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CPA's Role in Mergers

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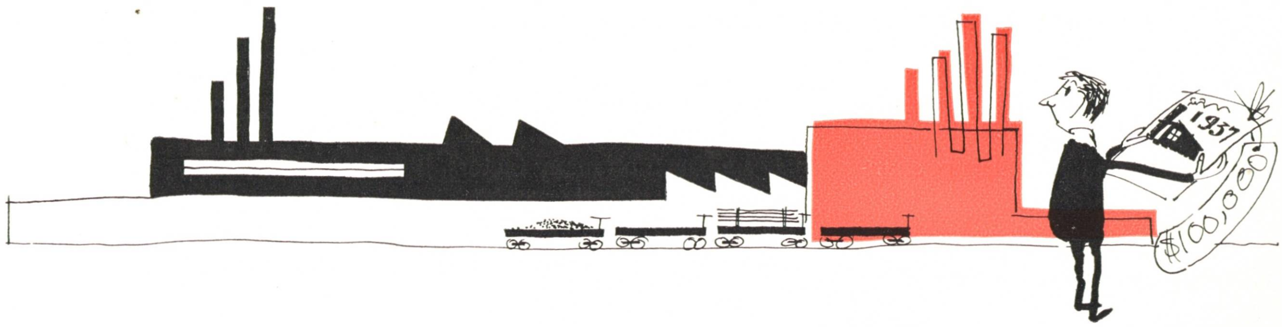


A $50,000 investment in a subsidiary acquired 30 years ago may well be worth $5,000,000 today.

Merger negotiations require more of the CPA advisor than a conventional audit of the acquired company. He must take into account the potential of that company backed by the resources of the acquirer.

THE CPA'S ROLE IN MERGERS

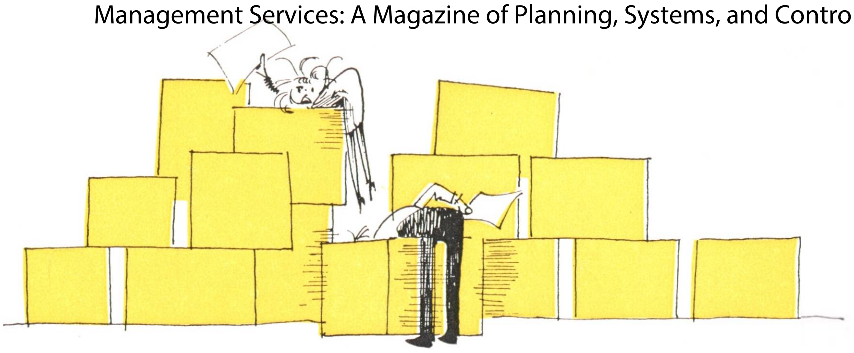
by David F. Linowes

Laventhol, Krekstein, Griffith & Co.

GROWTH through acquisition has been one of the most common methods of business expansion during the last two decades. The pace has accelerated to such an extent that completed mergers currently average about five for each working day and thousands of tentative mergers are worked on extensively each year but fall through for one reason or another during the latter stages of negotiations.

The acquisition psychology is well known. After the last world war industry was faced with insatiable demands for its civilian products, and new supertechnology was ready for a giant lunge forward. Completely new products were signs of the times. To build production facilities, to develop research departments, and to create new products take much time, gifted manpower, and immense sums of money. Why not shortcut these painstakingly slow processes and acquire one or more companies that already have all these things?

Why would a company want to sell? Sometimes a family business has no second line of command ready to take over management from aging founders or there are estate tax problems that make the cost of keeping the business in the family prohibitive. Sometimes a company finds that it is expanding beyond the limits of its working capital. Frequently one-product companies are eager to become part of multi-product companies to



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take advantage of the economies and efficiencies afforded by common selling and purchasing channels.

Auditing only part of role

The very nature of a merger, which requires first establishing values and then integrating large masses of statistical data and administrative processes presents the imaginative CPA with great challenges and opportunities. These opportunities go beyond the conventional audit function. Important as it is, auditing is only a fraction of the total service a CPA may render if he also provides management advisory services.

The CPA's services in a merger or acquisition may be classified into distinct phases, conforming to the steps in such a merger program.

Valuation

When an acquisition is in the preliminary stages of consideration, the prospective purchaser must try to establish a fair price to offer for the company he seeks. This price may be based on many factors, but generally the starting point of all negotiating sessions is the financial statements. The audited financial statements, however, tell only part of the story. To be of maximum use to a purchaser, the selling company's statements should be recast to reflect a truer picture of present-day values than is normally shown on statements prepared in general accounting practice. Such recast statements become part of a pro forma report prepared by the CPA.

On the balance sheet there may be an item shown as a 50 per cent interest in a subsidiary acquired some 30 years ago. Today, that same subsidiary, originally valued at $100,000, may have a net worth of $10,000,000. Obviously, to properly show the value of this investment, the $50,000 investment should become $5,000,000 on a pro forma balance sheet.

Patents are frequently carried at a nominal value of $1, yet the mere existence of these patents may be the primary reason the acquiring company is seeking to make the acquisition. The purchaser should place some fair value on these patents when he evaluates the financial statements.

Land may be more valuable

In this period of rising land values and explosive suburban growth, it is not uncommon for a company suddenly to find that unused excess acreage, which it bought 50 years ago along with its factory site, has substantial value as development land. Appropriate present-day values should be assigned to this acreage.

Close examination of the fixed assets could reveal some factory buildings in a depressed industrial area being carried at cost less normal depreciation. Present-day value for such property might be only a fraction of the book value. Often in such areas operating income from such a branch factory is marginal, and new management may expect to close it down. If so, the value for this property should be written down to the realizable value.

In general, undervalued and overvalued assets should be fully disclosed and treated appropriately. Unrecorded assets and liabilities should be ferreted out and presented in the accountant's specially prepared reconstructed report of financial condition.

Every effort should be made to discover and reflect contingent liabilities. Care should be exercised to determine whether there exist any circumstances that would create a new liability as a result of contemplated action after the merger. For example, if plans call for closing down a branch factory after merger, will liabilities be created under the union contract or under employment contracts as the result of layoffs?

Special factors

Frequently the purpose of the acquisition determines which items require special attention. If the CPA has been informed that the principal purpose of the merger is for the purchaser to utilize excess working capital of the seller more productively, special analysis should be made of the current asset and current liability sections of the acquired company's balance sheet.

If the apparent excess of working capital is in cash, the cash may in fact be distributed among dozens of bank accounts around the country for the use of the branches of the company. In this event,

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there probably would not be any surplus of cash actually available for siphoning off; such cash would have to remain relatively fixed as working capital just as it had always been.

Similarly, on first examination accounts receivable and inventories may appear to be unnecessarily high in relation to the volume of business and therefore subject to substantial liquidation. Further analysis could reveal, however, that the nature of the industry requires long credit terms and completely stocked warehouses in many locations ready for prompt delivery to customers.

Effects of merger

In the preparation of the reconstructed pro forma income statement provision has to be made in most cases for substantial changes in the depreciation and amortization charges. Sales should be analyzed to determine whether competitors of the acquiring company are among the selling company's customers. Such outlets would probably be lost after the merger, and provision should be made for an appropriate reduction in forecasted sales.

Sometimes the company being acquired has been so limited in working capital that it has had to forego significant quantity discounts in its purchases. If the merger will bring in adequate financing, then the savings through quantity raw material purchases may be reflected in the pro forma income statement.

If the purchaser has good distribution facilities, and the products of the new company are sufficiently compatible to be sold through the same sales channels, then consideration should be given to the anticipated increased sales and/or lowered distribution costs.

Included in the CPA's full pro forma report on the financial condition of the proposed acquisition should be a cash flow statement as well as significant ratios. These ratios may include all the normal financial ratios submitted in a long-form report, but they should also include many ratios and computations not as familiar to the average accountant. These are the ratios and computations that are commonly used by investment bankers. Items such as "Net Quick," "Market Capital," and "Sales to Common Stock Equity" are meaningful and could be significant in an acquisition analysis.[1]

Without making a conventional audit, the CPA consultant must satisfy himself that he understands the composition of all material items he proposes to include in the pro forma statements. This he does by examining documents made available to him and by conversations with key executives.

The figures in the completed pro forma statements must be *fairly stated in relation to the going concern value in the hands of the purchaser*. The fact that the original statements of the company were regularly audited by a CPA firm does not obviate the need for this recasting of all figures, largely because figures presented in accordance with "generally accepted accounting principles" do not necessarily represent fair present-day values.

After the pro forma report is completed and submitted to the client, the CPA may be called upon to advise the negotiators. Here the resourceful accountant can be invaluable to his client by bringing into play his background in taxes, SEC regulations, and corporation finance as well as his own business acumen. At this stage the CPA also would be consulted on whether the acquisition should be a "pooling of interest" or "purchase."

After terms are agreed to and the legal merger takes effect, there then open up two other areas of substantial service by the CPA.

Audit of acquisition

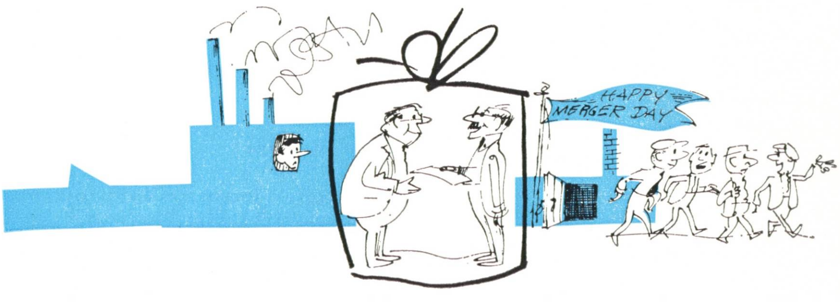
The immediate area is an audit of the newly acquired company. This may be a conventional audit, with especial emphasis on items that may have given rise to questioning during the negotiations. Frequently certain items of a merger agreement are left open pending a determination of values by just such an audit. There is no need to elaborate on the service performed at this stage since it is done in accordance with generally accepted audit standards.

The final role played by the CPA consultant could be the most significant and lasting.

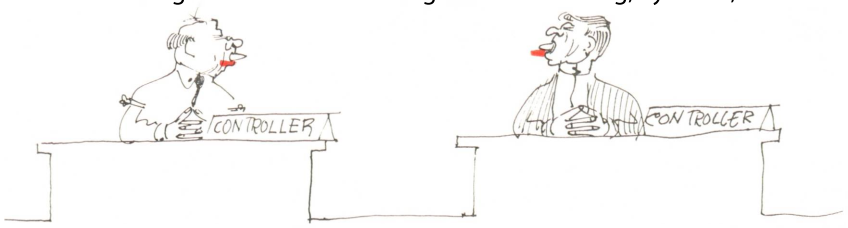
Integration

In a takeover control is first exercised over the acquired company through financial supervision and required reporting of economic data. This means that immediately after the legal merger has been effected, new reporting procedures must be developed, and the organi-

[1] The book *Security Analysis* by Benjamin Graham, David L. Dodd, and Sidney Cottle (Fourth Edition, McGraw-Hill Book Company, New York, 1962) gives excellent definitions and examples of applications of these and other ratios.



"Going concern" values are valid only if the acquiring company is sure the personnel of the acquired company will stay on the job.



Jealousies and antagonisms between opposite numbers in the merged companies are to be avoided at all costs. Make sure all sides know who is boss.

zational structure of the accounting and administrative departments may have to be modified. This is the beginning of the long and sometimes explosive integration process. Yet if the merger is to work out successfully, harmony and cooperation among all personnel are essential.

The acquiring company has negotiated for and purchased "going concern" values. Such values are valid only if the acquisition includes an organization of people, for people, not figures, are the key to going concerns. Everything possible must be done to prevent the appearance of disruptive factors. As Myles L. Mace expresses it, "Each organization that a company acquires is made up of a unique combination of human and physical assets, and it is the job of the acquiring company management to motivate and administer this unique group so as to achieve the objective which made the arrangement appear to be a good one in the first place. Preoccupation with financial angles of a merger deal often results in a failure to plan for the maintenance or strengthening of the going concern value of the acquisition."[2]

Because of the CPA's training and unique background in dealing objectively with many types of people in various administrative set-ups, he is in an excellent position to render invaluable service as an advisor all during the integration process.

Organization

As a starting point, organization charts of the accounting and administrative departments for both the acquired company and the acquiring company should be prepared. These charts should indicate by name the person currently occupying each position. Biographical sketches and performance records for each of these people should also be available for study.

At the same time paperwork flow charts should be prepared that set forth procedures currently in effect. With this material on hand, a careful evaluation of the best personnel and systems in each company can be made. This work may be executed by a committee composed of the administrative head of each company and the consulting CPA. Out of this study should evolve the framework for integrating the accounting and administrative functions, including a revision of paperwork procedures where necessary and a clarification of organizational relationships.

Who is boss?

Organizational relationships must be clarified early to avoid misunderstandings and disruptive attitudes. This clarification should cover such basic points as where each person's responsibility begins and ends under the merged set-up; what reports are to be submitted and to whom, and who is superior to whom.

What to do with excess supervisory manpower when functions are combined is always an important consideration. Such questions as these must be answered: Which chief accountant is chief, and which controller is boss? Possible benefits of a merger are quickly lost if key personnel stop doing their best or if the executive payroll goes up because the headquarters office decides to hire top financial or administrative executives to sit above the chief financial or administrative officers of the merged companies. The CPA advisor can materially assist management by pointing up these human relations elements in a merger.

So these are some of the things that must be done: a hard look at current values and assets of the company being acquired; evaluation of the effect the acquirer's resources would have on it; some insurance that its personnel will stand by.

No matter how pretty and comprehensive the elaborate pro forma financial statements may appear when presented to top executives, no financial merger can really be considered consummated until there is organizational merger. Postponing this integration in the hope that matters will work out by themselves as the members of each group of executives get to know one another better can be, and often is, disastrous. By constructive, mutually accomplished integration, new systems and machines may be explored, needless paperwork can be eliminated, and a progressive atmosphere may evolve in the entire administrative area.

A word of caution. If, after study, it appears that nothing can be gained by unifying the systems, then let things remain as they are. We should not concern ourselves with building neat, uniform organizational and flow charts as an end in itself. Our objective must always be efficient, harmonious integration in a manner which will permit effective control.

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[2] "Mergers and Incentives" by Myles L. Mace, Harvard Business School, in *Incentives for Executives*, edited by David W. Ewing and Dan H. Fenn, Jr., McGraw-Hill Book Company, New York, 1962.