



Buying or Selling a Business? Understanding Purchase Price Adjustments

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You have agreed to buy or sell your business for \$3,000,000 and settlement is approaching. The buyer pays, and the seller receives \$3,000,000 on settlement, correct?

Not necessarily.

In many share sales, the agreed price is based on assumptions about the company's financial position when ownership transfers. A purchase price adjustment mechanism reconciles those assumptions against the company's actual position at settlement and adjusts the price accordingly.

Its purpose is to ensure that:

- the buyer only pays for what it receives; and
- the seller receives the value for what they are genuinely selling.

Why is an adjustment needed?

Unlike an asset sale, when shares are sold, the business continues to operate. The buyer acquires the company with its existing assets and liabilities, including cash, debtors, stock, creditors, employee entitlements and debt. These amounts fluctuate daily.

There may also be a significant period between agreeing the price and completing the transaction. During that time, invoices are paid, suppliers and employees are paid, stock is purchased and sold, and loans may be repaid or drawn down. By settlement, the company's financial position may differ from the position assumed when the price was negotiated (and the agreement was signed).

Many businesses are valued on a "cash free, debt free" basis and with a "normal level" of working capital. In practical terms, the seller retains surplus cash and remains responsible for any debt, while leaving the business with enough working capital to continue operating normally. A purchase price adjustment translates that commercial understanding into a calculation.

What is working capital?

Working capital is generally the amount available to fund the business' day to day operations. It is commonly calculated by subtracting agreed current operating liabilities from the agreed current operating assets.

Depending on the business and what the parties agree, this may include debtors,

stock, prepayments, creditors, customer deposits and accrued expenses. It may also be necessary to consider cash, bank debt, shareholder loans, tax, GST and employee entitlements.

How does a standard-form adjustment work?

For smaller or more straightforward transactions, it is common for a standard form agreement, such as the Law Association's Legal Forms agreement to be used.

When using this standard form agreement, the purchase price is often recorded in Schedule B as a fixed amount, rather than being adjusted through an embedded purchase price adjustment mechanism.

If the transaction requires contemplation of one or more purchase price adjustments, the relevant provisions need to be included as standalone clauses and inserted as further terms in Schedule B.

What does a mechanism in more a substantial transaction look like?

If only one or two items need to be reconciled, a standard form agreement with tailored further terms may be appropriate. However, where multiple items need to be addressed, a bespoke agreement is often a clearer and more practical option as it can embed these terms rather than having them 'bolted on' as further terms in a standard form agreement.

This does not mean that a bespoke agreement must be excessively long or complicated. For a transaction valued between \$500,000 and \$10,000,000, the adjustment mechanism can often be addressed through a focused purchase price clause and supporting schedule. The advantage is that the adjustment mechanism is clearly built into the agreement, and both parties can see how the settlement price will be calculated, including the scope of items that may be reconciled, significantly reducing the likelihood of a purchase price dispute arising at settlement or at a later date when an adjustment is scheduled to be made.

The calculation may be as straightforward as beginning with the agreed business value, adding cash, subtracting debt and other liabilities, and adjusting for any difference between target and actual working capital. To support this calculation,

the agreement should also address the matters relevant to the business in practice, which may include:

- which accounts are included in cash, debt and working capital;
- how overdue debtors, obsolete stock, employee entitlements and related-party balances are treated;
- the accounting policies that apply;
- who prepares the completion statement and when;
- what access the other party has to supporting records;
- the process for objections and payment; and
- referral of unresolved accounting disputes to an independent accountant.

The agreement may also provide for part of the price to be held back or placed in escrow until the adjustment is finalised. This can be useful where the likely adjustment is significant or recovering money after settlement may be difficult.

Key takeaways

A purchase price adjustment mechanism is not an attempt to renegotiate the deal after signing. It is the process used to give effect to the deal the parties originally agreed.

A clear mechanism should identify:

- any assumptions underpinning the headline price (and their scope);
- any items that may adjust it;
- the accounting policies that apply; and
- the process for resolving any dispute that may arise.

Getting those details right can prevent a seemingly simple wash-up becoming the most contentious part of the transaction and protect both the seller and buyer from receiving or paying any amount not due to them.

Choosing the right form of agreement matters too. A standard form may suit the sale and purchase of a smaller, simpler business with stable working capital and a clean balance sheet, whereas a bespoke agreement often streamlines the transaction where the business is more complex, for example if it has seasonal trading, material stock, significant employee liabilities or shareholder loans.