Pricing a transaction

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Kevin Clark examines the methods and considerations for pricing a transaction for share acquisitions

Key Points

What is the issue?

Pricing is fundamental to any transaction, but what are the differences in pricing methods and how do they interact with tax?

What does it mean to me?

Tax and DD risks are an important aspects in terms of pricing a transaction. If not managed correctly they could result in your client facing a potentially unnecessary cost post-transaction, where there is not adequate protection in place.

What can I take away?

There are distinct methods for pricing a transaction, with each bringing their own tax issues which need to be considered and managed.

Transactions for share acquisitions currently tend to be priced based on either a ‘locked box accounts’ approach, or a ‘completion accounts’ approach.

In a locked box (or ‘fixed price’) scenario the price will usually be based on a set of locked box accounts (accounts covering a period ending before signing). The price is negotiated and agreed based on these accounts and due diligence, and there is no mechanism for the buyer and seller to adjust this after completion.

In a completion accounts scenario the price will be estimated prior to completion and a payment made at completion based on this estimation. A ‘true up’ will then take place shortly after completion, based on the completion accounts. These are prepared after completion for the period to completion, based on accounting policies set out in the SPA. The price may then be adjusted with a true up payment between buyer and seller depending on the position as determined by the completion accounts, when compared to the estimated price paid at completion.

Locked box accounts

These are prepared prior to the transaction taking place in order to ‘lock in’ a price at that date. This form of pricing is usually preferred by private equity buyers and sellers as it provides more certainty on price at the point of completion.

A provision for tax will be included in the locked box accounts, and as part of the diligence process this will need to be tested to ensure it is appropriate, as this provision (along with any other assets and liabilities on the locked box balance sheet) will directly affect the price. For more on the due diligence process, see the article ‘Under the surface’ by Helena Kanczula and Robert Harness in the August 2017 issue of *Tax Adviser*.

The locked box accounts are used to price the deal, but the locked box date does not represent the point when the legal ownership of the target business is actually transferred, which occurs at completion. Because the price is determined and fixed before closing, buyers usually protect themselves against leakage of value to the seller in the interim period between the locked box date and completion. This is usually by way of an indemnity in the SPA covering any ‘leakage’ flowing to the seller after the locked box date. Buyers also need to ensure that any tax costs from this leakage are also considered.

To illustrate, consider a scenario where the target company has a total balance sheet of £100 at the locked box date. In the period between the locked box date and the closing date the seller will still operate and legally own the business. If the seller decides to strip £30 out of the business one week prior to closing, the value of the balance sheet will be reduced to £70. The buyer would not want to pay £100 for the business (i.e. the price as fixed at the locked box date) if at closing the value is only £70. As such, the buyer may seek to have a leakage indemnity drafted into the SPA to ensure they can recoup the £30 of leakage from the seller.

Depending on the tax status of the target business and/or the seller, the buyer also needs to be careful to avoid any adverse tax effects of stripping value from the business. If there is a 20% withholding tax obligation, for instance, the buyer may look to increase the payment from the seller to the buyer, in respect of the leaked value, by an extra £6 to a total of £36. This represents the real cost to the business (covering the £30 received by the seller as well as the withholding tax obligation of £6).

Separately, where risks are identified in the tax due diligence process, which are not reflected in the locked box accounts and there is a significant risk these will materialise into a cash tax exposure, a buyer may wish to factor these future liabilities into the price paid. Effectively treating the future liability as if it were a debt of the business at the time of the transaction. Clearly this is subject to commercial negotiation and may or may not be acceptable. If it is unacceptable to price a risk, then the buyer may seek alternative protection in the SPA, or consider insurance for the risk.

Completion accounts

The completion accounts are prepared after the transaction completes and cover the period to the completion date. At the time of closing the final price is not fixed, so the price will have to be estimated and trued up once the accounts are prepared.

As with locked box accounts, it is important to remember that completion accounts are usually drawn up for the purposes of pricing the transaction and are not usually audited statutory accounts. As such, while often using the statutory accounts as a reference, they do not necessarily have to follow the statutory accounts and can reflect specific accounting policies negotiated and agreed between the buyer and the seller.

A consideration for both buyer and seller is that the agreed accounting policies are drafted such that the completion accounts capture the assets and liabilities appropriately at the point of completion, as this will determine the ultimate price of the transaction. The process of assessing which items are reflected, and how these are reflected, is based on diligence findings and negotiation.

In terms of tax, both parties (the buyer and the seller) need to consider which liabilities and/or assets are appropriate to include in pricing (i.e. whether they are real value drivers). For example, as the completion accounts cover the period to completion, sellers usually want to ensure profits earned in that period are recorded in the completion accounts (thus reflecting these profits in the price paid for the business). We would expect a buyer to argue that tax on these profits should be included as a liability in the completion accounts (thus reducing the price), if the tax will result in a real future cost to the business.

At a very basic level, if we imagine a company has assets of £100 at completion, but those assets are partly made up of profits accumulated in the period to completion, and we are able to determine that a cash corporation tax charge will become due of, say, £10 on those profits, then we would seek to include the £10 liability in the completion accounts such that the assets of the target company would be reduced to £90 net.

Deferred tax also needs to be considered, in particular whether or not a deferred tax balance is likely to unwind into a cash item for the target entity. Appropriate payroll and indirect taxes should be considered when calculating the accruals figure, as well as any specific tax consequences of the transaction, such as tax on vesting of options.

It should be noted that the determination of what is reflected in the locked box accounts or completion accounts (and so pricing of a transaction) is a process of negotiation and there is no ‘correct’ answer in terms of whether items should be priced or not.

The above text is designed as a high level overview of what may be appropriate in certain transactions, but does not factor in transaction specific issues or risks and so cannot be applied to specific transactions without considering the overall commercial context of the deal.