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Mergers and Acquisitions: The Strategic Role of the Management Accountant

Mergers and Acquisitions have been the focus of attention in the decade of the 1980's when such business activity was most prevalent. In the '90's, the approach of many businesses in considering Mergers and Acquisitions will be a more strategic and reasoned procedure with special consideration of the ethical consequences on the many parties affected. The management accountant is in a position to contribute his expertise in the analysis of acquisition strategy. The need to determine whether acquisition or internal growth is more efficient in reaching long term goals requires accounting expertise and studied analysis of each company's situation. In certain instances, synergies may be obtained or developed which may result in creating an even more advantageous position for the acquiring company. The management accountant should be poised to provide insight into the determination of an appropriate strategy during the various stages of analysis from the defining of objectives to the integration of the companies, if a merger is consummated.

Mergers and acquisitions received a great deal of attention in the 1980's when mega deals such as the acquisition of RJR Nabisco by Kohlbert Kravis Roberts & Company sent shockwaves through the corporate world. While the great majority of activity prior to the 1990's took place within national boundaries, the last decade has seen a sharp increase in the rate of global merger activity. The international complexities require a more sophisticated analysis involving foreign exchange rates and social, political and economic environments.

Corporations participate in mergers and acquisitions for a variety of reasons, the most prevalent in recent years being growth through external rather than internal means. Such growth may benefit the acquirer by increasing capability for product diversification, expansion of existing product lines and increasing market share. Other quantifiable reasons for entering into mergers include achieving economies of scale for operations and obtaining tax advantages [Larsen, 1991].

An important aspect of merger and acquisition strategy focuses on strengths and goals before taking actions. Managers and management accountants, as partners in the strategic planning process, must take a cautious view of potential activity, to observe a basic compatibility between the two companies, to determine whether the product mix makes sense, and to determine if the companies' core beliefs are the same [Pouvot, 1991].

While quantitative factors provide the identifiable aspects that make the merger attractive, they do not portray the whole picture. Many qualitative factors must also be considered before the real value of a company can be estimated. Qualitative factors are based upon intangibles, such as a skilled labor force, favorable location or a strong management team. While these intangibles are harder to quantify, consideration of their value is essential.

Whatever the rationale or goals of the combining businesses, the success or failure of the merger is based largely upon financial considerations. Because success or failure is ultimately measured in dollars, the target company's financial position must be measured carefully so as to quantify as many expected benefits and costs as possible. This process provides the framework wherein a management accountant can make an important contribution [Allison, 1984]. The purpose of this article is to identify the manner in which the management accountant can utilize his or her expertise to analyze financial data relevant to the acquisition process and provide an informed opinion of valuation with due consideration to all of the qualitative factors and differing parties affected by the potential merger.

ETHICAL CONSIDERATIONS

All suggested analysis and procedures set forth herein must be guided by a consideration of ethical behavior and value judgments. An increased emphasis on the ethical behavior of the management accountant has developed in recent years. While CPA's involved in public accounting, particularly auditing, have been the focus of ethical standards for many years, the National Association of Accountants (NAA), now the Institute of Management Accountants (IMA), first issued its Standards of Ethical Conduct for Management Accountants in 1983. These standards address the management accountant's obligations concerning competence, confidentiality, integrity and objectivity as well as providing guidance for the resolution of ethical conflicts [Larson, 19]. Though Ethical Standards provide a value system for behavior that attempts to distinguish right from wrong, the development of a code of ethics from such framework that would apply for each of the many "players" in a business takeover and which would adjudicate and direct their behaviors proves to be very difficult. Mergers are complex transactions, and the participants' interests are often competing and conflicting [Drucker, 1981].

The basic ethical conflict usually concerns the specific interests of the "targeted stockholders". These stockholders should not only be protected against third parties who seek to take over their companies by unfair tactics, but also against unethical managers who favor their own interests over their stockholders. Such conflict creates a financial and emotional strain on the relationship among stockholders, corporate boards and management officers. In the past, the "business judgment rule" has governed the ethical code of the takeover process and as a result, the courts have permitted management itself to judge the overall fairness of the takeover [Fogg, 1985].

The interests of the company's stockholders are not the only relevant issue. It is also necessary for the management accountant to assess the effects of the proposed acquisition on each and every segment of society affected, including shareholders of both the acquired company and the acquiring company, employees, managers, communities, customers, suppliers, the industry, the general public and the overall economy.

The management accountant must consider utilizing basic ethical principles as they relate to the above-mentioned segments, when analyzing contemplated actions to effect a proposed merger. An important example of such analysis would be the application of utilitarianism, a consequentialist theory, which holds that ethical behavior produces the greatest balance of good over evil (i.e., the greatest good for the greatest number). Utilitarianism can be viewed as being similar to "cost-benefit analysis", with the key difference being that utilitarianism implies that the effect on ~ affected groups must be evaluated before a decision can be made in the merger.

Another ethical tenet which may be applied, is the principle of universality, which suggests to the management accountant that a person only acts on those principles that he or she is willing to become "universal laws". Pursuant to such ethical principle, each person is viewed

as having absolute worth and, therefore, should be treated as an end -not solely as a means to an end. Consequently, each person is deserving of consideration, regardless of whether he or she is a target manager, target shareholder, employee, supplier, customer or corporate raider.

Another measure for ethical behavior which may be applied is the classical theory of justice (i.e., give to each person/constituency what is due to that person or constituency). The determination of the true right for each constituency is not a simple process; however, current practice in mergers and takeovers often runs "roughshod" over the rights of any number of constituencies. Moreover, numerous injustices are, indeed, suffered by these various constituencies, often without legal recourse.

The management accountant is in a unique position with regard to evaluating the ethical consequences of a merger. While his or her primary consideration will be assessing the benefits for the acquiring company with respect to its goals and objectives, the overall effect on each related party or entity must also be considered. This awareness of the effects of mergers on a variety of constituents should, thus, serve as a basis for examining and judging the desirability of a merger and aid in the elimination of abusive merger practices.

THE ACQUISITION PROCESS

The acquisition process is often viewed for analytical purposes as a five stage procedure. These stages have been designated as (1) Goal (and Strategy) Definition, (2) Selection and Review of Targets, (3) Forecast Evaluation, (4) Analysis, and (5) Management Review and Decision [Allison, 1984]. For purposes of this article, however, it is suggested that the process more readily reflects a sixth stage, which is categorized as (6) Negotiating the Acquisition [Anderson, 1987]. A detailed examination of each of the six stages with an emphasis on the

management accountant's contribution in light of ethical principles, is pertinent to a complete understanding of the acquisition process.

Stage One: Goal (and Strategy) Definition

In the first stage the acquiring company must set forth its goals, objectives and strategic plan which should include alternatives to the proposed acquisition. This is done during the strategic planning process when the firm attempts to match its organization with the changing environment. As the business environment changes, the organization is exposed to a variety of threats to its economic stability and opportunities to expand its markets. Some organizations adapt to their changing environment by implementing changes in their structure. These changes may influence the firm's relationship to its environment and have an impact on the firm's effectiveness; or, the changes might instead relate to the external operations of the firm and affect its efficiency [Armitage, 1990]. Management accountants serve as key professionals on the management decision making team and their expertise facilitates the development and implementation of a firm's strategy. The management accounting function in the past seemed to be driven by operational requirements, but in today's dynamic environment, the necessary information tends to be more strategic in nature. Such strategic analysis is, in fact, cost analysis from a broader perspective where far ranging factors are more conscious, explicit and formal. The goal is to use management accounting tools and data to aid in the development of superior strategies that will enable the firm to gain a sustainable competitive advantage.

Stage Two: Selection and Review of Potential Targets

The second stage of the process involves screening of target companies. The management accountant can aid in targeting potential merger or takeover candidates by identifying firms with undervalued assets resulting from conservative accounting policies. In addition, the

management accountant may choose to employ available multivariate models based on a series of accounting ratios in a firm's efforts to identify the best acquisition candidates. Computer models, using data from annual reports, SEC filings, etc., could then be used to generate a set of financial projections based upon different assumptions made about such factors as the hurdle rate, capital investment level and profitability of the candidate. The candidate's expected performance would be shown in terms of cash flow and standard financial statements. This data, in turn, could be used in another model to investigate the implications of alternative financing strategies. Finally, yet another model could be employed to generate projected consolidated data reports at the corporate level.

Many times the acquirer's first impressions of the company and its management team can highly influence its interpretation of the target's value [Richards, 1986]. Therefore, the target company is evaluated in terms of its growth potential, market share of the products it makes, technology and potential synergies [Allison, 1984]. Growth potential and market share of its products are obvious criteria to consider when a company is a takeover candidate. The marketing department of the acquiring company assesses the relative market share of the target's products. The growth potential of the target is a unique area wherein the management accountant can provide expertise in conjunction with the evaluation of the marketing department. The role of the management accountant in this process will be covered in more detail at stages three and four. However, what is not obvious but necessary to stress at this stage, is the management accountant's role in the evaluation of the target's technology and its potential synergies. Engineers provide data and assessments which allow the management accountant to analyze a target company's technology while taking into consideration the company's manufacturing process\es in light of recent technological advances. The management accountant's task is to

quantify these assessments, compare and project the expected cost of acquisition to the cost of manufacturing the products in-house [Allison, 1984]. The assessment, to be realistic and informative, must include an estimate of the cost of purchasing equipment with the latest technology as compared to the costs of acquisition. .

The effect of potential synergies is treated in much the same manner. Synergy is an interaction between parts that increase the effectiveness of each part to the whole. Synergy, therefore, provides that the whole is greater than the sum of the parts. The acquisition of a firm that results in expanding existing product lines or geographic coverage through horizontal integration will be the most likely producer of synergy. Vertical integration involves acquisitions to obtain production or distribution efficiencies by acquiring firms in different, but successive stages of production and/or distribution. Vertical integration is less likely to produce synergies than horizontal integration [Anderson, 1987].

To quantify expected synergies and assess appropriate value requires a technical knowledge of the market in question as well as a disciplined understanding of the industry as whole, and a creative intuition to project a dynamic working relationship between the disparate parts. An additional purpose of such assessment will provide a value of the potential target, which may then be compared to other available candidates.

Stage Three: Forecast Evaluation

The third stage of the process involves the evaluation of the target company's financial forecasts. These projections are especially important if the acquiring firm is considering alternative acquisitions. The management accountant uses these financial forecasts to furnish the basis for comparing prospective acquisitions and arriving at the ultimate decision to chose or reject an individual firm. Before the forecasts can be effective, they must be carefully analyzed,

especially if the necessary data to formulate the forecasts has been provided by the target firm. All assumptions inferred from the data must be identified and assessed as to their elements of risk, accuracy and reasonableness [Allison, 1984, and Richards, 1986,].

The forecasted income statements must be analyzed as to the legitimacy of projected revenues and growth in sales with consideration of the economy, industry conditions and inflationary expectations. If inflation is incorporated in revenue estimates, variable expenses such as labor and materials should also include appropriate increases. If absorption costing was used in the projections, preparation of estimated direct cost statements will emphasize the effect of changes in sales revenue, sales volume and manufacturing costs on profit. Sensitivity analysis could then be performed to determine the change in profit at various sales levels.

An analysis of past financial statements can verify the accuracy of forecasts in relation to past results. Cash balances should be scrutinized for peaks and valleys and a determination made as to the cause of any divergence. It is important to know if cash flow or lack thereof were the result of the seasonal nature of the business or of unexplained origin. A close analysis of cash receipts and disbursements would also reveal if borrowing would be necessary to provide for the normal operations of the firm. An examination of accounts receivable can indicate if customers are complying with the company's payment terms to avoid shortcomings. The existence of old accounts may indicate uncollectibility. By the same token, accounts payable should be consistent with the payment terms of the suppliers. This review may also indicate the existence of excess cash, which could be used in other facets of operations. Finally, the credit policies and collection procedures of the target company should be reviewed to determine the composition of their customer base. This gives the management accountant an idea of the risk involved relative to the future cash receipts of the target company [Gunther, 1979].

Examination of inventories relative to the acquisition presents an area wherein the management accountant may utilize his or her expertise to make a significant contribution in the valuation process, especially if the potential acquirer is a manufacturer or distributor and carries a large amount of inventory. The primary areas of concern include a determination that the inventories are carried at the lower of cost or market and further, that inventories do not contain obsolete items. The basis for allocating labor and overhead to work-in-process inventories must be examined for reasonableness to determine that an adequate foundation exists. The management accountant should also be concerned with the amount of inventory carried in the various categories of product lines and look for any unexplained changes among raw materials, work-in-process and finished goods. The quantity of inventory in the various stages of production and product lines is also important in the valuation process [Gunther, 1979].

An examination of the components of the target firm's asset composition is also a significant analysis to be performed by the management accountant. Such an analysis of property, plant and equipment may indicate that operations can be conducted at less than one hundred per cent capacity, resulting in assets which could be sold. The current market value of assets may be higher than the carrying value and these assets may be sold and leased back by the acquirer. An examination of these factors might provide cash that could be used in financing the acquisition [Gunther, 1979]. As the acquisition process moves forward, the accounting system is subjected to an internal auditing process. Accounting policies should be formalized and written and internal controls in place. An example of defective internal controls was discovered in one analysis of a target company wherein a major write-off existed due to a "sequestered" petty cash account, which had not been reconciled by auditors. The account balance was not to exceed \$2500.00. However, it was eventually detected that certain deposits and withdrawals created a

\$175,000 loss over a six-month period. The final audit revealed the problem and the deal failed to close. It is, therefore, important that the management accountant carefully review all accounts, policies and internal controls in detail [Richards, 1986]. The management accountant should also review income statements for a number of preceding years. He or she should be aware of any items that may have been omitted, such as fringe benefits for labor, sales tax, freight, sales discounts, bad debts, administrative overhead, insurance, state and local taxes, installation costs of equipment, professional fees, etc [Allison, 1984].

If a business segment of an acquired entity has been discontinued, the reasons and accounting for the transactions should be scrutinized. Any allocation of overhead to the discontinued segment is reviewed to decide whether the basis of such allocation is reasonable. The allocation could be a device to improve reported income from operations still in existence. Finally, a review of significant ratios from the statement of operations should be performed to determine any changes in the level of profitability [Gunther, 1979].

Stage Four: Analysis

Once the financial statements have been evaluated and deemed to be acceptable, the fourth step of the acquisition process is reached. This step consists of the analysis of the financial projections and the subsequent evaluation of the acquisition relative to other investment opportunities. Its internal rate of return is calculated by the management accountant and then compared to any internal financial requirements [Richards, 1986].

Stage Five: Management Review and Decision

The final step in the acquisition process is the review of the reports generated by the management accountant and his team by upper level management. With the help of these reports and the input of the management accountant, upper level management can focus on the purchase

price that would be required to achieve a specified internal rate of return or a required payback period. The management accountant has a number of tools for valuing companies, including discounted cash flow analysis, the use of price/earnings multiples, and determination of the effect on the parents' earnings per share if it acquires the targeted company. The projections and subsequent conclusions drawn can be used to compare the current acquisition prospect with previous acquisitions. As stated before, they can also be compared with alternative investments [Allison, 1984]. Of course, there may be intrinsic rewards associated with a given acquisition that may offset a comparably low internal rate of return. The target company, for instance, may have a certain technology that is considered very important to long-term goals. An example of such technology purchase is AT&T's acquisition of NCR, Inc. in 1990. In addition, it should be noted that certain synergies resulting from the acquisition may not be obtained by any other means.

Stage Six: Negotiating the Acquisition

The decision to acquire a company requires a great deal of analysis, expertise and intuition, each aspect of which includes an appropriate consideration of ethical principles. Once a decision has been made, the manner in which negotiations are conducted will have significant implications upon the successful integration of the two companies. While negotiating, it must be recognized that each company will have a differing opinion as to the value of the firm to be acquired. Therefore, an environment must be created that enables the negotiations to proceed in a manner conducive to establish a fair value for all parties, taking into consideration the application of the ethical tenets set forth earlier in this article. The individuals who are involved in the negotiations are the same people who must accept responsibility for attaining the benefits projected in the valuation process. The integration of the merging companies through the

transition phase requires a dedication and commitment from all parties involved and cannot succeed without due consideration of the people crucial to the success of the marriage.

The role of the negotiator includes the recognition of the effects of the merger on various groups comprising the corporate entity, including officers, employees, shareholders, suppliers and customers. Therefore, an attempt should be made to anticipate the potential, ethical consequences that the contradicting forces constituting the merger impose on all parties concerned. This is no easy task, but one that requires a blend of skills conditioned upon ethical values.

CONCLUSION

The management accountant plays a vital role in the acquisition process from the strategic planning phase where objectives are defined to the integration of the infrastructure of the two organizations after the merger is complete. As companies continue to compete and attempt to gain an economic advantage, mergers and acquisitions will provide a vehicle for the management accountant to display his or her skills and values. A strategically sound investment is the result of a venture in which input is provided by numerous individuals within the company, including the management accountant. More important, however, is the recognition that the implementation of ethical principles and an appreciation of the effects on the various constituents in a merger will aid in restoring the corporate merger as a viable and ethical option in the future growth of the American economy.

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