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Role of the accountant in mergers and acquisitions

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The Rôle of the Accountant in Mergers and Acquisitions

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INTRODUCTION

A careful reading of the financial pages during the early part of this year would lead one to the conclusion that the recurring theme of the 1956 operations of many business organizations was "Sales up — Profits down." The inevitable result has been to force many corporations to consider, even more critically than usual, their cash requirements for, in order to finance increased sales, business organizations have been obliged to invest greater amounts in inventory, in receivables, and in new and more efficient plants. Reduced profit margins, on the other hand, have meant that less cash has been available to business organizations for reinvestment, and the present-day intense competitive conditions have compelled companies to invest in more modern equipment in order to produce more efficiently and more economically.

RÔLE IN FINANCING

This need for cash to maintain operations at existing levels and for being, at the same time, in a position to take advantage of additional sales opportunities has caused many business organizations, both large and small, to go to the "financial well." The need presents a common problem on which the accountant can be of tremendous assistance to management. Obviously, the independent public accountant's services are necessary if a corporation is to secure funds by a public offering of its securities; the registration procedure of the Securities and Exchange Commission as to financial statements is too well known to require discussion here. But the other rôles that the accountant can play in assisting business organizations in their quest for funds may not be as well understood or appreciated.

The accountant, by virtue of training and experience and knowledge of his client's affairs (if he is a public accountant) or of his company (if he is not in public practice), is in a position to anticipate the future cash requirements. He can see the danger signs well in advance of the time when the company finds itself in need of cash. He cannot, however, properly serve his client if he confines himself, as the auditor, to verifying bank reconcilements, footing cashbooks or examining paid bills, or as the controller, to recording what happened last month. He must study the trends of the industry in which his company is engaged; he must review the financial policies his company has adopted; he must, in short, use his own knowledge of the financial facts of life in combination with his client's knowledge for the betterment of his company's or his client's affairs.

RÔLE IN MERGERS AND ACQUISITIONS

CONDUCTING THE ANALYSIS

Tonight let us consider the rôle of the accountant in this area. For the purpose, let us discuss a hypothetical corporation having some of the problems we have met during the past few years. Our typical company has been engaged in a highly competitive business and its sales have increased steadily, but not dramatically, in recent years. Over the past ten years assume that sales have increased at the rate of about 5 per cent a year and that profits have increased at a rate only slightly lower. The company has consistently paid out somewhat less than 50 per cent of earnings as dividends each year and on the basis of its year-end statements appears to be adequately financed. The independent accountant's more detailed study of the financial statements reveals some disturbing facts, however.

Property Accounts

An analysis of the property accounts indicates that the company's machinery and equipment is, on the average, more than ten years old, and that maintenance and repair costs are climbing rather steadily. Furthermore, the percentage of finished products rejected at final inspection is increasing because of failure of certain machined parts to meet prescribed tolerances. Discussions with operating personnel indicate a need for substantial investment in new machinery which will produce more efficiently and more economically.

Inventories

A review of the company's financial statements also indicates that the total inventory is, on the surface at least, substantially in excess of normal sales requirements. Discussion with the purchasing department reveals that the company has adopted the policy of stockpiling raw materials generally two to three months in advance of anticipated usage. A more penetrating analysis of material requirements by the company's purchasing department indicates that one of the basic raw materials is in short supply and, on the basis of present indications, will continue to be so for the foreseeable future, and that, therefore, a three-months' supply would not be unrealistic. On the other hand, two other basic raw materials are plentiful, there are several sources of supply, and there seems to be no reason, in the judgment of the purchasing department, why the stockpile could not be maintained safely at the one-month level.

Sales and Receivables

A review of the sales and accounts-receivable records reveals that the company's customers are scattered throughout the United States but that a heavy proportion is concentrated in California, Illinois, and New York. The company's policy is to have all checks in payment for outgoing shipments mailed to its home office located in New Jersey, and thereafter to deposit the checks in the company's bank accounts maintained in New York. An analysis of the incoming checks revealed that between five and six days elapse between the time the checks are mailed from the customer's office until they are deposited to the account of the company. The accountant's discussions with his client's bankers indicated that the use of local depositories maintained in San Francisco and Chicago, as well as New York, and the use of wire transfers, would reduce this "float" appreciably.

Other Sectors

This kind of study should be conducted to cover other sectors of the company. Suggestions as to procedures can possibly be made, for example, which will give management greater control over the company's outstanding receivables and develop prompter information as to past-due or slow-paying customers.

Industry Comparison

One further aspect of the study may be of interest. The company's balance sheet and operating statistics, both actual and projected on the basis of the foregoing studies, should be compared with companies of comparable size in the same industry. This analysis should comprehend figures dealing with inventory turnover, sales to receivables ratios, total investment per dollar of sales, and so on, to determine whether our company will be operating within the same general levels as the rest of the industry.

Forecasts

When these studies are completed, the accountants will have a fairly clear picture of the company and its probable cash requirements. At this point, with the active cooperation of the company's staff, cash forecasts can be prepared for the next four or five years, by fiscal quarters, in order to develop the future cash needs of the company. The sales department can prepare a series of sales forecasts from which future cash receipts can be estimated. The production department, the purchasing department, and the cost department working in close cooperation can estimate cash-disbursement requirements.

Accountant's Limitations

Two words of caution may be appropriate. First, the accountant must be ever mindful of his limitations; he is not, in ordinary circumstances, a purchasing agent, a production supervisor, a salesman, or even a successful business operator who combines all of these attributes. He can be no more than a trained, experienced reader of financial statements and analyzer of financial facts. In preparing forecasts of probable future operations he must rely on persons who have a greater know-how than he possesses.

A second word of caution: The accountant must be realistic if the forecasts are to be effective. There is something about making forecasts which generates optimism. Too often the most hard-headed business man will suddenly decide that all his difficulties are now over and the future looks wonderful. This may be a fine outlook on life in general, but it has no place in judging financial figures. If your client has been able to increase sales, by dint of hard work, at the rate of 5 per cent a year, there is no justification for the accountant's accepting blindly a sales-department estimate of a 15 per cent increase; if customers have always taken forty-five days to pay their bills, there is no reason to expect they will suddenly start mailing their checks on the day the material is received.

ADVISING THE CLIENT

You have now analyzed your client's operations, you have compared your client's financial statements with those of his competitors, and you have worked as part of a team in developing future cash needs. Your forecast will indicate whether your client needs short-term financing to take care of seasonal demands, implying a need for bank loans; or long-term financing, perhaps meaning a private or public sale of debentures; or permanent capital, possibly to be obtained through the private or public sale of preferred or common stock.

Working with Bankers and Lawyers

At this stage the wise accountant will suggest calling in the bankers. For just as the typical accountant is not a competent purchasing agent or sales manager, neither is he well versed in the investment banking field.

If the company, after consultation with its bankers and on the basis of the figures which you have helped to develop, decides to borrow – either on a long or short-term basis – the work of the accountant is not yet completed. Financial statements, probably in more detail than the company normally prepares, will be required for use by prospective creditors. Loan agreements or indentures, prepared by the attorneys, will contain provisions for various covenants by the company and the feasibility of complying with certain of them will be solely within the province of the accountant to determine – such as the maintenance of minimum working-capital requirements, debt to equity-capital ratios, and so on. The loan agreements will undoubtedly contain certain accounting terms which will require definition – current assets, working capital, and net earnings are but a few examples.

The accountant, if he is to serve his client properly, will also read the agreement in the light of his knowledge of the company's affairs. A requirement that net quick assets be maintained at, let us say, one million dollars may be realistic and attainable in one case, but completely inappropriate for your company which needs to build up large inventories during the year to cope with the seasonal nature of the business. A prohibition against incurring contingent liabilities of any kind in a loan agreement may be unrealistic for a company which regularly discounts customers' notes receivable at the bank.

WEIGHING THE ELEMENTS

Let us assume, however, that your client's company decides, instead of obtaining funds from the sale of securities, to merge with another company. Suddenly your participation in the program becomes even greater. You have already, presumably, determined your company's cash requirements; now you must attempt, with the cooperation of your professional counterparts in the other company, to determine the latter's cash requirements – and how these combined cash requirements will mesh. If your company needs cash in the spring and summer of the year to finance sales during the fall and winter, a merger with a company with the same cyclical demand for cash is not, by itself, going to solve any of your problems. Minus one and minus one cannot, in the ordinary situation, equal plus one.

The merger of two companies can present a number of operating problems where the accountant can render valuable assistance. For example, the merger of Company A, with plants in the east, with Company B, with plants in the west, may offer attractive opportunities for generating cost savings. Combining a manufacturing business with another engaged primarily in distribution will require some serious thinking as to whether savings will actually result from the prospective elimination of duplicate distribution costs.

Let us assume that all of the studies made by the bankers, the operating personnel, and the accountants indicate that combining the two companies would be a good thing for both, since no merger can be a happy one unless there are advantages for both sides. The next question to arise will be how best to accomplish the merger. Shall it be an exchange of securities, an outright cash purchase by one company of the capital stock of the other, or should assets be acquired. Here the accountant takes off his "financial hat" and starts to wear his "income tax hat." The Internal Revenue Code, as you all know, provides two roads in situations of this type: one, the "reorganization route," which can be tax-free to both corporations and shareholders, and the other taxable to either the Corporations, the shareholders, or both.

Reorganization Route

As a broad generalization the tax laws provide that one corporation can acquire substantially all of the capital stock of another, or substantially all of its assets, in exchange for its voting stock without any taxable income to either the corporations or their shareholders. This can be extremely important if the assets of the corporation have a present value substantially in excess of their tax basis, for it permits a corporation, or its shareholders, with certain definite limitations, to sell or exchange assets without immediate recognition of taxable gain. It can be most attractive to the shareholder of a closely held corporation whose capital-stock investment has increased appreciably in value over the years and who wishes to attain greater flexibility by having an investment in a more readily marketable security.

Other Routes

The use of the tax-free reorganization route is not, however, necessarily the best road to follow in every case. While the individual shareholder can avoid a capital-gains tax computed on the basis of 25 per cent of his gain, the acquiring corporation will be estopped from taking advantage of the higher value of the assets in computing depreciation which would be deductible for tax purposes at 52 per cent. Let us consider for a moment the case of a family-owned corporation. The tax basis of the capital stock in the hands of the present shareholders is one million dollars, the assets of the corporation have a tax basis of three million dollars, and it has a prospective purchaser willing to pay ten million dollars for the company. In a taxable transaction the shareholders would pay capital-gains taxes of $2.25 million (that is 25 per cent of the $9 million gain) and the corporation, if it could assign these values to depreciable or amortizable assets, would save taxes to the extent of $3.5 million (52 per cent of $7 million), a tax saving in the net of about $1 million. This could be made even more attractive if a deferred pay-out to the selling shareholders could be arranged, for then they would be paying their capital-gains taxes at about the same time as the acquiring corporation was realizing its tax savings.

Suppose that one of the corporations which is considering the possibility of merging had lost money in the preceding year or years. The operating loss carry-forward is frequently a valuable asset for a corporation to bring to the merger table. Indeed, in some cases, it is the corporation's most valuable asset. While the new Tax Code – supplemented by the Treasury Department's interpretations – has made the ground rules under which the operating loss can be used by a successor corporation more difficult, it is still possible to use the prior-year losses of one corporation to reduce the income taxes payable by another in future years. There are, however, some points that must be considered. In addition to the general rule that provides that the merger must make good business sense (and not, to use the words of the Code, have as its principal purpose "the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance to which the corporation would not otherwise be entitled"), there are two other sections of the Code designed specifically to limit the availability of operating-loss carry-overs to successor corporations. One of the sections provides that if, in a taxable transaction, there is a change of 50 per cent in the individual stockholdings and coupled with that change there is a change in the "character of the business" (and no one yet has been able to completely satisfy himself as to the precise meaning of that phrase) then in that situation, the operating-loss carry-forward is lost. The other section provides that if, in the case of a non-taxable transaction (*i.e.*, a reorganization generally), the shareholders of the loss-corporation do not receive at least 20 per cent of the voting stock of the new corporation, the operating-loss carry-forward is scaled down proportionately.

There are, of course, many other tax aspects which must be considered in connection with a contemplated merger or acquisition. Corporation A and Corporation B contemplating a merger, may be of equal value, but Corporation A, for various reasons, may be unwilling to give the shareholders of Corporation B 50 per cent of the voting power of the combination. In a situation such as this, the use of voting preferred stock – which will serve to dilute the voting power of Corporation B's shareholders – may be used, although in a non-taxable transaction the dangers of a new section of the Code (Section 306) must be considered. This section provides, in effect, that if a stockholder receives preferred stock in part in exchange for his common stockholdings, then the entire proceeds are taxable as ordinary income when the preferred stock is sold. The Internal Revenue Service has recently ruled that the penalties provided by this section will not be invoked against widely held corporations, but the wise management contemplating the use of preferred stock in a merger will, in my judgment, do well to obtain a ruling in advance.

Determining Values

We have discussed so far some of the elements that make for a successful merger and some of the related tax considerations. Now what about values? How do two companies considering merging decide what the respective shareholders shall receive? Basically, there are two standards that are used: One is asset value and the other is earning power. Where two companies are listed on a stock exchange and their securities are actively traded, the problem is usually fairly simple. If the stock of Corporation A is selling at 15 and the stock of Corporation B at 30, you can, in the ordinary situation, feel reasonably sure that the stockholders of Corporation B will receive about two shares for each share received by the stockholders of Corporation A. This is based on the theory that the investing public have already considered the respective values of the companies and have established their relationship marketwise. Suppose, however, that only one of the companies is listed or that neither of them is. Then the problem becomes more difficult. A company having high and rapidly growing earnings in relation to the book value of its assets will naturally expect to receive more than book value. Conversely, a corporation with relatively high book value and with low earnings will want to trade on the basis of asset value. It is my view that in the last analysis earning power is the controlling factor, for assets usually are worth only what they can earn. There are, of course, various ways of adjusting differences in earning-power values and book values.

One of the more popular methods is to employ a combination of preferred and common stock. A current example is the merger of two moderately large closely held corporations. Corporation A has a book value of about $8 million, current earnings of about $1 million; Corporation B has a book value of about $9 million and current earnings of about $2 million. Obviously, a division of common stock solely on the basis of earnings would result in a proportion for Corporation A considerably below its book value. To overcome this obstacle Corporation A's shareholder was given convertible preferred stock in addition to common stock in the surviving company, the theory being that as the assets contributed by his corporation generated earnings, there would be an increase in value in the market price of the common stock, thereby making a conversion of the preferred into common more attractive.

"Toni" Formula

I am sure that you are all familiar with the so-called "Toni" formula which has become increasingly popular. This formula, in general terms, provides that a figure, usually equivalent to book value, is paid to the shareholder immediately and additional amounts based upon a percentage of the net income earned is paid to the shareholder over future years. This formula is frequently applied when the historical earnings of a corporation are not thought to be a fair test of potential earnings, but where the buyer and seller are unable to agree as to the probable level of future earnings.

Pooling-of-Interests Route

There is one other aspect of this problem of mergers and acquisitions in which the accountant can be of considerable help. Recent bulletins of the American Institute of Certified Public Accountants have recognized a relatively new concept in this field — the concept of the "pooling of interests." Generally speaking, whenever two or more corporations are combined for the purpose of carrying on businesses previously conducted independently, the accounting to give effect to the combination will vary, depending largely upon whether an important part of the former ownership is eliminated or whether substantially all of it is continued. Where the former ownership is eliminated, the transaction can be described as a purchase; where it is continued, as a pooling of interests. The distinction between the purchase and the pooling-of-interests concepts is found in the attendant circumstances rather than in the precise legal form in which the transaction occurs. If the transaction can properly be considered as a pooling of interests, the asset and liability accounts of the companies are combined and the earned surplus accounts of the companies are carried forward intact (except for such changes as may result from changes in the par values of the capital stocks), and are therefore available for dividends to the continuing shareholders.

In a purchase, the earned surplus of the purchased company, of course, disappears. There is, however, an even more important consideration in many cases. In connection with a purchase, generally accepted accounting principles demand that the assets purchased be recorded on the books of the acquiring corporation at cost measured in money or at the fair value of such other consideration paid. This means, in effect, that while the assets purchased have a higher base in the hands of the acquiring corporation, future depreciation charges, if the excess has been applied to property, will be higher; or if the excess has been applied to goodwill, the amortization of the goodwill will be charged against future earnings.

This can have a double-barrelled effect on the corporation's earnings if the purchase has been accomplished through a tax-free reorganization, for in this situation the write-off of the goodwill and the higher depreciation charges will not be deductible for tax purposes. On the other hand, in a pooling of interests, no goodwill would arise, there would be no need, in the ordinary situation, to revalue the assets of the combined companies, and there would be no write-off against future earnings of the corporations.

CONCLUSION

Obviously, in the little time available this evening we have been able only to touch upon a number of the aspects of mergers and acquisitions and have not even mentioned the host of ramifications which can arise in any given situation. If I have given you a feeling that the accountant can and should play a significant rôle in this area, I will have served my principal purpose. The proverbial bookkeeper equipped with green eye-shade and seated at a roll-top desk has long since disappeared from the American scene, and in his place is emerging the accountant well versed in the knowledge of taxes and finance, and uniquely qualified to advise his clients on a wide variety of financial and tax matters.