. Secondly, the buyer's confidence relies on the accuracy and completeness of the financial information at their disposal, enabling precise calculation of the equity price, encompassing a reasonable estimate for the value accrual."

THE TRADITIONAL VERSUS LOCKED BOX APPROACH



Two aspects, briefly explained here, bear important consideration in lock box mechanism, namely, leakages and quality of financial information.

Leakages

Leakages comprise any form of value extraction from the Target business to benefit the Seller between the Locked Box Date and Closing. This includes dividends (actual or deemed), management fees, asset transfers below market value, and the forgiveness of owed amounts or liabilities.

On the other hand, Permitted Leakage refers to any pre-agreed forms of Leakage between the involved parties, explicitly outlined in the Sale and Purchase Agreement (SPA) before formal signing. Whether Permitted Leakage affects the price is contingent on the specifics agreed upon. For instance, a dividend disbursed to the Seller post the Locked Box Date would lead to a price reduction, whereas routine salary payments to employees would not impact the price."

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Quality of Financial Information

The necessary quality and standard of financial information required by the buyer can vary significantly. Such is heavily influenced by the industry of the target company and the buyer's thorough assessment of the business risks involved. In a stable, well-established business, the buyer may find comfort with a lesser degree of quality.

Similarly, the buyer may accept a broader estimate of the value accrual if they deem the resulting amount inconsequential in relation to the overall deal value. Conversely, if they anticipate significant changes within the business during the Locked Box period, they will insist on comprehensive, precise financial details and higher levels of assurance regarding accuracy.

PRACTICAL CONSIDERATIONS

IMPACT ON THE DEAL PROCESS

In the initial bidding round, whether employing Closing Accounts or a Locked Box mechanism to finalize the deal, 'cash-free, debt-free' bids are submitted to the Sellers, establishing their anticipated Enterprise Value expectations. Before moving to the next round in the deal process, Sellers frequently attempt to anticipate potential price adjustments by prospective Buyers.

This anticipation allows Sellers to proactively construct counterarguments, mitigating potential deductions. In a growing trend, Sellers are now expressing their interpretation of the Enterprise to Equity Value schedule. This strategic move aids in influencing and 'managing' Buyers' expectations related to adjustments in Cash, Debt, and Working Capital.

The Seller often provides indicative 'guidance' to Buyers, outlining acceptable deductions from Enterprise Value and pointing out adjustments that could negatively impact the competitiveness of their bids in a competitive auction process.
To secure Buyer acceptance of the fixed share price based on a historical balance sheet, it's imperative that the Seller offers a warranty asserting that no Leakage has transpired since the Locked Box Date. This warranty, extending to the Closing Date, is typically fortified by an indemnity. Under this indemnity, the Seller commits to reimbursing the Buyer for any Leakage on a dollar-for-dollar basis. It's essential for the Buyer to insist on a detailed schedule of Permitted Leakage items (including payee, amount, and timing) to properly price them, as Permitted Leakage is exempted from the definition of Leakage.

Subsequently, the Sale and Purchase Agreement (SPA) outlines a post-Closing period during which the Buyer can diligently review the Target business's books and records to identify and claim any Leakage. It should be noted that Leakage claims should be carved out of the de minimis and maximum thresholds applied to the general representations, warranties, and indemnifications.

VALUE ACCRUALS FROM LOCKED BOX DATE TO COMPLETION DATE

Since economic interest effectively shifts to the Buyer starting from the Locked Box Date, the Buyer gains from the cash profits generated by the business during that period. Conversely, the Seller faces an opportunity cost, not receiving payment at the Locked Box Date but instead at Closing.

To offset this opportunity cost, interest is typically imposed on the Purchase Price (Equity Value) for the duration between the Locked Box Date and the Closing. The Seller usually seeks either:

- An interest charge on the Purchase Price (Equity Value) for this period, reflecting the Opportunity Cost incurred due to delayed payment from the Buyer since the economic interest has already passed; or

- A proxy for the profits that would have been earned (e.g., daily profit rate) had they been received from the business since the Locked Box Date.

This interest charge, whether proposed as compensation for the opportunity cost or a proxy for profits, usually mirrors the anticipated 'Cash Profits' generated by the Target after the Locked Box Date, not the Operating Cash Flow.

Regardless of the Seller's reasoning, Buyers should scrutinize the amount payable under the interest charge in comparison to the projected Cash Profits to be generated between the Locked Box Date and Closing. Cash Profits generally represent the increase in net assets of the Target during this period. We emphasize that Working Capital movements are addressed within the Locked Box, thus not impacting the calculation of Cash Profits (assuming a securely 'locked box' with no Leakage, any increase in Working Capital would result in a decrease in Cash or an increase in Debt). Common miscalculations often involve the interest accrual not aligning with the debt deduction and potential double counting of deductions or Leakage items.

CONCLUSION

To sum up, the pricing principles and operational mechanics in a Locked Box mirror those of the traditional Completion Closing Accounts. Ultimately, the Buyer will remit payment to the Seller for the shares, constituting an Equity Price (i.e., Enterprise Value adjusted for Cash, Debt, and the difference between Target Working Capital and Working Capital). The integrity of value in both pricing mechanisms hinges on shrewd management of these critical financial drivers linking Enterprise Value and Equity Value through effective negotiation and prudent treatment.

In contrast to the traditional Completion Accounts process, discussions regarding these balance sheet elements occur while the auction process is ongoing, not exclusively during the Buyer's exclusivity period, granting more influence to the buyer to control the deal process.

PRACTICAL TIPS

- ✓ Know the potential, alternative Locked Box dates that could be used
- ✓ Review the balance sheet at the Locked Box date to determine net debt and "normal" levels of working capital (including adjustment to purchase price, if necessary)
- ✓ Prepare and review the monthly financial information between the Locked Box date and closing (likely consisting of actual reporting and forecast)
- ✓ Compare (where possible) the outcome of checkpoint 3 to your budget/forecast and prior year in order to understand business performance, analyze unusual developments and separately identify movement in net debt items
- ✓ Identify any actual leakage since the Locked Box date and any specific leakage risks
- ✓ Review the SPA to ensure appropriate clauses relating to the use of a Locked Box mechanism, including clauses to address any actual or possible leakage
- ✓ Calculate the value accrual (absolute and as a daily/monthly percentage based on purchase price)
- ✓ Perform a tactical assessment of the value to attribute to post Locked Box date cash flows, and consider how to present this.

LOCKED BOX: COMMON FAQS

Shouldn't the sale and purchase agreement have a mechanism for adjusting the price if cash, debt or working capital is different on completion?

No, there is no subsequent adjustment — that's the point of a Locked Box mechanism.

Don't we need a balance sheet just before completion so that we can adjust the price?

No, the price is fixed. Once the sale and purchase agreement is signed, the price is not adjusted. But an up-to-date balance sheet is nevertheless useful for funding purposes.

What happens if the mix of cash, debt or working capital is different on completion to what we thought?

This isn't relevant for pricing, as the business being acquired has been locked — all value generated is captured in the business. The mix of cash, debt and working capital is only relevant for funding purposes

What happens if trading after the Locked Box date turns out to be different from what is expected?

For the seller, nothing; this risk is passed to the buyer.

Shouldn't we adjust for the shortfall in capex spend identified after the Locked Box date?

No, the box is locked. Any shortfall in capex would result in an increase in cash.

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Endnotes

1. Debra C. Jeter, Paul K. Chaney (2018), Advanced Accounting
2. Grand Thornton, Insights into IFRS 3
3. PWC Insights, Business Combinations
4. Based on HFG's own consultative experience of working with clients on Mergers & Acquisitions.
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