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Mergers and Acquisitions

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IN THE PAST DECADE, in fact ever since World War II, one of the phenomena of our business economy in the United States has been the increase in size of our business entities and the resultant decline in the proportionate volume of business conducted by our small corporations, partnerships, and individual proprietorships. There are many reasons for this, of course—economies of operation through volume purchasing, mechanized manufacturing processes resulting in lower labor costs and more defect-free and uniform products, ability to hire and retain more competent management because the higher cost of such management is spread over greater volume, more efficient research and development programs and departments—one could go on and on. We are not gathered here this evening, however, to discuss the relative merits of big business and small business—whether big business is good for our economy as a whole and whether we, as individuals, are the benefactors of this phenomenon through lower prices and improved products. Instead, let us take a look at some of the ways in which big business gets big and some of the problems and pitfalls to look for in the process, so that we can be forewarned and can plan ahead to meet intelligently or avoid and circumvent as many of them as possible.

EXPANSION

Basically, I think we can all agree that there are two principal means by which a business entity can expand in size—growth or expansion from within and mergers and acquisitions from without—it's as simple as that. But while it may be simple to say, either means is not simple to accomplish. Let us consider first, and rather briefly, growth or expansion from within, because I want to spend most of the time discussing mergers and acquisitions from without.

GROWTH FROM WITHIN

Growth from within can be accomplished either by expanding the market for present products or by developing new products, either entirely new or related to present products. One of the greatest single

reasons given for the necessity of a business to expand is diversification—the desirability of not having all business eggs in one basket. We are all aware of numerous examples of businesses standing still—and even going downhill or out of existence—because of failure to diversify and of shrinking demand. Products of many companies are constantly being replaced by products of others that do the job better. The weaker companies find the competition from the stronger sources just not possible to meet. I have personal knowledge of a company that is unfortunately in this weaker category and, it appears, will soon be forced to close its doors. This company has been the primary industry in its community for many years, and its demise is not only a financial catastrophe to its stockholders, to management, and to other employees, but also to the entire community. And so management must constantly be alert to the dangers of possible obsolescence of its products and to competition it cannot meet and be working toward the development of other products that would be compatible with the know-how of its employees and the physical facilities, with some modifications, of its plant and equipment.

Now, let's consider the advantages of expansion by growth from within. First of all, you're working with the same general management team and employees although, of course, additional members of each will have to be added as the expansion occurs; actually, it is generally true that considerable added production of present products and addition of new products can be handled with much the same work force. The same is true of facilities, both production and office. Any additional capital required is normally easier to obtain—through short- or long-term bank loans, bonded indebtedness, or sale of additional capital stock—because growth from within is generally a gradual process and does not ordinarily require substantial outlays of cash or its equivalent all at one time. Actually, in many instances such expansion can be financed through retained earnings because of its gradual nature. The entire process is smoother, less disrupting to the entity's organization and personnel, and control of the business remains pretty much in the same hands, both management-wise and ownership-wise.

The primary disadvantage of expansion from within—such expansion was cited above as an advantage—is the gradual nature and length of time required for its accomplishment, assuming it can be accomplished at all. We are living, fortunately for all of us I'm sure, in a predominately competitive economy, and when a business

attempts to get a greater share of its present market or to introduce new products, even though related to present products, in its present market or in a new market, competitors stand in the way, and, regardless of the merit of the products, expansion in this manner cannot be accomplished overnight. Today, it is the isolated case indeed when a completely new product comes on the market—and thus what may be a completely new product for a particular business entity will generally not be such to the market place. Therefore, while the desire may be to expand from within by the introduction of new products, not only is it necessary to have management and a research and development department capable of developing a new product, but unless the product is completely new or substantially superior to anything similar on the market, it is a most difficult and long-term process to secure marketplace acceptance and to develop sales volume of sufficient magnitude to accomplish the objective.

I have said above "not only is it necessary to have management and a research and development department capable of developing a new product"—now, that's a pretty big "not only"; few business entities have it, and it's practically imperative for expansion from within. It must be constantly kept in mind that almost every business is looking toward expansion, increased dollars of sales, and increased profits through increased unit volume of present products and the introduction of new products, and it is only the very few with superior and outstanding personnel in almost every facet of the organization —top management, research and development, production, sales and distribution, finance, etc.—that are able to accomplish it to any great extent, and then only over a considerable period of time.

GROWTH THROUGH ACQUISITION AND MERGER

Now let's get to our other method of expansion, through merger and acquisition. For the majority of this discussion, the terms merger and acquisition of one business entity into, or by, another business entity are being treated as synonymous; actually, a merger occurs when one company absorbs another, the absorbed company losing its separate identity, and is just one type of acquisition; there are other types of acquisitions, such as consolidation (two companies combining to form a new company, both of the original companies losing their separate identities) or a company issuing its capital stock for all of the outstanding stock of another, the latter retaining its separate corporate identity and being operated as a subsidiary. So let's just

refer to this other method of expanding a business entity as the acquisition method.

The primary advantage of the acquisition method of expansion is, of course, speed; you accomplish your purpose for expansion, whatever it may be—diversification, new markets, additional production facilities, sales outlets, more competent management, or other personnel, etc.—without the long period of time consumed in growth from within. Thus, this method is frequently referred to as the "buying time" method of expansion; you get today what it may take years—even decades—to accomplish from internal growth. The primary disadvantage is, of course, the large capital expenditure required at one time, whether in cash, in long-term indebtedness, in equity capital, or in some combination of the three. Also you have the problems of amalgamation of the two separate business entities into a single, cohesive unit, which is a major task and one that may take years to accomplish even in the most compatible circumstances.

THE ACQUISITION MARKET

If a company is in the acquisition market—and we recognize, of course, that almost every company is in this market, some actively, some passively, since if the right company at the right price is available, management of the companies for which it is "right" will be interested; so let's say in the active acquisition market—how does it go about finding companies that are available? First of all, management should determine in a rather general way, but within limits, the types of companies in which it would be interested, as to size, products, manufacturing facilities, sales organizations, locations, management, and what it would be willing to pay and by what means payment would be made. Then it should make this information known, first within its own organization to those who are in a position to hear, probably in a more or less casual way in the performance of their regular duties, of the availability of other companies. For example, the fact might be mentioned to its purchasing agents, for the reason that the salesmen who call on them also call on other companies, some of which are undoubtedly in similar businesses, and may have heard (even if only by rumor) of such a company's being receptive to offers of acquisition. The purchasing agent can then report back to management, who can follow through in whatever manner and to the extent they deem appropriate. Salesmen are another example; since the customers on whom they call will also be

called on by salesmen from companies in similar businesses, and should any of the latter companies be available for acquisition, they may mention the fact to the customer, who, in turn, may relay it back to the acquisition-minded company's salesman. Management should also make its "acquisition-desired" information known to its banking connections and to its stockbrokers, both of which groups are most fertile sources of information on companies that might be receptive to offers for acquisition—also to its independent public accountants. Each of my Firm's offices in the United States maintains a file on those of our clients that seek to acquire companies and on those available for acquisition; I am sure other national firms of CPAs also do this, as well as many local firms. The information in such files for the client companies desirous of making acquisitions concerning the types of companies they would be interested in acquiring is much the same as indicated previously; as to those clients that would consider offers for acquisition, the files usually contain a condensed balance sheet as of a recent date, condensed summaries of earnings over a period of years, information on age and location of plants, types of products, sources of raw materials, sales organization and outlets, age of management, period of association with the company, desires concerning continuation if an acquisition is consummated, asking price, and manner of payment contemplated. The files also contain information on the extent to which the material therein can be disclosed to prospects and to others, and instructions concerning which of our offices and/or what party in the client's organization is to be notified should a prospect develop. These files are maintained and kept current as a service to the clients; and no finders or other fees are accepted for bringing the parties together.

BASIC INFORMATION

Once a company available for acquisition has been found on which the basic information previously mentioned has been secured and which comes within the requirements of the company interested in acquisition, the next step—if it hasn't already been taken—is to bring the legal department or outside counsel, or both, into the picture. Almost all matters in connection with the acquisition are of such importance and can have such far-reaching effects—in preliminary negotiations, in the actual acquisition (when and if consummated), and in the subsequent success of the now singly controlled companies—that it is essential to have competent legal advice each

step of the way. Depending on the particular circumstances, such as the nature and type of business in which the company whose acquisition is being considered is engaged, it may be desirable to bring in other outside experts at an early stage—engineers, appraisers, or market research people, for example. Also, considerable information will be required by management concerning the company whose acquisition is being considered to enable them to make an informed decision on the desirability of the acquisition and the price to be paid. Because so much of the information is of a financial and accounting nature it is extremely desirable to get the accounting department and the independent public accountants into the negotiations at an early stage. For example, as to the company whose acquisition is being considered, the most recent company-prepared financial statements, the audited financial statements for the past two or three years, reports (if any) to the Securities and Exchange Commission for the similar periods, and Federal and state income tax returns for the most recent fiscal years should be obtained and carefully reviewed and analyzed. Consideration should also be given to having the public accountants make a review of the company's accounting and related records and documents in relation to the most recent company-prepared financial statements. This is generally not an audit and does not take the place of an audit; it is more in the nature of what is referred to as a "businessman's review"—a relatively quick look to see if there are any matters that obviously raise questions needing attention—and can be particularly useful in determining the advisability of the acquisition and the price to be paid. Such a businessman's review is of special importance if the period of time that has elapsed since the last audit by the company's public accountants is longer than three or four months, or if the company has not been examined by independent public accountants, or if only condensed reports (such as the usual printed report to stockholders) have been issued containing no comments and few details of the accounts and transactions during the period covered by the reports.

SPECIFIC INFORMATION

It is interesting to consider some of the specific information that should be secured through the businessman's review and from the company-prepared or audited financial statements, SEC reports, and the tax returns mentioned previously, or from any of these items

singly or in combination. The information mentioned is not necessarily all-inclusive or in the order of its importance for every acquisition. Since no two acquisitions are exactly alike, the purposes for which they are contemplated vary to such a degree, and what is important to management in one acquisition may be of little importance in another. However, in my experience it has been basic for management generally to have at least the following information of an accounting and financial nature about the company whose acquisition is contemplated.

With regard to Federal and state income taxes, is the liability therefor as recorded in the accounts adequate; what is the latest year for which such returns have been examined by the taxing authorities; have any additional assessments resulting from such examinations been paid and the year closed, and have any adjustments made as a result of such examinations which affect the returns for subsequent open years been given effect to in such returns or provided for in the accounts; are any substantial tax matters in litigation and, if so, has an adequate liability been provided in case of an adverse decision; does a review of the returns for the open years disclose any unusual material items whose handling may give rise to additional tax assessments upon examination; to the Schedule M items in the Federal returns (which reconcile book and taxable income for the period of the return) disclose any material amounts of either income or expense which are recorded differently for book and tax purposes and, if so, has recognition been given to this in the accounts or is the tax basis of certain assets and liabilities (frequently fixed assets and deferred income) substantially different from the book basis? In this connection, many (if not most) companies are on one of the accelerated methods of depreciation of fixed assets (150% or 200% declining balance or sum-of-the-years digits) for tax purposes and straight line for books, with the result that the undepreciated cost of the fixed assets is substantially less for tax than for book purposes; unless a reserve for deferred taxes has been provided to compensate for future depreciation deductions for tax purposes being less than book depreciation charged against income, the effect upon future income can be substantial and should be recognized.

Does the company have any bonus or profit-sharing plans for employees to which it is committed for future periods and how great is the commitment; is there a pension plan in effect and, if so, what are the approximate current service and unfunded past service costs, if any? Do the executive and managerial employees, particularly, work under employment contracts; at what annual salaries and for what future periods; can such contracts be terminated by the company before expiration, and if so, at what cost? Are there stock options outstanding; for how many shares and at what price per share, particularly in relation to current price?

Does an aging of accounts receivable disclose substantial amounts past due and, if so, what is the reason—are there any substantial amounts in dispute? What has been the bad-debt experience in recent years and is the reserve for doubtful accounts adequate? How many days' sales are represented by accounts receivable? Are receivables discounted and, if so, what is the contingent liability with regard thereto?

What is the basis of valuation of inventories, "fifo" or "lifo" (there can be a substantial difference, particularly if at "lifo" adopted in the 1940s with the subsequent rising price levels); how is cost determined; what elements of overhead are included in the valuation; when was the last physical inventory taken and what was the amount of the adjustment from book to physical; are adequate perpetual inventory records maintained; is the inventory "in balance," and to what extent are obsolete and slow-moving items included therein and how are they valued; what are the various inventory turn-over rates and how do they compare with those for similar companies or with industry averages?

Of what do the deferred charges consist and, since they normally represent costs incurred that can be charged against operations of future periods but for which no further services will be received, are they of any value to the acquiring corporation except to the extent they may be deductible for future income tax purposes?

Has the liability for all trade accounts payable been recorded; for other accounts payable? Has provision been made for all accrued liabilities—payroll, commissions, vacation pay, real estate, personal property, and other local taxes, insurance, etc.? As to real estate taxes, what is the basis for providing for the

liability—lien date, fiscal year of the taxing authority, payment date, or a mixture?

As to long-term debt, is it payable in instalments and, if so, when do such payments commence, are they payable annually or semi-annually, and what is the amount of each? Can the long-term debt be prepaid, and what are the prepayment premiums? What are the provisions of the indenture, particularly as to maintenance of working capital, payment of dividends, acquisition of the company's own capital stock, and mergers and acquisitions? Are there any indications of default under any of the terms of the indenture?

Are there any purchase or sales commitments and contracts; any commitments for acquisition or construction of fixed assets?

In assembling some of the information described above, the accountants and attorneys will work closely, as there are certain areas where the line of demarcation is fine and by working together duplication of effort can be avoided. Also, by so doing the attorneys can indicate areas in which their investigation has disclosed the desirability of securing additional or more detailed accounting and financial information, and the accountants can bring to the attorneys' attention matters disclosed in the performance of the work requiring additional legal investigation.

Before leaving the subject of information of an accounting and financial nature to be secured through a businessman's review, from the company-prepared or audited financial statements, or from SEC reports and tax returns, and just to make sure I haven't given you an erroneous impression, I should like to stress one point. As stated before, a businessman's review is not an audit but only a relatively quick look at and for some of the more important information of an accounting and financial nature—and may not disclose all the information of this type that could be important or that would be disclosed by an audit. Thus, if at all possible, an audit rather than a businessman's review, should be performed by the acquiring company's independent accountants. It is only when time does not permit an audit —and time is frequently a factor in acquisitions—that only the businessman's review should be performed.

PRICE

I am going to touch, though briefly, on determination of price to be paid in an acquisition. There are so many intangible factors encountered that influence this decision, and the number and weight

given to each vary to such an extent from acquisition to acquisition, that I shall only mention a few matters to which some consideration will almost always be given.

The book value of the net assets and capitalization of average earnings over a period of years—both adjusted (at least mentally) for any material items brought to light in the businessman's review of the financial and accounting matters described previously—will undoubtedly be considered, as will be the current market price of the company's capital stock if it is a listed company. Often one factor, or some combination of them, will determine the price to be paid. However, if the primary purpose of the acquisition is diversification, for example, or location of plants, or sales outlets or organization, or to secure outstanding management or a particularly efficient research and development department, then some premium over the factors mentioned above may be indicated. Conversely, if the company to be acquired is in a poor competitive position because of a deficiency in one or more of the areas mentioned, or in other areas, that the acquiring company can furnish, some discount would certainly seem appropriate. Probably the matter of price can best be summed up by saying that after the managements of both companies have all the facts they can secure about what they are buying and the persons to whom they are selling, after they know what an indicated price would be based on the factors mentioned above, and after they know what premium or discount is indicated by plus and minus intangibles they are obtaining or giving up, from then on it is pretty much a matter of which management is the better horse trader.

ACCOUNTING FOR ACQUISITIONS AND MERGERS

The accounting for acquisitions and mergers is an interesting subject and one on which there has been considerable discussion, particularly in recent years, as a result of the pooling-of-interests concept. While not new, this concept really came into its own with the issuance, in January 1957, of Accounting Research Bulletin No. 48, *Business Combinations,* by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants. Briefly, the Bulletin distinguishes between a pooling of interests and a purchase and indicates that in an acquisition susceptible of being accounted for as a pooling, a new basis of accountability for the net assets of the acquired corporation does not arise; and if the acquired corporation retains its separate identity as a subsidiary or is merged,

when subsequent consolidated financial statements of the two companies are issued, the earned surpluses of the companies (including the earned surplus of the acquired company at date of acquisition) can be combined and the total shown as earned surplus for the merged or consolidated companies. On the other hand, if a purchase, a new basis of accountability for the net assets of the acquired company does arise (which is cost determined by the fair value of the consideration given by the acquiring company or the fair value of the net assets received, whichever is more clearly evident) and the earned surplus of the acquired company at date of acquisition cannot be carried over in a merger or in subsequent consolidated financial statements. Two of the more important characteristics of a pooling of interests are that (1) the earned surplus of the acquired company at the date of acquisition is carried over and is thus usually still available for dividends, and (2) a higher value of assets of the acquired company is not recognized, thus avoiding any need to record intangibles or to amortize the higher values of assets against future income.

The circumstances in each case determine whether the acquisition is a pooling of interests or a purchase. One major determinant is the means and terms of payment for the corporation being acquired.

For example, even if it is planned to exchange voting stock solely for voting stock so that a pooling is indicated, if there is an agreement or firm intention at the time of the acquisition to repurchase any substantial portion of the stock issued in exchange to a former stockholder of the acquired corporation, or a particular group of them, it tends to change the indicated accountability from a pooling to a purchase. Certain other circumstances of an acquisition that should be considered in determining whether a purchase or a pooling of interests is to be consummated are set forth in paragraph 6 of Bulletin No. 48. I shall not go into these matters other than to point out that, while no one of them is necessarily governing in such determination, management of both companies should be aware of their existence and of their implication concerning the method of accounting that follows.

Another point to bear in mind is that, because of income tax effects, there may be a conflict of interest between the acquiring corporation and the stockholders of the corporation to be acquired concerning the type of payment to be given for net assets or voting stock acquired, and so affect the method of accounting for the acquisition. A conflict usually occurs when the selling stockholders desire a

straight exchange of voting stock or an exchange of voting stock for net assets, either of which plans would make the transaction nontaxable. However, the acquiring corporation may desire a taxable transaction (in which cash or debt securities or both, but not voting stock, are part of the consideration) in order to increase the tax basis of the net assets acquired. If a nontaxable transaction is decided upon it can, as previously indicated, be accounted for as a pooling (provided other requirements for a pooling are also met) or as a purchase, whichever method is preferred. If a taxable transaction is agreed upon, it can be accounted for only as a purchase. I know of no way to resolve this conflict to the complete satisfaction of both sides; it may be the impasse that terminates negotiations. On the other hand, compromises can frequently be worked out along lines calling for (1) the acquiring corporation to increase the amount of taxable consideration to be paid the selling stockholders so that the after-tax consideration the latter will retain will approach the consideration they would retain in a nontaxable transaction; or (2) the selling stockholders to agree to a somewhat lesser price in a tax-free exchange to compensate the acquiring corporation for its inability to secure the stepped-up tax basis of net assets that would result from a taxable acquisition. Also, both a knowledgeable buyer and a knowledgeable seller will have the tax implications very thoroughly in mind at the very outset of the proposed acquisition or sale. Therefore the original offer by the buyer and demand by the seller will be predicated on the exploratory thinking of each and the disposition of each toward either a taxable or nontaxable transaction.

OTHER MATTERS

Other matters to be kept in mind in connection with an acquisition, in addition to the accounting and tax aspects, are the filings that may be required with the Securities and Exchange Commission and the various stock exchanges if the securities of either company are listed or traded over the counter. General legal counsel and the independent public accountants should be consulted on these matters, as they will be familiar with such requirements and will be able to advise management on procedure.

These, then, are the primary ways in which small business gets big and big business gets bigger, and some of the financial aspects of the process. To average business management, whose primary concern is the day-to-day conduct of regular operations and the

producing and selling of products, and who may be faced with an acquisition or merger not more than once in a business lifetime, such problems can be very difficult and crucial. However, to the extent that business management is made aware of the problems and pitfalls before they arise and can, therefore, plan and arrange to get all the facts to face up to the problems and avoid the pitfalls, then can the full benefits that should result from the bigger business be realized.