The Strategic Role of the CFO in Mergers and Acquisitions Transactions

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I. INTRODUCTION

The mergers and acquisitions process is a sophisticated, multifaceted and exciting endeavour about which much has been written. The focus of this article will be to examine selected aspects of the mergers and acquisition process in respect of which a Chief Financial Officer ("CFO") can add value to the process as an integral part of, and active participant in, the M&A team (whether on the buy side or the sell side).

The essential point that I would like to make can best be described with reference to the manner in which the process should *not* be conducted (a scenario which may unfortunately be all too familiar to the readers of this paper).

Essentially, a CEO (or vice-president, business development) walks into the CFO's office, tosses a termsheet for a significant cross-border transaction on the desk and announces in a self-congratulatory manner that the company had reached an agreement in principle on a significant transaction which was due to be put before the board of directors for its approval later that week, giving the CFO precisely three days to arrange the financing for the transaction and prepare a presentation for the board of directors.

In the somewhat disturbing scenario that I have just painted, the transaction in question might engender significant issues that have not received adequate attention (or which have been overlooked). In addition, the opportunity to have structured or priced the transaction in a more advantageous manner having regard to accounting, tax and certain operational issues, will have been lost.

Based on my experience, it is essential that a CFO be an integral part of, and active participant in, the M&A team for three principal reasons:

(a) A CFO will typically bring an independent and objective perspective to the strategic analysis of the proposed transaction, with greater emphasis on rigorous financial modelling and testing of assumptions;

(b) CFOs will bring a unique skill-set that will enable them to spot issues that might be missed by operational executives; and

(c) the CFO's detailed understanding of the existing business will enable him or her to comment on the financial and operational integration of an acquisition target or the financial effect of a disposition.

II. STRATEGIC ANALYSIS OF THE TRANSACTION

The value of mergers and take-overs in Canada topped $148 billion during 1998, a level 47% higher than the previous record of $100.9 billion in 1997. There was particular activity in the entertainment (Seagrams/Polygram and Alliance/Atlantis), oil and gas, retail (Loblaws/Provigo and Sobeys/Oshawa Group), telecommunications (BC Telecom/Telus and Northern Telecom/Bay Networks) and media (newspapers and television) sectors. The record was achieved without the consummation of the two proposed bank mergers that were a significant focus in the business press for much of the year.

As recently reported by Crosbie & Co., the rapid pace of transactions has continued in 1999, with approximately $114 billion of transactions completed through October 31, 1999. Significant activity has been reported in the telecommunications (Nortel/Clarify, Bell Canada/BCE Mobile, Cantel/AT&T/BT), paper and forest products (Alliance Forest Products), oil & gas and media (Canwest/WIC/Shaw) industries.

Merger mania is also rampant in the United States (where the focus is on the same industries as Canada's merger activity plus banking and pharmaceuticals), as well as Europe. For the fourth consecutive year, the volume of annual and completed European cross-border transactions reached a new record, rising by 37% to US$261 billion (deals completed in 1998 totalled US$233.3 billion). Vodaphone Airtouch PLC's of LC's US$125.3 billion bid for Mannesmann AG would set a world record if completed.

1998 was also a record year for U.S. M&A activity, not only in terms of aggregate value (about US$1.7 trillion) but also size of deal. 1998 saw the seven largest deals ever, and eight of the ten largest ever. U.S. mergers and acquisition dollar volume for 1999 (quoted by Thomson Financial Services Data at US$1.6 trillion through November) will surpass last year's record, lead by significant media, pharmaceutical and telecommunications transactions (such as Sprint Corp.'s proposed US$115 billion merger with MCI Worldcom, Bell Atlantic's US$72.1 billion acquisition of GTE and Pfizer Inc.'s US$72 billion bid for Warner Lambert Inc. – which had proposed to merge with American Home Products).

The current take-over wave differs significantly from the 1960's, an era of conglomerate building (such as LTV, Textron, Gulf & Western and ITT) which is now clearly out of favour in an environment where institutional shareholders are demanding "pure plays". Similarly, the current wave differs significantly from the 1980's activity, which was dominated by financial buyers and transactions that were justified solely by the availability of financing and the extent of permitted leverage.

The 1990's merger wave is defined by primarily friendly transactions (sometimes described as "mergers of equals" or "strategic alliances"), with some exceptions, such as the recent AMP transaction in the U.S. and Canadian media and online transactions. These transactions are generally financed by stock and senior debt (rather than junk bonds) and exceed in size, scope and ambition anything that has come before. Further, as indicated above, the current phenomenon is spread over many industries.

What are the factors driving the frenetic level of activity? These can be summarized as follows:

(a) *Consolidation Opportunities (Roll-Ups).* This business model applies to many, often fragmented, industries (the players being referred to as “consolidators”) and essentially involves an intent to capture value through the following factors:

- spreading of administrative overheads
- expansion of geographic markets
- reduction of duplicate staffs
- creation of economies of scale in manufacturing, distribution and marketing
- acquiring sales volume
- lowering the aggregate cost of debt and equity capital for the combined business
- addition of professional management and board-of-director level expertise
- creating goodwill through “branding”.

(b) *Competitive Factors*. The globalization of commercial activity has lead to a desire on the part of many companies to position themselves strategically in industries undergoing fundamental change as a result of the new competitive environment. This is manifested by a desire not to overlook acquisition candidates that could enhance the company’s future strategic position, which could be used to defend existing market share, or which might otherwise be acquired by a competitor. In a global market, greater scale is needed to take advantage of, and protect, world-wide market share. For example, the implementation of the Canada/U.S. Free Trade Agreement (and subsequently NAFTA) lead Dorel Industries Inc., Canada’s largest manufacturer of ready-to-assemble furniture and juvenile products, to acquire several companies in the United States in order to develop world-class manufacturing facilities and to capitalize on the acquired companies’ US marketing channels and US customer base.

(c) *The Growth Imperative*. There has been a recognition that attempting to increase returns solely through cost-cutting is a dead end strategy (the material opportunities are quickly captured, leaving an uncertain future). By contrast, driving top-line growth is not so limited. There is also a prevailing view that companies must grow to survive, since only through growth can a company offer career paths to the bulk of its key employees. Particular interest is paid to fast-growing companies that can rejuvenate larger companies with more mature product lines. Growth is also sometimes required in order to retain customers which are, in turn, experiencing rapid growth or which are expanding into new markets.

(d) *Buy vs. Build Decisions*. Growing within an industry requires a strengthening of the existing business, the development of new distribution channels and markets, or the development of new products. In industries where innovation meaningful to the ultimate consumer has slowed, and which are otherwise mature, growth can only come at the expense of competing firms. In addition, existing firms may be priced more advantageously than the cost of independently developing a competing business or product. In these industries, growth by acquisition can be the primary strategy. Buy vs. build decisions are continuously being made as companies look at new lines of business, new geographic markets or plugging holes in product lines.

(e) *Financing.* The current wave of large high-profile mergers has primarily been funded by stock at a time when North American stock markets have frequently tested their all time highs. Indeed, merger activity noticeably declined during the 1998 summer market swoon. In addition, financial institutions were flush with deposits and the equity markets were somewhat favourable prior to the summer, resulting in significant financial capability for strategic buyers. Similarly, equity and sub-debt investment funds have raised tens of billions of dollars over the 1990s, and merchant bankers are therefore stumbling over each other in their pursuit of transactions.

(f) *Deregulation*. This has been a factor for media companies, utilities, the US banking sector, the telecommunications sector and the defence sector. These companies are all frantically trying to adapt to a new marketplace. The recent Canadian airline takeover bids are a further example of potential regulatory change becoming a catalyst for transactions.

(g) *Divestitures of Non-Core Businesses*. The M&A market, like all markets, is driven in part by available supply. Institutional shareholders and stock analysts have made it clear that there is a preference for single-industry investments. Institutional shareholders would prefer to create diversification within their own portfolio and, in effect, frown on managers who try to operate in more than one industry. Conglomerates are clearly out of favour and focusing on core operations is what the market demands. The consequential divestitures are being achieved by sales to strategic or financial buyers, spin-offs, initial public offerings, contributions to joint ventures and by the issuance of "lettered stock".

Let us examine, briefly, how these factors have in fact manifested themselves in certain of the significant transactions over the course of 1998 and 1999.

(a) *Technology Industries.*[1] The technology sector (which currently accounts for about 8% of US gross domestic product) has for the past two decades been one of North America's fastest growing sectors. The growth was initially driven by product innovation rather than through M&A. A good product, coupled with lots of marketing, produced breathtaking rates of organic growth (with Microsoft Corp., the world's largest software producer, as the classic example). There was also some concern that technology companies, so often run by maverick founders, could not successfully merge disparate cultures.

However, this school of thought has changed with the emergence of consolidators such as Computer Associates International and Cisco Systems Inc., which have achieved extraordinary growth through takeovers. Computer Associates has built a dominant position in certain types of business software by continually buying complimentary products; while Cisco has prospered by buying smaller businesses with a strong technology base which lack a competitive sales and marketing infrastructure.

Today, an additional dynamic – convergence – has resulted in fundamental changes in the competitive market, leading to significant mergers within the internet sector (AOL-Netscape) and mergers between the internet and telecommunications sectors. For example, Northern Telecom Ltd.'s acquisition of Bay Networks Inc. was an attempt to widen its presence in a key US market for web-related technology, as its core business of supplying telephone switching equipment experienced lower rates of growth. A similar transaction is the recently announced proposed acquisition by Lucent Technologies of Ascend Communications, with a value in excess of US$19 billion. Each of these acquisitions could clearly be said to be defensive in nature.

Further, technology companies have difficulty continuously guessing correctly the direction in which markets will evolve due to rapid changes in technology and short product lives. Consequently, acquisitions with the objective of filling holes in the product line are frequent (e.g. Compaq-Digital, IBM-Lotus). A series of transactions involving the acquisition of Canadian technology companies by larger U.S. companies occurred in 1995 (for example, Silicon Graphics' purchase of Alias Research and Symantec's acquisition of Delrina) as a result of the underlying products being marketable worldwide and the Canadian capital markets valuing those earnings at a smaller multiple than the U.S. market was affording technology companies.

(b) *Pharmaceuticals*. A series of transactions through the 1990s has created huge multi-nationals. Companies resulting from significant mergers have gone on to additional marriages. The impetus for the transactions are cost savings. These companies require the financial clout to sustain ambitious research programs over many years while at the same time putting global marketing muscle behind the new drugs. Defensive acquisitions with the goal of acquiring products to replace expiring patents were also common-place. This is the impetus behind the drug industry's frantic urge to merge, notwithstanding historical evidence that combined market share typically falls after a significant merger (though pre-existing weakness of the merger partners is often to blame). In Britain, Glaxo bought Wellcome. Later, Ciba and Sandoz, both of Switzerland, came together to form Novartis, and a transatlantic merger created Pharmacia & Upjohn. As indicated above, Pfizer and Warner-Lambert are engaged in a hostile takeover bid. In the Novartis transaction, the parties used the merger as a catalyst for change and conducted a company-wide review and re-engineering of all processes, from research and development to marketing and sales. Between the time the merger was announced in March 1996 to the time it closed in December 1996, 600 task forces were assigned to find cost synergies in specific areas, to identify possible cuts, and create a time plan for implementation. By the time the merger was completed, the integration strategy had been mapped out and integration commenced immediately after the conclusion of the merger. The re-engineering process allowed the research programs of both predecessors to be aggregated and the seven therapeutic categories identified then had resources allocated to them based on perceived market opportunity and internal expertise. Of 165 research projects between the two predecessors, Novartis kept 150.[2] At the same time as it was revising its research and project management procedures, the Novartis development team evaluated the 85 drugs in its combined portfolio, terminating 15 of them. The resulting development portfolio fits Novartis' strategy of doing more with less and their experience is that the output of successful drugs has not been affected by the reduction in the number of compounds selected for development.

(c) *Oil & Gas*. Deflation, slack demand and overcapacity in this sector has spawned an intense cost-cutting imperative, with lesser opportunities for growth. Further, exploration activity is becoming increasingly expensive and risky. The last major oil merger had been the 1984 combination of Chevron Corp. and Gulf Corp. Then, in August 1998, British Petroleum announced a US$64 billion deal to buy Amoco Corp. Late in the year, Exxon agreed to acquire Mobil Corp. for US$75 billion in the largest industrial merger in history, while France's Total SA agreed to acquire Belgium's Petrofina SA in a US$14 billion transaction. The deflation has been caused by a steep fall in production costs due to advances in drilling and searching technologies (with the consequential effect on supply) and therefore the consolidations are likely to continue even after oil prices eventually rebound, as they almost certainly will. In addition to cost cutting opportunities, the mergers will allow the combined companies to create a better portfolio of assets, keeping projects with the best returns and jettisoning the rest. Being discriminating about which property to develop is crucial when oil prices are at ten year lows and margins are falling for chemicals, refining and natural gas.

(d) *Food Retailing*. Consolidation in the Canadian industry followed several transactions in the United States (Safeway purchased such chains as Vons, Dominick's and Randall's; Albertson's purchased Lucky Stores and American Stores; and Kroger purchased Ralphs and Fred Meyer). Industry analysts have speculated that the deals are a reaction to: (i) competition from warehouse clubs, Wal-Mart and Kmart, which are increasingly selling food along with other products; and (ii) limited population growth.

III. WHY MERGERS FAIL – THE SYNERGY TRAP

The ultimate test of a successful acquisition is whether it generated a sufficient return on the investment (i.e. the transaction assists in building long-term shareholder value).

Quite often, acquisition decisions are driven by confidence about the future (or lack of same), which is not a particularly objective or rigorous process in light of the size of the transactions that are taking place. It is often said that people will buy on "mystery" and sell on "history". Confident buyers will see a potential for synergy or market share improvement in a manner that leads them to believe that a potential transaction will add value (some display an inherent belief that bigger is better). Myron Beard of RHR International, a consulting firm that helps companies integrate mergers, has recently been quoted as stating: "When you get into an acquiring frame of mind, it's like a love affair: you absolutely block out anything closely approximating reality about a person's flaws."

Investment bankers are only too happy to exploit this typical inclination of operational executives to over-estimate possible synergies, by modelling the transaction many years into the future. In fact, experience shows that, except for the most successful deals, available synergies are not exploited beyond the first couple of years, after which any acquired competitive advantage tends to erode.

Another fatal flaw often encountered when reviewing the justification for a transaction is the assumption that funding an acquisition with shares trading at a higher multiple than the price for the acquired business (i.e. the transaction is "accretive") is a valid independent justification for the transaction. Indeed, Deutsche Bank CEO Rolf Breuer, in justifying the US$10 billion purchase price proposed to be paid for Bankers Trust (a 43% premium), focused on the short-term accretive nature of the transaction, the fact that the purchase price was lower than Bankers Trust's price earlier in the year and the fact that the price being paid was 2.3 times book value compared to an average book value multiple of 3.9 that has recently been paid in similar broker-dealer transactions in the U.S. financial sector. In fact, if Bankers Trust's free wheeling investment-banking culture is not properly integrated with Deutsche Bank, relative purchase prices and short-term effects will be irrelevant.

Academic and professional studies[3] consistently show that public company acquisitions fail to earn the cost of capital deployed approximately 60-70% of the time. While the strategic transactions of the 1990s are performing slightly better, market evidence shows that the total return (dividends plus capital appreciation) to the acquirer's shareholders in the period following a U.S. transaction is less than the industry average in over 50% of the transactions (Canadian transactions have fared marginally better in some studies). The DaimlerChrysler team which is working on the integration of those two companies completed a study of cross-border combinations which indicated that 70% of such transactions fail to thrive.

The principal reasons that transactions fail can be summarized as follows:

(a) *The Purchaser Has Overpaid*.[4] Acquirers in all industries tend to underestimate the difficulty of capturing the benefits that they have anticipated. Acquirers assume they can generate synergy faster and in greater amounts than is really possible. Achieving cost savings without losing customers or demoralizing staff has proven to be very difficult. Recently, a lot of relatively marginal deals have been driven by stock prices. Even though the deal economics were marginal, the acquirer felt that they were getting an advantage by paying in stock trading at a much higher multiple than the complementary business of the target was achieving.

The fact that a transaction is accretive is not sufficient justification to pursue the transaction unless the acquired business can be substantially integrated with the existing business or significant synergies exist (so that the market does not penalize the multiple historically given to the acquirer's shares on the basis that the growth prospects of the aggregate business had been diluted by the acquisition).

As Warren Buffett observed in one of his memorable Berkshire Hathaway shareholder letters: "A too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favourable business developments". A perfect execution of all the other elements of a transaction (as outlined below) cannot compensate for overpaying, particularly in a non-inflationary environment.

As I indicate above, one of the 1990's more popular business models was the consolidation roll-up. For this strategy to work, the consolidator typically funds purchases with its stock and therefore is under great pressure to maintain an ever increasing stock price. Many of these companies tended to overpromise in an effort to keep their stock price up and please the momentum traders. However, when a stock held by momentum players disappoints, it is quickly punished. Operational issues arose from growth exceeding the consolidators' ability to integrate the acquisitions. Further, potential vendors in the industry tend to hike their prices when they suspect that one or more consolidators are scouring the industry for acquisition targets. This has led to consolidators significantly overpaying to maintain their record of growth. Recent Canadian examples of consolidation plays that have not stood the test of time include Philip Services, Loewen Group, Newcourt Credit, Pallet Pallet, Railink Ltd. and DC Diagnosticare Inc. It is interesting to note that this business model has failed to stand the test of time in numerous different industries.

As Mark Sirower, author of *The Synergy Trap*, points out, competitors don't stand still. Quaker Oats' acquisition of Snapple failed when Coke and Pepsi quickly reacted with Fruitopia and Lipton Ice Tea. Other transactions foundered on integration problems, as discussed below. In some cases, it is hard to imagine what synergies the purchaser thought were available in the first place (such as Eastman Kodak's acquisition of Sterling Drug). The higher the price paid, the greater the amount of improvements and the speed of realization required to make the deal pay off. Further, public company acquisitions typically demand a significant premium for the shares of the acquirer. This applies even in so called "mergers of equals transactions".

By way of example, analysts commenting on the AT&T/Tele-Communications Inc. transaction in 1998 were concerned that TCI's outdated technology and exposure to competing technologies would not give AT&T the access to local telephone and internet services over TCI's pipeline in time to adequately recoup the premium purchase price and required capital expenditures. AT&T is now in the process of purchasing cable operator MediaOne Group for US$57 billion of stock. AT&T's strategy had been to put itself into a position to originate, carry and terminate as much telecommunications traffic as possible, whether local, long-distance or wireless. AT&T intends to provide local phone service nationwide and intends to use a fixed wireless network to serve customers it can't reach through its cable holdings or cable joint ventures. In the past, AT&T hasn't had great luck in buying businesses outside its core industry. It acquired computer-maker NRC Corp. in 1991 but could not figure out how to manage it, finally spinning it off after losses of more than US$10 billion. AT&T bought McCaw Cellular in 1994 and has only recently fully integrated the unit after having lost most of its senior management team. Market analysts now are warming to AT&T's strategy of eventually offering a full package of telephone, video, cellular and high-speed data services and, in particular, its plan to spin off its wireless unit through the use of a tracking stock so as to unlock its unrealized value and create a currency for further wireless acquisitions.

Similarly, analysts had questioned the rationale for the purchase of Bankers Trust by Deutsche Bank. A premium price was paid for a business coming off three years of terrific gains, which might not be sustainable, and some analysts surmised that Bankers Trust was not Deutsche Bank's first choice for its entry into the investment banking market. Investors agreed, as Deutsche Bank's stock initially fell after the transaction was announced.

However, as recently reported in the Wall Street Journal, while Deutsche Bank's stock is still below the levels reached in the spring of 1998, its shares are up 36% in the last year. In handling the intricacies of a trans-atlantic acquisition and integrating two very different corporate cultures, the bank has largely avoided the predicted pitfalls, notwithstanding the usual clash of cultures that occurs when a commercial and investment bank come together. Indeed, Deutsche Bank's investment banking business is having a record year underwriting high-yield debt, equities and Eurobonds. The business has withstood raids by competing U.S. investment banks for its prized talent and has managed the personnel integration by leaving non-Germans in charge of most of the investment banking departments.

In effect, it often seems that transactions, of significant size, are being pursued to please market watchers or to follow competitors' moves, without adequate focus on sensitivity and strategic risk analysis. Strategic risk analysis involves a focus on possible flaws, stumbling blocks and market events that could seriously impact the transaction assumptions, rather than focusing solely on the scope of the acquired benefits.[5] Strategic risk analysis involves canvassing the M&A team for a priority list of possible future events which could materially impact on the assumptions underlying the acquisition model and ranking them as to their impact, on the one hand, and probably of occurrence, on the other (being the two principal elements of risk). This can assist the M&A team in the due diligence process as well as in pricing the deal to fairly compensate for the risk inherent in the deal. For example, over-dependence on a particular customer might be the reason why an attractive acquisition target is being priced favourably by the vendor.

A noted Canadian example of a failure to apply a vigorous risk analysis is the acquisition of Algoma Steel Corp. Ltd. by Dofasco Inc. in 1988. A classic buy vs. build analysis justified an acquisition at half the replacement cost of the underlying assets. The transaction seemed like a solution to Dofasco's shortage of supply and held out the promise of cost savings through the elimination of overlapping administrative functions and the sharing of production expertise in an industry increasingly driven by technological advances. Nonetheless, the transaction failed as a result of: (i) an increase in interest rates; (ii) a stubbornly over-valued Canadian dollar; (iii) a four-month strike at Algoma; (iv) plunging real prices for steel products; (v) a lack of integration strategy; and (vi) a failure to replace non-performing Algoma management.[6]

Similarly, in Inco Ltd.'s $4.3 billion acquisition of Diamond Fields Resources (the carrying value of which is currently under review), the fear of losing a strategic nickel deposit to a competitor and a desire to obtain an easily extractable supply of ore led to an auction which resulted in the vendor capturing the inherent value on a risk-free basis and the purchaser undertaking a "bet the company" transaction (which has suffered in the face of political, environmental and other risks).

Interestingly, a thorough strategic risk assessment analysis led Northern Telecom (since renamed Nortel Networks Corp.) to undertake a "bet the company" transaction. Nortel perceived that the switch-based long-distance equipment market would rapidly mature and experience declining revenue growth as a result of technological improvements in fibre optics. In addition, the move to Internet-Protocol based networks that can carry voice and data (such as e-mail) left its core business exposed to a paradigm shift in the market. Investors balked at first when Nortel said it planned to pay US$9.1 billion in stock for Bay Networks, a direct competitor of data networking leaders Cisco Systems and 3Com Corp. Nortel's stock price dropped 30% in the three months after it unveiled the acquisition on June 15, 1998. By October, 1998 it warned that second half sales would be disappointing and was trading at its lowest price since 1996.

While the ultimate price paid eventually declined to US$6.9 billion, as Nortel stock tumbled upon announcement of the transaction, the transaction has proved to be essential to helping Nortel re-invent itself. Nortel, which now gets a fifth of its sales from switches that direct telephone calls, has unveiled equipment that gives it a full line of products to build data networks. The transaction also resulted in Nortel acquiring engineers familiar with Internet Protocol-based products. Nortel's purchase price amounted to three times Bay Network's sales in the four quarters before the acquisition was unveiled. By comparison, Lucent Technologies paid a seventeen times multiple for

Ascent Communications Inc. when it bought the networking-equipment maker for US$25.2 billion in June, 1998.

Nortel stock is now up a stunning 198% so far during 1999. Nortel is the largest component of the TSE 300 index, accounting for 14% of its value, resulting in a request from active fund managers to hold up to 15% of their funds in a particular stock, as index fund managers are now allowed to do.

(b) *Unjustified Assumptions About Available Synergies*. Despite the prevailing views in support of the business model, the much ballyhooed combination of "content" and "distribution" has produced inferior returns for media companies almost everywhere it has been tried. As of November 1998:

- Time-Warner's average annual return is 14% since the merger of its two predecessors in 1989, as compared to a 16% average annual gain for the S&P 500 during that time.
- Viacom Inc.'s average annual return is only 10% since its Blockbuster/Paramount transaction, versus a 24% average annual gain for the S&P 500.
- Disney's average annual return has been just 7% since its purchase of Capital Cities/ABC, as compared to a 22% average annual gain for the S&P 500.
- CBS stock has shown a return of –9% since the company was restructured in October 1997, versus a 17% return for the S&P 500.

(c) *Poor Financing*. Transactions fail to adequately account for the true cost of equity. Statistics show that the failure rate for transactions involving exchanges of stock exceeds the failure rate of all-cash transactions. In *The Synergy Trap*, Sirower hypothesizes that the discipline imposed by a debt repayment schedule in an all-cash transaction helps to impose organizational effectiveness and that using stock as currency sends a message to the market as to the acquirer's view of the inherent value of its own stock. Even in all-cash transactions, debt repayment schedules often do not mesh with operational business plans or the terms of the debt financing are too restrictive and do not mesh with the business model for the combined business. For example, cash strapped Viacom starved its acquired businesses of needed capital.

(d) *Poor Due Diligence*. The assumption that publicly traded companies are continually market-tested and that an efficient market will assist in pricing a transaction has not borne out in many cases, as discussed below. In addition, private company transactions lack an independent market test and the rigor of complying with public continuous disclosure requirements. Most importantly, missing a $100,000 item might not be considered material. However, if it detracts from the normalized income that was used in the acquisition model, the revenue or profit growth curve for the acquired company will suddenly look entirely different; further, the purchaser has overpaid by an amount equal to the value of the overlooked item times the multiple used in setting the purchase price.

In BankAmerica Corp.'s 1991 acquisition of Security Pacific Corp., BankAmerica (having missed an earlier chance to acquire Bank of New England Corp.) negotiated the US$4.6 billion purchase for Security Pacific in less than a month, with minimal opportunity to conduct detailed due diligence. In return for agreement not to entertain competing offers on the part of the seller, the buyer locked itself into a purchase price with little opportunity to renegotiate. What ensued was a series of post-merger loan write-downs and other nasty surprises, resulting in accounting charges of US$3.5 billion and an effective purchase price of US$8.1 billion. Insufficient due diligence led to a failure to realize the stark differences in the two banks' corporate cultures. BankAmerica had been centralized, rules-driven and ultra-conservative since its mid-80's loan problems, while Security Pacific was decentralized and free-wheeling. Even during the eight months needed to obtain regulatory approvals and put the merger into effect in April 1992, lax credit controls and other problems that had been missed during the once-over-lightly search for big red flags were becoming apparent. Purchase accounting rules (purchase accounting was used notwithstanding the share exchange consideration) allowed the losses recognized within one year of the acquisition to be capitalized as goodwill. However the aggregate goodwill charges and other recurring and purchase-related write-offs amounted to US$130 million a quarter, cancelling more than half the cost savings.

Operational due diligence is just as important as financial due diligence. In 1995, Unisource Worldwide Inc., then the U.S.'s biggest distributor of office supplies, saw an opportunity to modernize the Mexican industry, which was dominated by small, inefficient family enterprises. After purchasing 30 companies and seeking to merge and modernize their operations, much as it had successfully done in the U.S. and Europe, the US$90 million investment was significantly under-performing. Due diligence had failed to focus on the fact that the companies being purchased had dirt-floor warehouses with goods scattered about, making it impossible to use fork lifts. That required big investments in construction and racking. Rationalizing sales routes was a nightmare because each of the companies had dozens of small customers that were uneconomic to serve (50% of the combined invoices accounted for less than 5% of the billings). Controls and sales targets for existing staffs were non-existent. Economic problems in Mexico have further hurt the transaction.

In August, 1988, CAE, a Canadian manufacturer of flight simulators, paid $665 million to Singer Co. (subsequently renamed Bicoastal Corp.) for Link, a U.S. defence contractor. The failure to uncover money-losing contracts and allegations of over-charging on government contracts led to significant losses on the transaction. Link was ultimately sold by CAE at a loss.

(e) *Mismanaging The Post-Transaction Integration*. Ultimately, all acquisitions are successful only if people and process issues are properly dealt with. Too often, however, acquirers get too focussed on the financial aspects of the merger (price, products and markets). Acquisitions that appear to be both financially and strategically sound on paper often turn out to be disappointing for many companies: the acquiring company takes too many years to realize the expected synergies, is unable to get people to work together productively or puts the companies together in such a heavy-handed way that the unique capabilities of the acquired company (its best people and most valued customers, for example) melt away.

For example, a manic drive to reduce costs and assimilate (rather than integrate) the acquired business in the post-takeover phase of a merger has crippled the growth of acquirers as varied as Union Pacific Corp. and financial services providers Key Corp. and Wells Fargo & Co. Technology mergers are especially fraught with danger, as witnessed by British Telecommunications' acquisition of Mitel, the IBM acquisition of Rolm and the AT&T acquisition of NCR. Indeed, the recent acquisition of Ascend by Lucent, referred to above, is interesting in light of Ascend's difficulties with its US$7.3 billion purchase of Cascade Communications in 1997. Many of Cascade's key engineers left as soon as they received payment in respect of stock incentives and integrating Cascade's products into the Ascend catalogue proved more difficult than the company had anticipated. Ascend's stock was pummelled, falling by more than 50% in the months following the takeover. It has since recovered, in large part because the Cascade products were finally fully incorporated into Ascend.

Similarly, Viacom's acquisition of Blockbuster Video initially did not work out. Blockbuster, in a classic example of the consolidation or "roll-up" model, was acquired in 1994 by Viacom on the basis that the retail stores would be a natural outlet for Viacom's films and music. Significant write-offs were then occasioned by an unsuccessful attempt to expand Blockbuster's sales by emphasizing music, candy and comics and moving the head office to Dallas from Fort Lauderdale at the behest of the former CEO. Required operational improvements suffered from a lack of capital imposed by Viacom. New management ultimately successfully overhauled the Blockbuster business model by agreeing to relinquish roughly 40% of rental income to the studios in return for a dramatic reduction in the up-front purchase price of movie cassettes.

Post-merger integration is more fully explored in Appendix "B" to this Article.

(f) *Failure to Focus on a Required Return on Management*.[7] Even transactions justified by reasonable, analysis-driven, implementable strategies (as compared to certain of the "roll-the-dice" synergy assumptions outlined above) often provide disappointing results. If managerial energy is misdirected (i.e. there has been a failure to effectively communicate corporate goals and strategy by senior management) or diffused over too many opportunities, even the best strategies stand little chance of being implemented and translated into value. Managers today are faced with a plethora of marketplace opportunities, particularly those occasioned by a strategic merger, and the natural tendency is to attend to the most pressing crisis, apparently promising project or demanding client, rather than maintaining the discipline of weighing available time and energy against the organization's critical priorities. Similarly, a transaction in respect of which the integration process is anticipated to cause great disruption and impose significant demands on management time should result in sceptical reviews of projected cost savings and market share expansion.

IV. <u>WHY M&A TRANSACTIONS SUCCEED</u>

(a) *Strong Strategic Fit*. Business combinations should result from a thorough analysis of size, industry, technology and geographic and financial criteria. Based on this analysis, a determination should be made of the strategic synergies (are the target's products, markets, management and operational strengths complementary), operating synergies (are there obvious potential cost savings, cost spreading, economies of scale or other operational efficiencies), organic growth (are there strong growth prospects for the target), management talent (is the management team well-regarded and can they work with the acquirer's team) and technology (does the target possess proprietary technological information and are its systems complementary with those of the acquirer).

(b) *Price Discipline, Objective Modelling and Strategic Risk Analysis*. The academic research concerning the historical success rate of mergers and acquisitions suggests that, at best, a skeptical attitude should govern the review and approval process. Re-evaluate, with suspicion, the anticipated synergies. Be equally sceptical about the assumed value of future growth or expansion of the business. Appropriately discount the assumed value of recent investment or other changes concerning the target that are only expected to deliver value in the future. Set appropriate hurdle rates reflective of risk and cost of capital. Ensure the assumptions are realistic. Be cautious about auctions and look for an "exclusive" transaction process. Do not bid against yourself and be prepared to walk away. A transaction is a success only if it delivers economic value added (i.e. after taking into account cost of capital). Statistics show that stock acquirers under-perform matching firms while cash acquirers outperform matching firms, largely due to the discipline imposed by the acquisition financing.

Seasoned acquirors will rely on heads of operations to identify acquisition targets and shepherd integration, but not for purposes of negotiating the deal (out of concern that they would be too emotionally attached to the deal).

At first glance, Compaq Computer Corp.'s US$4 billion cash and stock acquisition of Digital Equipment Corp. in June 1998 might have been viewed as a risky gamble to diversify a company with near total reliance on sales of computer hardware, particularly given that the target had exhibited declining competitiveness for years. However, further analysis reveals that Compaq's actual risk in the transaction was substantially less:

- significant cost savings were achieved from a rapid downsizing of 5,000 jobs in less than 4 months and the closure or sale of money-losing operations.
- Earl Mason, Compaq's CFO, has been quoted as stating that he had extracted US$400 million in cash from Digital's balance sheet, largely by speeding up the collection of accounts receivable and slowing payments to creditors and that further capital was to be freed up through the sale of a large chunk of Digital's US$3 billion of real estate assets as it closes duplicate facilities.
- Digital's balance sheet also included US$3 billion in cash and US$3.3 billion in tax loss carry-forwards.
- Compaq's net cost for the acquisition of approximately US$5 billion bought it the business that it coveted, Digital's US$6 billion, 22,000 employee computer services division and its US$3 billion a year data storage business.
- Digital's computer services unit alone reported pre-tax income of about US$1 billion last year and CFO Mason predicted that Digital's operations would start contributing to Compaq's earnings in the fourth quarter of 1998.
- The favourable results have been achieved notwithstanding that rivals such as Hewlett-Packard have been successfully soliciting Digital's customers with the argument that Compaq might not support Digital's VMS and Unix operating systems much longer.

One of the reasons for the successful acquisition, which is common to many of the other transactions discussed below, is that Compaq got a head-start on the cost-reduction and integration process by commencing the process in January 1998, just after the Digital deal was announced, and allocating more than 200 teams to draw up "road maps" detailing which products Compaq would continue to produce and how they would be marketed and sold. By the time the transaction closed on June 11, 1998, the bulk of the work had been completed.[8]

(c) *Perform Thorough Due Diligence*. Financial, cultural and operational due diligence can lead to better pricing and transaction structures and provide a basis for early work on integration processes. Potential deal-breaking issues can sometimes be dealt with if identified early on. Identifying reasons to terminate a transaction before the public announcement can save much disruption and embarrassment.

Due diligence conducted by Symbol Technologies Inc. (a competitor and customer) in connection with the potential acquisition of Telxon Corp. (a maker of wireless communication devices and computers) in late 1998 revealed certain revenue recognition issues in connection with a sale to a distributor booked late in the second quarter of 1998 in the amount of US$14 million. Both companies are in the bar code scanner business. Symbol had resisted Telxon's insistence that a deal be negotiated and announced quickly – i.e. without any chance to review Telxon's books – and performed detailed due diligence which resulted in the potential transaction being terminated (it had not been announced). Symbol took the position that the transaction was not a bona fide sale because the shipment was not irrevocable and Telxon had fully financed the distributor's purchase. After being informed of Symbol's position, Telxon restated its earnings for the quarter ended September 30, 1998. That restatement, announced December 11, 1998 along with an earnings warning, caused Telxon stock to drop 45% that day (it had traded up over the preceding months on speculation of a take-over transaction).[9] As indicated above, a due diligence item often has an effect beyond a one time adjustment. The restatement indicated that the underlying business was not showing earnings growth and the restatement of that one item caused the Telxon business to be viewed in an entirely different light. The SEC has since launched a formal investigation into Telxon's accounting practices.

Negotiated rather than hostile acquisitions allow access to auditors' working papers and interviews with staff that can prove invaluable.

(d) *Ensure That Post-Deal Integration is Well-Conceived and Rapidly Implemented*. The entire post-merger program must be resourced and managed as the major project that it is – not just for a few weeks after the deal, but for however long it takes for the ultimate value to be captured. Many organizations fail to translate the business model into operational strategy, delineate the structure to execute it or specify the underlying management processes and systems.

Academic and professional studies confirm that, generally, an acquirer should be less heavy-handed with controls and more open-handed with resources, communication and support. Acquiring companies often fail to add value (or even destroy value) if they lack a good feel for the acquired business, focus on the wrong issues, hire or promote the wrong managers or press for the wrong levels or measures of performance. Acquired companies are also smothered with requests for information and a bureaucratic imposition of new ways of doing business.[10]

The difficulties involved in managing a multi-national acquisition notwithstanding an apparently well-managed integration program is currently being played out at DaimlerChrysler AG. In the face of an unprecedented global merger with enormous logistical and managerial obstacles, DaimlerChrysler created an "integration room" with video conferencing and computer links to its worldwide operations. Those on the front lines of the merger – typically the second and third tier of DaimlerChrysler management – held as many as three video conferences a week. The heads of the strategy and planning departments held them even more frequently. Senior management kept tabs on progress with a glance at their computers. The status of the work on the 98 priority projects seen as crucial to the merger's success was highlighted with "traffic lights" signifying whether the project was on schedule. The teams were working to create a new firm culture. Watches and pass cards with the DaimlerChrysler logo were distributed to all 428,000 employees. Education and language classes were continuously offered. The process was designed to achieve integration within a two-year timetable. The DaimlerChrysler senior management is convinced that staying focused on top priorities and maintaining momentum are crucial to the merger's success.

The two companies had decided to pursue what was then the largest merger of industrial companies in history because they needed each other. Daimler-Benz, having just completed a three year program of consolidation and cost-cutting, was nonetheless concerned that it was overly dependent on luxury cars, which were becoming prohibitively expensive to produce. Chrysler, on the other hand, while successful, feared that it would never have the financial muscle to best Ford and GM and wondered whether it would survive the coming round of worldwide automotive manufacturer consolidation. The deal was cast publicly as a "merger of equals" because neither company's chairman wanted to use the word "acquisition". However, in his enthusiasm for the deal, Chrysler Chairman Robert Eaton acceded to an acquisition of Chrysler by Daimler-Benz. Although the Americans wanted the new company to be based in the U.S., German law made it impractical and expensive. Inevitably, a German-registered company was going to be dominated by German managers, and it is. Eaton announced that he would step down as Co-Chairman within three years, thereby undercutting the Americans' influence with the Germans. The integration process proved to be overly rigid for the Chrysler culture and was implemented with inflexible dedication and excessive speed. Over the course of 1999, DaimlerChrysler's stock steadily declined as disappointing earnings and announcements of senior executive defections to Ford and General Motors shook the industry. Recently, however, results have improved and the integration is beginning to gel.

Post-merger integration is more fully explored in Appendix "B" to this Article.

(e) *Finance*. Does the operational model for the acquired business mesh with the terms of the financing for the transaction? Will the acquired business be starved of necessary capital to expand or restructure in accordance with the business model for the transaction? For example, where the acquisition target is viewed as a long-term growth business (particularly if given an expanded mandate as part of the acquiring business), the financing terms must provide room for the increased working capital, plant and equipment and investment needs of the acquired business as its grows. It is not enough to merely fund the purchase price and existing working capital needs of the acquired business.

(f) *Management Resources*. Planning to ensure that efficient integration and operational teams are allocated to the project is essential. Further, the implementation of incentive plans to ensure that key employees of the target do not leave is equally essential.

V. DUE DILIGENCE MATTERS

The due diligence process will see the establishment of various functional teams which will focus on particular areas of expertise. It is a multi-disciplinary process.

A full discussion of the due diligence process in mergers and acquisition transactions is beyond the focus of this paper. There are certain areas, however, where the CFO can obviously bring value to the process.

1. *Financial Due Diligence*

It is safe to say that we are currently experiencing a crisis as regards the investing public's and regulators' declining confidence in the quality of reported financial results and, therefore, the quality of financial reporting.

The crisis extends far beyond recent highly-publicized examples of falsified accounting records and/or deliberate breaches of securities laws relating to continuous disclosure and financial reporting (these types of matters have been alleged concerning Cendant, Livent, Leslie Fay, Bre-X and YBM).

Rather, increased emphasis is being placed on due diligence which goes behind the audited financial statements of the target company (something that is difficult to achieve in the case of a hostile public-market transaction). As indicated elsewhere in this article, merger transactions negotiated in haste (often as a result of an auction or competing bid scenario) have led to failed transactions.

The source of the problem lies in the very nature of generally accepted accounting principles themselves, as well as the integrity of the reporting companies.

Financial due diligence for a private or public market transaction, as well as the structuring of the purchase price, must reflect a fundamental understanding of the nature of GAAP. GAAP is merely a framework setting out underlying concepts, broad principles and conventions of general application and provides specific guidance on reporting only in particular circumstances and sometimes not in the depth or to the degree that transaction participants may desire. Even if a specific accounting issue is covered, alternative practices may be allowed and therefore the exercise of professional judgment is often required in choosing and applying accounting principles.

Inter-period cost allocation is often an important concept in a purchase agreement. Representations and warranties are tied to financial statements as at a given date and purchase price calculations may be based on earnings for a specified period. GAAP does not provide a full answer to the issues that need to be addressed for a purchase agreement to be self-applying. For example, consider the differences between recurring and non-recurring charges, the write-off of asset carrying values and the booking of expenditures that cannot be easily matched to the periods which they will benefit.

Estimates are often required (such as in the case of reserves, estimated useful life, whether overhead costs are related to a particular activity or function, etc.).

Most importantly, GAAP recognizes that financial statements should be cost-effective and that there is a trade-off between the benefits and costs of more detailed accuracy. The *CICA Handbook* defines materiality as: “the term used to describe the significance of financial statement information to decision-makers. An item of information, or an aggregate of items, is material if it is probable that its omission or mis-statement would influence or change a decision” (paragraph 1000.17). While helpful, this definition is clearly not self-applying and reasonable professionals can disagree. However, the concept of the acceptance of immaterial errors for reporting purposes is less acceptable to a purchaser where the business deal requires the vendor to be responsible for all expenses pertaining to the period up to closing or where the purchase price is based on a multiple of normalized earnings (where items which are immaterial in isolation become material when viewed in relation to their effect on the purchase price).

Some commentators have surmised that GAAP, developed in an environment where the principal assets of a company were tangible, is losing relevancy in an environment where the primary drivers of value (normalized earnings rather than balance sheet values) are intangible. For example, the value of clothing retailer, the Gap, has little to do with the historical cost of its store fixtures and everything to do with its “brand”, based on a feel for the market and carefully nurtured with advertising (see also Coca Cola).[11] Intangible assets of a company are generally not found in its financial statements other than through their effect on earnings. These include: (i) operational intangibles (skilled work force, operating and administrative systems and “culture”); (ii) production intangibles (intellectual capital and production and product design expertise resulting in competitive advantage through lower production cost, higher product quality, faster production, etc. – i.e. “know-how”); and (iii) marketing intangibles (customer lists and relationships, pricing strategies, marketing strategies, trade marks, service marks and trade names).[12]

It is worth emphasizing that many of the accounting practices currently being criticized by stock analysts, investors and regulators can be accommodated within the flexibility inherent in GAAP.

Nonetheless, Arthur Levitt, the Chairman of the SEC, in a noted speech given at the New York University Centre for Law and Business on September 28, 1998, indicated that the SEC would pursue a 9-point program to increase public confidence in the U.S. capital markets. This has the aim of improving the accounting framework through more detailed and vigorous auditing and accounting standards and guidance, renewing a focus on auditor independence and auditing processes and a strengthening of the audit committee process.

Chairman Levitt expressed the widely supported view that the tendency of the capital markets to significantly penalize companies for failing to meet analysts' market consensus estimates of earnings has to led extreme pressure on senior management to avoid taking a conservative approach to their financial statements (i.e. taking advantage of the flexibility inherent in GAAP).

Chairman Levitt focused on certain accounting practices which the SEC considers to be frequently abused in recent filings.

- *Restructuring Charges*. By combining several years of expected future expenses and writing them all off at once as an "extraordinary" one-time charge, future earnings can be enhanced. Feeding the trend is the fact that stock traders tend to ignore these (supposedly) non-recurring charges, focusing instead on normalized sustainable earnings. The recognition that the market will forgive and forget one-time charges has led to an explosion of such charges to an extent not seen since the "great recession" of the early 90s. According to First Call Corp., the number of companies taking restructuring charges in the United States jumped from 96 in 1995 to 230 in 1997. While some of these charges are mandated as part of the accounting rules applicable to mergers and acquisition transactions (see, for example, the $49 million after-tax restructuring charge reported by Alliance/Atlantis shortly after that merger was completed) or by accounting rules requiring the write-down of "impaired assets" to enhance the conservatism of the balance sheet, there is a concern that these charges are being used improperly in the following respects:

  (i) future on-going operating expenses are being bundled with the legitimate extraordinary charges;

  (ii) avoidance of amortization of goodwill on acquisition of technology companies through the write-off of in-process R&D;

  (iii) the blurring of the distinction between "recurring" and "extraordinary" events – AT&T booked major restructurings in 1986, 1988, 1991 and 1996; Citicorp 6 years in a row between 1988 and 1993; Kodak did so 5 out of 6 years between 1989 and 1994 and Westinghouse Electric in 7 out of 10 years from 1985 to 1994; and

  (iv) a masking of the inherent volatility of the business.

- *Misuse of Reserves*. There is a concern that some companies are using unrealistic assumptions to estimate liabilities for such items as sales returns, loan losses, warranty costs or in respect of restructuring charges. When the future costs in fact turn out to be less than were reserved for, no additional reserves need be taken in future periods and/or the excess reserves can be reversed and added back to income (even to operating income before extraordinary items). In effect, companies are being overly conservative with reserves (on the basis that they would not be penalized by the market in respect of the one-time charge) and thereby "managing" or "smoothing" their earnings.

- *Materiality*. There is a concern that "deliberate" or "known errors" in a company's financial statements are being explicitly tolerated on the basis that they fall short of a standard of materiality. Chairman Levitt's reply to this practice is that: "In markets where missing an earnings projection by a penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of these so-called non-events simply don't matter".

- *Revenue Recognition*. The SEC and the U.S. Financial Standards Accounting Board have recently published guidance in an area noted for abuse. How quickly or slowly revenue is booked is especially important in industries such as computer software, where service contracts and upgrades can legitimately stretch revenue out for years.

In the fourteen-and-a-half month period since Chairman Levitt's speech, in which he raised serious concerns about the erosion in the quality of financial reporting and pledged that the SEC would become more aggressive in dealing with abuses of the financial reporting process, five significant initiatives have been launched:

- *Audit Committees.* The SEC had established a Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which released its report earlier this year. The proposed rules (published jointly by the SEC, the NYSE and the NASD, SEC Release No. 34-41987) would require: (i) quarterly reports to be reviewed by the external auditors prior to filing; (ii) proxy statements to include a prescribed report of the audit committee confirming their discussions with management and the external auditors; (iii) proxy statements to disclose the written charter of the audit committee; (iv) certain disclosures pertaining to the "independence" of the audit committee members; and (v) certain purported "safe harbours" from certain liabilities under federal securities laws. The proposed rules have been issued in conjunction with proposed revised listing standards by the AMEX, NASD and NYSE which would specify the independence and competency requirements of the audit committee members. The SEC is currently soliciting public comment on the proposals. Clearly, the new requirements (notwithstanding the "safe harbour") could expose audit committee directors to claims based on a more onerous duty of care than is applicable to the other directors. Purchasers in negotiated transactions will, no doubt, ask to review the deliberations of the audit committee in the course of their transaction due diligence.

- *Auditor Independence.* At the instance of Chairman Levitt, a committee composed of auditors and others was established and its recommendations have lead to the American Institute of Certified Public Accountants announcing, on November 2, 1999, new requirements relating to the setting of specified independence policies by accounting and auditing firms and relating to reviews of investments and other business relationships that might be restricted. The new rules will become effective January 1, 2000. The AICPA rules include: (i) each member firm setting independence policies; (ii) firms maintaining a database of all restricted entities with explanations of why, when and how public company clients and related enterprises are included on the list or excluded from it; (iii) communication of the firm's independence policies to each professional and communication of relevant changes on a timely basis; and (iv) completion of independence training by professionals at the time of hire and periodically thereafter.

- *Enforcement Initiative.* On the first anniversary of Chairman Levitt's speech, the SEC announced a sweep of thirty enforcement actions against 68 individuals and companies alleging fraud and related misconduct at 15 different public companies. In addition to underscoring the SEC's "zero tolerance" of deviations from GAAP, the proceedings suggest the following lessons for corporate officials and others. The SEC charged more chief executive officers than chief financial officers in this sweep. The SEC's director of enforcement warned that CEOs would be prosecuted on the basis that they set the tone and create the culture for the company. He asserted that, even when senior management has not actively participated in a fraudulent scheme, the SEC will consider whether they nevertheless bore responsibility for a deficient system of internal accounting controls that allowed a fraud to occur. Senior management will be more likely to avoid enforcement action if appropriate internal controls and audit committee structures are in place and internal policies are enforced. The SEC's vigorous crackdown on accounting abuses and earnings management (through ongoing review of corporate filings as well as enforcement action) has lead to some industry commentators and chief financial officers worrying that the agency may be second guessing even legitimate accounting methods. The SEC's crackdown has sent a chill through corporate America, prompting executives to second-guess themselves on legitimate exercises of discretion permitted by GAAP. In an article published in the *Wall Street Journal* on September 13, 1999, it was reported that charges for acquired R&D, merger-related charges, and restructuring charges may be decreasing in response to the SEC's campaign.

- *Materiality Guidance.* On August 13, 1999, the SEC released Staff Accounting Bulletin No. 99, which addresses the application of "materiality" thresholds to the preparation and audit of financial statements. SABs are not rules or interpretations of the SEC; they represent interpretations and practices followed by staff of the Office of Chief Accountant and the Division of Corporation Finance in administering the disclosure requirements of the federal securities laws. Existing accounting and auditing literature indicates that certain pronouncements need not be applied to items that are immaterial to the financial statements. SAB 99 indicates that companies should not rely exclusively on quantitative benchmarks to determine whether an item is material (historically, errors, even if known, not exceeding five percent of a financial statement line item could be ignored as immaterial). Equally important is a consideration of whether, in light of the surrounding circumstances, a reasonable investor would consider the item to be important. The SAB also states that management should not make intentional immaterial errors in a financial statement to "manage" earnings.

- *Revenue Recognition.* In December 1999, the SEC issued new accounting guidelines concerning revenue recognition. Falsifying revenue has increasingly become the earnings management tool of choice according to the SEC. A study by accounting organization officials showed that half of all SEC accounting fraud cases from 1987 to 1997 involved revenue misstatements. Much of the focus of the revenue recognition rules relates to the high-tech sector where ".com" companies have increasingly created clever ways to pump up their revenue with questionable items, such as booking as revenue the entire sale price for a product or service when the company merely acts as agent for a sale and is really only entitled to a commission on the sale.

During 1999, the Financial Accounting Standards Board also issued two significant pronouncements that are relevant to acquisition transactions. If approved, they will take effect January 1, 2000. The practices that will no longer be acceptable are write-offs for in-process research and development costs acquired as part of an acquisition. Proposals are being developed to treat in-process research and development costs as an intangible asset and write them off over some period to be defined. The SEC had expressed concern that the current accounting treatment for purchased research and development had become subject to abuse.

The second proposal relates to the abolishment of the "pooling of interests" method of accounting for acquisitions. Pooling has been used in the majority of the stock-based mega-transactions over the last couple of years, such as the Citicorp–Travellers transaction and the Exxon-Mobil merger. If approved, the proposal would require merging companies to write-off the goodwill arising from the transaction over a new, shorter twenty year period. FASB is proposing to let companies display in their financial statements a second earnings-per-share number that doesn't include the goodwill charges. The proposal is being implemented with a goal to bringing U.S. accounting practices more in line with that of other countries (such as Canada, where pooling is less readily available). In November, the board of the International Accounting Standards Committee met with a view to pursuing an international accounting standard on the topic.

The SEC's crackdown on aggressive accounting and managed earnings is suspected to be in part behind the announced proposal to consider the abolition of the multi-jurisdictional disclosure system, which enables Canadian companies to use Canadian disclosure documents for purposes of raising funds in the United States. The Ontario Securities Commission has jumped on the bandwagon and, in a series of speeches during 1999, each of David Brown, the Chair of the OSC, and Howard Wetston, the Vice-Chair, have echoed the sentiments of Chairman Levitt of the SEC. The OSC has created a Continuous Disclosure Team which will monitor and assess the continuous disclosure record of reporting issuers and, in particular, selective disclosure and aggressive accounting.

An excellent summary of the accounting practices in respect of which financial due diligence should focus has been published by Howard Schilit, (the President of the Centre for Financial Research and Analysis in Rockville, M.D. and a professor at American University) in his book "Financial Shenanigans" (McGraw Hill, 1993). I have summarized his findings below using the headings and subheadings of his book (with some amendments for which I assume sole responsibility). I have then cross-referenced the headings to recent real world examples of shareholder suits, regulatory investigations or voluntary earnings restatements concerning the named companies, as reported in the press. Remember, GAAP is merely a state of guidelines and its inherent flexibility requires professional judgment in respect of which reasonable people can disagree.

CREATIVE ACCOUNTING 101

SHENANIGAN NO. 1: RECORDING REVENUE TOO SOON

1. Shipping goods before a sale is finalized
   - Watch for early shipping, before the sale occurs (Sunbeam, Bausch & Lomb)
   - Long-term contracts are the exception (percentage completion)
2. Recording revenue when important uncertainties exist
   - Check whether the risks and benefits have been transferred to the buyer
   - Determine whether the buyer is likely to return the goods (Bally Total Fitness, Knowledgeware)
   - Consider whether the buyer is likely to pay (Fairfield-timeshares)
3. Recording revenue when future services are still due
   - Watch for hasty recognition of franchise or membership revenue (Bally, Costco, Boston Chicken)

SHENANIGAN NO. 2: RECORDING BOGUS REVENUES

1. Recording income on the exchange of similar assets
   - Be alert for revenue recorded on the exchange of property
2. Recording refunds from suppliers as revenue
   - Question how retailers account for returned goods
3. Using bogus estimates on interim financial reports
   - Determine whether the estimates are realistic

SHENANIGAN NO. 3: BOOSTING INCOME WITH ONE-TIME GAINS

1. Boosting profits by selling undervalued assets
   - Watch for the sale of pooled assets acquired in a business combination
   - Watch for the sale of inventory and equipment bought at distress prices (Wise Stores – Marks & Spencer, Terex Corp.)
   - Look closely at inventory recorded under the LIFO method
   - Watch for gains from the sale of undervalued investments, including real estate
2. Boosting profits by retiring debt
   - Don't be fooled by "profits" from retiring debt
3. Failing to segregate unusual and nonrecurring gains or losses from recurring income
   - Adjust for the mixing of gains from recurring and non-recurring activities (Livent)
   - Watch for the mingling of operating with non-operating income
4. Burying losses under non-continuing operations
   - Be alert for companies hiding losses as "non-continuing"

SHENANIGAN NO. 4: SHIFTING CURRENT EXPENSES TO A LATER PERIOD

1. Improperly capitalizing costs
   - Watch for the capitalization of start-up costs
   - Consider the propriety of capitalizing R&D or product development costs
   - Look for companies that capitalize advertising and marketing cost (America Online)
   - Watch for companies that capitalize administrative costs
2. Depreciating or amortizing costs too slowly
   - Question companies that depreciate fixed assets too slowly
   - Be alert for overly long amortization periods for intangibles, pre-production costs and leasehold improvements (Livent)
   - Watch for the slow amortization of inventory costs (Philip Services)
   - Be concerned when the depreciation or amortization period increases
3. Failing to write-off or write down the carrying value of assets ("impaired assets")
   - Watch for impaired assets, bad loans and other uncollectibles that have not been written down (Livent, Standard Trust, Miniscribe)
   - Be wary of the carrying value of investments, particularly where current assets are reclassified as long-term assets so that no adjustment is made to reflect declining market value (Philip Services, Waste Management)

SHENANIGAN NO. 5: FAILING TO RECORD AND DISCLOSE ALL LIABILITIES

1. Reporting revenue rather than a liability when cash is received
   - Ascertain that cash received has been earned (Biovail – upfront license fee, Arbor – prepaid funerals)
2. Failing to accrue expected or contingent liabilities (Mattel – sales incentives)
3. Failing to disclose commitments and contingencies (Livent, Bausch & Lomb)
   - Probe for a troubled company with fixed payments
   - Watch for an unrecorded post-retirement liability
   - Read debt covenants carefully for contingencies
4. Engaging in transactions to keep debt off the books
   - Examine any debt for equity swaps
   - Be wary of companies using unconsolidated subsidiaries for borrowing
   - Watch for Defeasance of Debt

SHENANIGAN NO. 6: SHIFTING CURRENT INCOME TO A LATER PERIOD

1. Creating reserves to shift sales revenue to a later period (Sun Trust Banks)
   - Smoothing could mean income manipulation (Lockhead Martin - percentage of completion/Sears – credit card reserves)
   - Smoothing using reserves usually brings unpleasant surprises later (Mercury Finance – subprime loan securitization)
   - But not everyone understands that smoothing is wrong
   - Auditors must also be more alert
   - Be critical of successful companies with large reserves (Microsoft?)

SHENANIGAN NO. 7: SHIFTING FUTURE EXPENSES TO THE CURRENT PERIOD

1. Accelerating discretionary expenses into the current period
   - Be alert for prepayment of operating expenses
   - Be concerned when the depreciation or amortization period decreases
2. Writing off future years' depreciation or amortization and other restructuring changes (Motorola acquisition of Starfish Software – in process R & D, McDonalds – replacement of restaurant equipment)
   - when management changes
   - to shelter a large non-recurring gain
   - if the period is already showing a loss

Effective financial due diligence will, of necessity, involve the application of vigorous financial analysis to the working papers of a target company and the performance of typical ratio analyses. A focus on "free cash flow" and comparison of the respective fluctuations in revenues, receivables and inventory is a start. However, effective financial due diligence requires going beyond the financial statements and speaking with customers, suppliers, the employees of the target company, competitors, analysts following the industry as well as the senior executives of the target itself. Obviously, the ability to do some or all of the matters will depend on the dynamics of the particular deal and whether it is a private or public transaction.

An understanding of the audit process for the target company and whether there were any disagreements or matters which, in the opinion of the auditors, required detailed consideration by the target's audit committee, as well as the scope, planning and performance of the audit itself, should be obtained. Focus should be placed on changes in accounting principles from previous years (and their application) and whether the accounting principles are in common usage by other companies within the same sector. Related party transactions and significant arrangements with customers, suppliers, agents or employees should be focused on. An assessment should also be made of management's programs and policies regarding the adequacy and effectiveness of internal controls over the accounting and financial reporting systems. In this regard, review should be made of the typical "internal control" letters that form part of the audit process, as well as any specific consulting mandates given to the external auditors.

The ultimate goal of the financial due diligence process is to develop a comfort level with the financial presentation, as well as an understanding of the accounting discretion utilized by the target company for purposes of: (i) settling on a form of pricing mechanism that will be reliable, objective and fair and not susceptible to manipulation; (ii) developing a list of matters that will form the basis for the representations and warranties in the purchase agreement; and (iii) building a foundation for the financing of the transaction (in terms of representations and business models to be provided to lenders to assist in the structuring of the required credit facilities).

In many contexts, the concept of "normalized" and "sustainable" earnings is essential to the pricing negotiation. The sustainability of earnings in the hands of the acquirer will determine whether the transaction is a success. Unfortunately, these terms are not self-applying and GAAP does not provide definitive guidance as to their calculation. In this regard, there is no substitute for developing a true understanding of the business model for the acquired business and an understanding of the impact of that business model on the revenue recognition process.

As an example, fast-growing restaurant franchiser Boston Chicken's stock soared from its initial public offering in late 1993. However, by 1996 analysts were surmising that its earnings growth was not sustainable. The biggest share of its revenues came from interest on huge loans made to its national network of franchisees, while the franchisees themselves were typically suffering large operating losses. Similarly, Newcourt Credit Group's stock came under pressure in the fall of 1998 notwithstanding a stunning 14-year rise to become one of the largest commercial finance groups in the North America. Certain analysts and investors became concerned that Newcourt's revenue stream was dependent upon a continued flow of transactions in which loans that it originated would be syndicated, while the syndication market was contracting. The perceived problem became a reality in 1999 and Newcourt has recently been acquired by CIT Group. A similar concern has been expressed in connection with Imax Corp., which receives and books the bulk of the revenue associated with a lease of a theatre system before the theatre is even built, while the on-going royalties are modest. Sustainability and growth of earnings is therefore tied to additional theatre installations rather than an existing "book of business".

2. *Other Areas of Due Diligence*

Obviously, a detailed study of the due diligence process is beyond the scope of this paper. However, certain other aspects of the due diligence process lend themselves to value-added contributions by the CFO.

- *Labour and Employment Matters.* The due diligence process should yield an understanding of the exposure to union demands (such as pending unionization or pending renewal of the existing collective agreement), assumed benefit obligations (including post-retirement benefits), exposure to employees on layoff, disability, maternity or other leaves and whether there are any hidden costs involved in integrating pensions plans (a highly technical area where specific expertise is required). An understanding of the target company's planning for and experience with "pay equity" will lead to a better understanding of the risk of future payroll increases. Lastly, if downsizing is part of the restructuring and integration plan, detailed calculations should be made of the expected termination and severance costs, as well as outplacement and other benefits that would be occasioned by the transaction, so that these can be built into the business model.

- *Tax Matters.* The tax due diligence process should yield the following results: an understanding of potential tax exposure in the acquired business and required tax indemnifications; an understanding of the relative values of a purchase of assets transaction as compared to a purchase of shares; an understanding of the tax basis of the acquired assets as well as the nature and remaining life of available tax losses; withholding tax and interest deductibility issues; GST/PST/HST exposure on the transaction, and insight into how the transaction might best be structured with a view to taxation issues. Other taxes which should be considered are payroll related (CPP, QPP, EI, health taxes and workers' compensation). An understanding of the target's history of workers' compensation claims will lead to an understanding of whether any future experience rating reassessments would be likely.

- *Contract Issues.* A thorough understanding of the material contracts of the target should lead to the following understanding: whether there are any contracts that it would be essential to have terminated prior to closing due to conflicts with the acquirer's business and the cost related thereto; whether in-process contracts are likely to result in losses on the part of the target (i.e. expected cost to complete exceeds remaining progress payments); are there any "change of control" or "non-assignability" provisions that will be impacted by the transaction; are any of the benefits inherent in the contracts not transferable to the purchaser; and whether relationships with suppliers or customers are expected to be impacted by the transaction.

- *Regulatory Issues*. A review of this area will determine whether regulatory approval is required to complete the transaction and what informational needs will be required to satisfy the regulators. For example, if pre-notification is required to be made under the *Competition Act* (Canada), the vendor and purchaser will have to work together to provide the detailed information required by Industry Canada.

- *Financeability of the Transaction*. This process will result in a thorough review of the asset base of the target company (which may provide the borrowing base for the acquisition financing, if applicable). Valuation issues and accounting and verification issues will have to be attended to. For example, most loan agreements contain detailed definitions of "eligible accounts receivable" and "eligible inventory" for purposes of establishing a borrowing base. Third party consultant reports (such as environmental consultants and asset appraisers) should be obtained as part of the acquisition due diligence and in anticipation of requests from lenders. The purchaser should ensure that it has the ability to pass the benefit of these reports to its banker and that the consultant or appraiser has adequate insurance. Verify whether such reports contain disclaimer clauses.

- *Insurance.* An insurance broker or consultant should review the target's insurance policies to determine whether coverages are adequate in light of standards set by the purchaser. If applicable, the business model must provide for the additional cost. An understanding of the extent of available insurance also assists in the risk management process, since many claims which might otherwise be made against the vendor pursuant to the representations and warranties might be covered by insurance. A review and analysis of reported and unreported losses at the target company is also important for purposes of reviewing sufficiency and cost of insurance.

- *Operational Due Diligence.* The historical and current year run rate for research and development expenditures, repairs and maintenance and capital expenditures should be closely verified. The seller should not be entitled to maximize short-term value as a result of the pending sale. An understanding of the current programs in these areas, together with physical inspections of plant and equipment and an understanding of future required capital expenditures will assist in the finalization of the business model. Further, where appropriate, specific covenants should be included in the purchase agreement for the continuation of these programs at historical rates.

3. *Due Diligence Process Issues*

There are numerous reasons why a due diligence review, conducted with the best of intentions, might turn out to be inadequate. They include:[13]

- Time pressure to get the deal completed quickly

- Staff conducting the due diligence not experienced or skilled enough in identifying red flags and other real business or competitive market risks and concerns. Effort is mis-directed towards minor issues on account of failure to focus on the key risk areas. A superficial "checklist" approach is adopted rather than a risk based investigation strategy

- Staff in charge of the due diligence feeling a vested interest in the deal getting approved, often because they identified the opportunity initially and brought it to the table for approval
- Uncritical acceptance of information provided by the other party
- Failure to ask the "tough" questions which may kill the deal
- Undue reliance on the other party's management for assistance in performing the due diligence
- Failure to understand the other party's financial and operational systems
- Failure to understand and/or lack of persistent follow-up on "red flags" identified in the course of the due diligence investigation
- Due diligence is focused solely on quantitative factors, such as financial projections, with inadequate attention paid to critical qualitative factors
- Failure to probe the background of the key principals in the deal
- Poor team work between members of the due diligence team causes key issues to be missed or mis-communication of findings
- Insightful findings of the due diligence provider are reported in vague or general terms, heavily or unnecessarily qualified, making them difficult for the end user to understand and/or act on
- Due diligence report or key findings are provided too late in the investment/acquisition process to be acted upon before concluding the deal
- Failure on the part of the recipient of the due diligence report to act on the findings

4. *The Benefits of Effective Due Diligence*

Successful due diligence enables effective decisions to be made:

- To stay or walk away
- To negotiate price adjustments
- To revise financial projections
- To restructure the deals
- To alter the management teams
- To require further representations and warranties
- To manage risk

VI. FINANCING THE ACQUISITION

An obvious area in which the CFO can add significant value to the transaction is in arranging the acquisition financing. A thorough understanding of the existing financing of the acquirer and the target company, as well as the current state of the equity and debt markets and the commercial lending environment is essential to this process.

While it is beyond the scope of this paper to provide a definitive treatment of acquisition financing techniques, I will address certain high level issues.

1. *Model the Combined Business*

The very business model for the transaction should be utilized to perform a sensitivity analysis in determining the extent of required financing. Unforeseen events will inevitably occur and these should not be permitted to impact on the operation of the target company in the ordinary course. Further, if the target is being acquired for its growth potential or as a platform to grow a business segment of the combined company, starving it of needed capital to support increased working capital, plant and equipment and other resources is counter-productive.

2. *Determining the Amount and Type of Financing Required*

The ideal financial structure for an acquisition is flexible and properly matches funding components with their respective sources of repayment and available security in terms of timing, magnitude and risk. Senior, junior and equity participants in the transaction must each be satisfied in terms of its particular investment criteria or risk profile.

The type of assets acquired has a direct bearing on the type of financing which can be raised. For example, asset-based lenders will provide higher margining on accounts receivable and inventory, but will not lend against intangible assets or available cash flow.

The financial model should show the amount of funds required over the model period (typically 3-5 years) to finance: (i) temporary or fluctuating current assets (based on short-term cash flow for cash and seasonal needs); (ii) permanent current assets (core working capital requirements); (iii) fixed assets; (iv) research and development programs; (v) capital asset replacement programs; (vi) one-time costs (i.e. moving costs, product launch costs, start up costs, integration costs); and (vii) the growth program for the company (this will involve additional capital requirements for each of the foregoing categories).

The financing model should then be reviewed against available sources of financing. The acquired business can, to some extent, be funded by its internal cash flow from operations. External financing sources can include: [14]

- Conventional short-term financing (bank lines of credit and supplier credit)
- Risk capital short-term financing (factoring and asset-based lending)
- Conventional long-term financing (term loans, leasing and mortgages)
- Risk capital long-term financing (subordinated debt and quasi-equity participating debt)
- Equity
- Strategic alliances
- Grants
- Guarantees from the parent company

Depending upon the stage of development of the acquired business and the variability of its cash flows, various possible sources for the external financing may be determined. Further, the selection of capital structure will also depend on the nature and maturity of the financing required, which must mesh with the business model. For example, having the facilities mature at a time when it is projected that the capital expansion needs of the acquired business will be greatest is not optimal.

The debt to equity mix should take into account the risk profile of the acquirer, the variability of expected future cash flows (and the consequent ability to service interest and debt repayment obligations) and whether giving up equity in the acquired business is a viable option.

The optimal capital structure will minimize the company's weighted average cost of capital. In other words, applying too much leverage will increase the cost of debt and possibly decrease equity trading multiples, in a public company scenario.

3. *Negotiation of the Loan Facility* [15]

The lenders should be involved as early as possible in the process. The management team should meet and communicate with the lenders frequently throughout the due diligence process. Use of consultants (industry experts, accountants, lawyers and appraisers) as warranted and making them available to the lenders as part of their due diligence will help expedite the process and more importantly add credibility to the borrower's application.

A deal summary and preliminary financial forecast, together with a proposed structure for the transaction, helps get the process off to a quicker start and, more importantly, provides the lender with the borrower's expectations. The summary information provided to the proposed lender should clearly state price, funding facility requested, anticipated pricing, repayment terms, required margining and flexibility in the covenant pattern and available security. Where more than one lender is involved, this also helps to alleviate any misunderstandings which could otherwise arise amongst lenders in terms of their respective priority and security.

Banks are less willing to exclusively fund a transaction. At a minimum, lenders will reserve the right to sub-participate their facilities. Borrowers should request that any participations be "silent", in that the lead bank will retain the discretion to grant waivers, etc. This is often difficult to achieve, however.

Uniformity with respect to representations, warranties and covenant pattern is essential in order to manage multiple lenders.

If required margining is not proposed to be made available, it may be possible to achieve this through offering the lenders penalty pricing or additional equity kickers in the event that certain paydowns or performance criteria are not met. Pricing of this nature can be an effective means of reducing the ultimate cost of borrowing by effectively rewarding the lenders for incremental risk in the event that their risk profile increases.

While it may involve additional cost, it is prudent to incorporate ample cushion into the operating line's availability.

Maturity dates should be straddled amongst the lenders as a means to reduce refinancing risk.

The covenant pattern should be fully modelled against the expected accounting treatment for the transaction (e.g. commitment fees, legal and accounting fees and transaction costs as well as opening balance sheet adjustments). A start-up period, delays in availability of required financial information, and bulge lines or increased/stepped advance rates to cover peak borrowing periods, should be provided for and the covenant pattern relaxed for the initial integration period. Watch for the frequency and timing of covenant calculations, particularly in a seasonal business (where annual calculations, rather than continuous calculations, may be appropriate).

A well-constructed covenant pattern will serve the purpose of providing early warning signals to the lender of material adverse variances from plan well in advance of any monetary default. Properly structured, the covenant pattern can instil a degree of discipline in the purchaser while still providing the purchaser with sufficient flexibility to run the business without unnecessary reporting requirements and lender approvals/waivers. Conversely, if the covenants are too stringent and are triggered without any material adverse variance, they can have the effect of straining an otherwise favourable relationship with the lenders, since the occurrence of an event of default generally precipitates internal exception reporting within the bank or lending institution. Similarly, ensure that cure periods are reasonable.

Where consent or waiver is required, the agreement should provide that the lender must act reasonably and without undue delay. The latter point is especially important in the case of syndicated facilities.

Avoid having to incur commitment fees in advance of a closing of the purchase. In addition, ensure that work fees and interim commitment letter fees are credited against the ultimate commitment fee payable on closing.

4. *Other Sources of Finance*

In addition to one or more levels of debt, sources of financing can include spin-offs and public offerings.

Due to longer lead times, significant planning has to be undertaken if public market equity or debt finance is part of the transaction. Conversely, closing a public financing in advance of the closing of the business acquisition is risky, since it is possible that the business transaction will not proceed as a result of due diligence, regulatory or contractual problems. The excess capital could then result in dilution.

Two transaction structures have been developed to deal with this issue:

(i) *Special Warrant Transactions.* (a private placement of a convertible security which is subsequently qualified by a long form prospectus) – which can only be marketed on an exempt basis; and

(ii) *Subscription Receipt Transactions.* (a convertible security marketed by prospectus) - which can be marketed generally.

In either case, the public financing can be marketed and closed, with the funds being held in escrow pending a closing of the underlying business acquisition. Of course, tying up a potential business acquisition with the intent of pursuing a public market financing is cold comfort if the market is not receptive. However, the market can be quickly tested by these structures. Subscription receipt transactions, even though they require a prospectus, are often structured on a "bought deal" basis. (See, for example, the recent Fairfax Financial and George Weston transactions).

An important factor to remember when accessing the public markets to finance a purchase transaction, is the requirement under Ontario and other provincial securities laws to include audited and interim financial statements *of the acquired business* in the prospectus. The applicable regulations and policies apply, generally, in two situations: (i) where an acquisition is being at least partially funded, directly or indirectly, by 40% or more of the proceeds of an offering; or (ii) a material acquisition is being at least partially funded, directly or indirectly, by at least a portion of the proceeds of the offering. Only general guidance is currently given as to the determination of materiality, however under proposed National Instrument 41-501 a more bright-line test will be enacted. [16]

Essentially, the regulations require three years of audited financial information for the acquired business, as well as the most recent interim statements, to be included in the prospectus together with one year of *pro forma* information for the combined business (in the case of a material acquisition). This will necessitate obtaining a covenant from the seller to provide: (i) the requisite segmented information for purposes of the purchaser's prospectus; (ii) its covenant to direct its accountants to provide the required consent and comfort letters for the information being included in the prospectus (the purchaser's accountants would not be able to provide this comfort); and (iii) any required updating of the information included in the preliminary prospectus.

Taxation aspects of the financing must also be considered and worked into the model.

Other sources of financing can be internal to the transaction, such as earn-outs (a portion of the purchase price is paid out to the vendor over time based on future cash flows of the acquired business) or vendor take-back financing (typically deeply subordinated debt).

Lastly, an increasingly common financing method being used, particularly in the larger transactions, is the stock-for-stock transaction (such as in so called "mergers of equals" transactions). This transaction structure, in appropriate circumstances, also permits transactions subject to U.S. accounting rules to be accounted for on a "pooling of interests" basis (such as the recent Northern Telecom-Bay Networks transaction), thus avoiding ongoing amortization of goodwill engendered by the transaction.

The use of securities as consideration in mergers and acquisitions is also being used creatively to: (i) capture the value of a specific asset as part of the transaction structure (for example, Inco's class VBN shares); (ii) to substitute for a valuation (for example in the Rogers Communications issuance of RCI Participating Rights); and (iii) to preserve tax flexibility (such as in exchangeable share transactions).

In stock-for-stock business combinations (whether a merger or acquisition), the market price of the acquirer's stock and the target's stock can change substantially between the date of signing and the date of closing (which may be a period of up to six or more months during which required regulatory and shareholder approvals are obtained). There are a number of increasingly complicated approaches to allocating this market risk between the acquirer and the target (such as, collars, caps and walk-ways).

Cross-border mergers and acquisitions involving Canadian public companies and U.S. public companies have often involved the issuance of "exchangeable shares" by the Canadian company (such as in the case of the Microsoft-SoftImage transaction, the Silicon Graphics – Alias Research-Wavefront Technologies transaction and the Symantec-Delrina transaction). In business combination transactions using exchangeable shares, the shareholders of the Canadian public company receive exchangeable shares of the Canadian issuer (which may be the target Canadian public company itself, a successor by amalgamation or a Canadian acquisition corporation owned by the acquirer) and the non-Canadian acquirer directly or indirectly receives all of the common equity in the target Canadian public company.

The exchangeable shares and other rights received by the Canadian public company's shareholders are designed to make ownership of an exchangeable share substantially equivalent to ownership of common equity in the non-Canadian acquirer; for that reason, exchangeable shares are often referred to as "mirror shares".

The principal benefits of the use of exchangeable shares in a cross-border business combination transaction include: [17]

- The transaction may be eligible for "pooling of interests" accounting treatment under U.S. GAAP.
- Canadian shareholders of the target Canadian public company will generally receive an income tax deferral until such time as their exchangeable shares are exchanged for common shares in the acquirer (a tax-deferral not available on a direct exchange of shares).
- U.S. shareholders of the target Canadian public company will also generally benefit from a "rollover" for U.S. income tax purposes which would not be available in a direct exchange.
- The exchangeable shares, which are listed on a Canadian stock exchange, are not treated as "foreign property" for Canadian tax purposes and are therefore eligible for investment by tax-exempt holders.
- The exchangeable shares may open up a new investor base for the acquirer. Future issuances of exchangeable shares, which tend to trade in parity with the underlying shares of the acquirer, can be used to fund future Canadian growth, either as financing vehicles or as currency in subsequent M&A transactions.
- The exchangeable share structure does not limit the flexibility of the acquirer with regard to future growth strategy, having particular regard to the pooling requirements of U.S. GAAP.

VII. MAXIMIZING VALUE IN SALE TRANSACTIONS

1. *Value Enhancement Initiatives*

Most buyers will tell you that they hate auctions and will try to avoid them, as they always lead to a better price for the seller than privately-held exclusive negotiations. Auctions also allow sellers to keep control of the process and create a set of guidelines or rules which work in their favour. The whole essence of auctioning is to present a process which encourages the prospective purchaser to believe it must compete for the target, which controls and directs the information available and which limits the time to make decisions. Auctions can create a market in and of themselves, a key factor when there is only one bidder.

A prudent vendor not only provides information to the purchaser about the subject business, but also seeks out information about the needs and objectives of the prospective purchaser in order to make sure that it is extracting the best price possible from the particular buyer. A prudent seller should try and understand what aspect of the target company is particularly attractive to the buyer, how the target meshes with the purchaser's stated or unstated strategic plans and what aspects of the target are considered to deliver competitive advantages (products, customer base, distribution, intellectual property or management). A better understanding of the expected synergies to the purchaser and possible future growth options if the purchaser uses the acquired business as a platform, will enable the vendor to negotiate to extract its fair share of the additional value of the business in the hands of the purchaser over and above the inherent value of the business in the hands of the seller.

Proposed sale transactions should always be evaluated in light of alternatives that do not involve a sale of the company. Capital market initiatives include: (i) spin-offs; (ii) split-offs; (iii) lettered stock; (iv) joint ventures; and (vi) changing the mix of debt and equity. Operational initiatives include: (i) outsourcing; and (ii) re-engineering the business. Alternative methods for divestiture should be modelled and market tested (such as an IPO, LBO, re-capitalization or strategic sale).

Throughout the process of attempting to negotiate an M&A transaction, regard should be had as to the feasibility of an equity market transaction as outlined above. The traditional rationale that strategic buyers can pay a premium over equity market values because they are able to extract synergies from the acquired company probably remains true. However, synergies may be limited in certain cases. The buyer may be putting disproportionate emphasis on problematic aspects of the target company or simply attempting to take advantage of a lack of competing bidders (due to the competitive environment, the scale of the target or certain legal/ownership requirements).

Conversely, the availability of the equity market alternative will be influenced by general economic activity and demand for equity in that industry.

The divestiture candidate must be, or be transformed into, a stand-alone company to access the equity markets. This involves: (i) an independent board of directors; (ii) arm's length agreements for inter-company transactions; (iii) elimination of shared services; (iv) stand-alone capitalization; and (vi) sufficient size to be taken public.

The company to be sold should be positioned for sale. This may involve a "clean-up" or restructuring of the company prior to the sale so as to extract redundant assets that purchasers will not be willing to pay fair value for, or to roll-in other operations to create critical mass in the business being sold. Operational and financial leverage should be maximized. Tax issues can be isolated and favourable tax positions booked or available refunds collected (as well as loss carry-forwards utilized) prior to a transaction.

The interim financial statements upon which the initial high level discussions between buyer and seller occur should present the best possible face for the company. If the company had previously not been managed on an arms-length basis (for example, related party sales were booked at less than fair market value), this practice should be reversed. The projected closing balance sheet which would form the basis for the price negotiation discussions should properly reflect all of the good news available to the company (i.e. excess reserves should be reversed, pending tax refunds should be booked and any other permissible accounting adjustments put through in order to create the best possible picture for the company).

The business to be sold should be positioned to function independently. Shared services and allocated corporate overhead expenses should be identified and the business placed on an "arms-length" footing. Management should be improved; and a documented, demonstrable track record of improved earnings and operations created so that prospective purchasers will view the business as one with earnings momentum, rather than a stagnant "orphan" business.

The proposed seller should conduct a full due diligence review of the business to be sold as if it was the buyer. Problems and issues that might detract from value on a sale can be identified and dealt with, usually at lower cost than the amount that the purchaser would deduct. The pre-sale due diligence will also enable the seller to prepare the detailed disclosure schedules that will qualify the typical representations and warranties. This will identify any remaining issues that might become the subject of an indemnity in favour of a purchaser, as well as accelerate the timetable for a transaction. Appraisals of assets that would be required by a purchaser as part of the financing process and phase one environmental reviews as part of the due diligence process can be arranged in advance. If audits of the financial results of the subsidiary have not previously been obtained, they should be commissioned.

Key employees should be signed up to retention arrangements in order to ensure that the sale process does not lead to the loss of key management (thereby impacting value) and a bonus pool or other incentive plan established which is tied to the completion of a successful transaction. Variable compensation tied to the value obtained by the seller has sometimes been a feature of these plans.

Lastly, the sale process itself should not extend over too long a period, as the management of the target subsidiary and operational employees will have difficulty working under the uncertainty created by the process for too long a time. Deteriorating results as a result of management distraction can seriously impact on value.

2. *Limiting Exposure for Representations, Warranties and Indemnities*

LBO firm Clayton, Dubilier & Rice's strong operational bent has allowed it to reap superior returns from turnarounds. Its favourite target for acquisitions are corporate "orphans" – operations with good managers that are nonetheless peripheral to a larger company's core business and thus have suffered from neglect, financial and strategic. In negotiations, CD&R attempts to take on as few of the target business's liabilities as possible, such as retiree healthcare and pension benefit liabilities and product and environmental liabilities resulting from pre-closing activities. It will also ask the seller to downsize the target company's staff and make other cost cuts prior to the sale.

These are typical issues to be negotiated in any transaction and therefore to be anticipated and, if possible, dealt with by the seller as part of the pre-sale value enhancement and due diligence process, so as to enhance value in the transaction itself.

However, there are numerous opportunities, through careful drafting and thought, to limit ongoing responsibility for matters pertaining to the business to be sold as part of the negotiation of the representations, warranties and indemnities contained in the purchase agreement. Much has been written about this process from the purchaser's perspective, and numerous precedents that are "purchaser oriented" exist. Appendix A to this article is a summary of my "top 25" suggestions for how to maximize the purchase and sale agreement process from the vendor's perspective. I hope they will be of use to the readers of this article.

VIII. EFFECTIVE COMMUNICATIONS BEFORE AND AFTER THE MERGER [18]

1. *Confidentiality In Merger Negotiations*

The most important aspect of a communications policy at the outset of negotiations is to maintain control of the discussions as well as copies of termsheets and correspondence.

Over the course of the negotiation and due diligence process, the seller will be providing the buyer with significant information about its affairs and will therefore require the potential purchaser to enter into a confidentiality agreement. It is beyond the scope of this paper to fully examine all of the issues pertaining to the negotiation of confidentiality agreements. However, I would point out that the potential buyer must focus on whether it already has knowledge and/or access to some of the information being disclosed (such that its right to use such information for purposes unrelated to the transaction should not be circumscribed). These discussions are often difficult where the purchaser is a strategic buyer. Regard should also be had as to whether the confidentiality agreement contains any direct or indirect restriction on the ability of the potential buyer to solicit or hire employees of the target or, in the public market context, to launch or participate in a proxy contest or takeover bid concerning the target.

In order to protect the seller in the event that the transaction does not proceed, certain information may be explicitly stated to have a higher degree of sensitivity and, therefore, that it would be withheld and only released later on in the transaction, perhaps after a binding agreement of purchase and sale was entered into. The fear on the part of the seller is that if a transaction is ultimately not completed, its competitive position would have been significantly impacted by material internal information having been disclosed to a competitor. For example, when negotiating the sale of a large retailer, information as to gross margins and rates of supplier rebates and incentives could be provided at a company and departmental level, with information for the category and SKU level withheld until later on in the transaction. In addition, it is common to withhold minutes of audit committee and management committee meetings.

Another alternative is for the purchaser to make full disclosure of its affairs to the seller so that, if the transaction does not proceed, any tactical competitive advantages will have been equalized.

Obviously, in share exchange transactions (whether considered an acquisition or a "merger of equals") there will be mutual disclosures. Where the transaction does not proceed, both parties walk away with trade secrets of the other. A recent example is the aborted merger of Big Six accounting firms Ernst & Young and KPMG Peat Marwick. Each firm had the opportunity to extensively explore the other's intranet and got the opportunity to see where the other was strong and they were not. KPMG's discussions with Ernst & Young confirmed that E&Y was ahead in knowledge-management systems and communications.

The merger boom is leaving plenty of companies full of useful new insights about their jilted partners. About 2,142 planned mergers – public, private, big and small – announced since 1992 fell apart before completion, according to a study by Securities Data Co. of Newark, New Jersey.[19] Notable transactions that did not proceed during 1998 included: (i) Monsanto – American Home Products; (ii) Smithkline Beecham PLC - Glaxo Wellcome PLC; and (iii) European publishers Reed Elsevier PLC and Wolters Kluwer NV (a merger that would have created the world's largest scientific and professional publisher).

The ten month mating dance between the number one and number two office - supplies superstores, Staples Inc. and Office Depot Inc., gave both companies valuable intelligence. The US$4.3 billion transaction was terminated in July 1998 after a federal judge ruled the combination was anti-competitive.

For example, Staples figured out why Office Depot had a much bigger delivery business. Office Depot's own trucks bring supplies c.o.d. to tiny business customers, who often lack decent credit history to charge their orders. Staples preferred UPS for deliveries, which requires advance payment. Today, Staples' trucks are delivering merchandise c.o.d. in certain markets, with plans to expand. In addition, during the merger talks Staples discovered that it was taking much longer than Office Depot to test new products, a practice that has been corrected. For its part, Office Depot shrank the size of certain catalogues after Staples described how its smaller catalogue and different printing methods saved significant costs.

Where confidential information about processes, employees, customers or other matters is too risky to disclose to the other side, disclosures have sometimes been made to merger consultants who have been retained to examine the potential suitors. The disclosed information is not shared with the other side but rather the consultant would prepare a report for the benefit of both sides as to whether there are likely to be any conflicts (suppliers, customers, etc.) or structural impediments to a successful merger and integration. Assuming that the parties have previously agreed on a share exchange price and there was not a significant risk of failing to obtain required regulatory approvals, the information would then be released to both sides.

In the end, there may not be any solution to the problem and transactions will have to proceed on the basis that both sides have disclosed strategic and tactical information which could prove damaging to them if the transaction does not proceed. So long as they do not raid each others' employees and certain selected information is withheld until late in the transaction, the benefits of combinations will out weigh the risks.

2. *Securities Law Issues*

It is not unusual for companies contemplating business combinations to share a variety of internally generated forecasts, budgets and forward-looking analysis with their potential partner and their financial advisor. However, in the public company context, parties should proceed with caution in providing such information, which is usually not prepared with a view to public disclosure. Selective disclosure of material non-public information is generally not permitted under Canadian and U.S. securities laws. Since the SEC typically reviews proxy materials for shareholders' meetings required to approve a business combination transaction, SEC staff has focused on references in the proxy materials to certain information provided to the financial advisor for purposes of assisting it in preparing its fairness opinion. In certain transactions, SEC staff has been of the view that financial projections and current fiscal year budgets provided to the other party or its financial advisor during a merger negotiation are material *per se* and should be disclosed to shareholders along with the underlying material assumptions.[20]

While it is beyond the scope of this paper to comment at length on the laws pertaining to when merger negotiations need to be disclosed generally to the public (particularly in light of the proposals to impose liability for continuous disclosure on issuers and their directors and officers), a few thoughts are relevant.

The parties should reach a common understanding that early disclosure would be counter-productive to the transaction and that any transaction would be subject to the approval of their respective boards of directors. The approval process would be managed so that the input of the boards of directors would not be taken as a "rubber stamp", but rather the boards would be brought along slowly, with senior management acting as filters, as the transaction negotiations progressed. This would give each board adequate time to study the transaction and, if required, to call for additional materials or input from advisors to the company.

There are usually sound business reasons for delaying disclosure until there truly is "a deal". In the public company context, announcement of a potential transaction will cause movement (one way or the other) in the company's share price, if the transaction is meaningful. To subsequently announce that the negotiations have ended unsuccessfully or that the agreement in principle had been terminated is both embarrassing and disruptive (and in the United States a recipe for a securities class action lawsuit). For example, OfficeMax Inc. disclosed in early September 1998 that it was in talks on a possible "business combination", and one week later had to announce that the talks had been terminated. Early disclosure is particularly troublesome for a potential vendor, since if the transaction does not proceed it might be viewed by the market as holding "damaged goods".

In addition, announcement of the transaction (or wide-spread internal dissemination of the potential transaction) causes great uncertainty with employees, customers and suppliers, all of whom question whether existing relationships and methods of doing business will continue.

What, then, is the impact of this analysis on the process that a buyer and seller negotiating a potential transaction will undertake during the period between the initial high-level discussions and a binding agreement of purchase and sale? There are essentially two choices.

The parties can work through the principal business terms of the transaction in the form of a termsheet in order to ensure that there is a meeting of the minds on all principal points before significant time and expense is spent attempting to settle a definitive and binding agreement.

Alternatively, the business terms in the termsheet can be fleshed out to an intermediate extent and certain interim contractual arrangements agreed to in binding fashion through the use of a letter of intent. The letter of intent will typically contain a few clauses that are in fact binding, even though the parties have not obligated themselves to proceed with the proposed transaction.

The binding clauses typically include non-solicitation, confidentiality and "no shop" provisions. It is generally accepted, however, that signing a letter of intent results in a disclosure obligation under securities laws (even though it is expressed to be non-binding and even though the ultimate transaction, as expressed in a definitive agreement to be negotiated, is subject to approval by the respective boards of directors). Obviously, if both parties are private market participants this will not be an issue. However, if any one participant in a transaction is subject to continuous disclosure laws, then the letter of intent may not be the way to go.

Where a business is being sold at a discount to book value, a vendor would also be concerned that it would have to book a write-down or reserve at the time that the letter of intent is entered into and possibly publicly disclose the write-down (if material). If the parties merely settle a termsheet, disclosure may be delayed until a definitive agreement is entered into or the issue of asset impairment is addressed at the time of its next quarterly financial statements.

Disclosure can sometimes also be triggered by regulatory concerns for reasons other than securities law requirements. If a transaction would attract pre-notification and review under the *Competition Act* (Canada), Industry Canada may decide that for the particular industry they cannot adequately vet the transaction without contacting suppliers and customers to determine the impact of the merger. Obviously, those contacts can only be made after the announcement of the transaction.

Recently some companies have timed announcements of proposed transactions to occur with the dissemination of earnings warnings, hoping that the latter would receive less focus by analysts and the press. For example, Mattel announced an earnings warning on June 15, 1998, at the same time as its proposed acquisition of Pleasant Company. Then, on December 14, 1998 Mattel announced another earnings warning at the time of its announcement of a proposed transaction to acquire the Learning Co.

3. *Investor Relations*

After a potential transaction has been generally announced, a public market acquirer or vendor must quickly update and explain the rationale for the transaction, as well as its probable affect on fully-diluted earnings per share. The relevant constituencies are: (i) stock analysts; (ii) credit rating agencies; and (iii) the press and investing public.

Effectively managing this process is essential in order to ensure that the business rationale that compelled the parties to transact is effectively communicated to the public, in order to avoid suspicion, rumour and uncertainty that can cause a decline in the trading price of the companies involved. Analysts and the investing public will, in the absence of a clear expression of the vision, rationale and monetary effects of the proposed transaction, assume that the transaction is purely defensive in nature or driven by ego (i.e. that the transaction will not intrinsically add value).

For example, Magna International Inc. stock fell in December 1998 on concerns about expressed plans to expand into non-automotive activities such as theme parks, luxury airlines and real estate developments. While Magna apparently intends to spin-off such ventures into a separate company, company officials have been vague about the spin-off's timing and the company's structure. Similarly, when 3Com purchased U.S. Robotics, the financial markets did not react favourably to the transaction. Only after several accounting cycles did the merits of the transaction become apparent. A better investor relations and communication strategy might have avoided the early scepticism about the transaction.

DaimlerChrysler has enjoyed better reception in the press and financial community as a result of its communications program.

Fairfax Financial is in the course of completing its latest in a series of purchases of under-valued or poorly performing insurers. Fairfax had to address market fears that the pace of its acquisition program would lead to difficulties in digesting the various transactions, the most recent one of which closed only in the third quarter of 1998.

The communications policy for the transaction will have to involve private meetings with credit rating agency analysts in order to more fully explain the proposed transaction and its affect on the company. Typically what occurs is that no advance notice to the credit rating agency is permitted, as a result of securities laws prohibiting selective disclosure. Upon the announcement, the rating agency might revise its rating to indicate that the debt of the particular company is "under review with developing indications" (as Dominion Bond Rating Service did in the case of the Fairfax transaction). In the case of the proposed Exxon-Mobil transaction, Moody's Investors Service reconfirmed the senior unsecured debt ratings for Exxon and placed Mobil's senior unsecured debt ratings under review for possible upgrade after it could examine the legal and structural position of Mobil's debtholders within the consolidated capital structure. For example, in the event that Exxon would assume or guarantee Mobil's debt obligations, such debt would carry the same ratings as Exxon debt.

IX. PURCHASE CONTRACT/TERMSHEET ISSUES

1. *Purchase Price Formulations*

There is an almost infinite number of variations in which a purchase price formula for the acquisition of an operating business can be structured. However, there are two principal models: (i) balance sheet-based formulations; and (ii) earnings based formulations.

A balance sheet-based purchase price formulation would focus on the net book value of the purchased business (or of the purchased assets) less the amount of redundant assets which are excluded from the transaction (and therefore retained by the vendor) plus, in certain cases, an agreed upon amount of goodwill.

A classic formulation of an earnings-based test is: (i) Normalized EBITDA multiplied by (ii) an agreed-upon multiplier, less the amount of long term debt, capital leases and affiliated debt.

In a balance-sheet based formulation, valuation methods for the material balance sheet items (such as inventory) will be paramount. I have personally drafted asset purchase agreements where the procedures and methodology for valuing inventory extend for four or five pages.

The pricing structure for the transaction should be reflective of a mechanism that will not expose the seller to the risk of significant purchase price adjustments. For example, in a distress sale situation, the bargain purchase price should not entitle the purchaser to a further "kick at the can" through a strict balance sheet measurement test and consequent post-closing adjustment.

Note that, in any earnings-based test, the balance sheet cannot be completely ignored (though the current market attitude to forgive and forget huge restructuring charges gives one pause). The reason is that for the acquired business to be able to continue to generate the normalized earnings used in the earnings or discounted cash flow modelling, the historical asset-base and infrastructure must be maintained to generate those earnings. For example, if, between the date of the agreement of purchase and sale and the date of closing, the business is run so as to maximize available cash for distribution, the purchaser will inherit a balance sheet bereft of working capital, with ageing plant and equipment and interrupted research and development, repair and maintenance and marketing programs. In effect, while the full benefit of earnings up to the date of closing should be retained by the vendor, the purchaser is entitled to inherit a balance sheet (a proxy for the earnings generating asset-base of the company) no worse than it was on the date that the purchase price formulation was settled.

Further, purchase price formulations are generally settled with a view to the determination of a theoretically fair method of valuing the acquired business and not with a view to the opportunities available to a vendor to manipulate its capital structure, asset and liability portfolio and operation decisions so as to maximize that very purchase price. For example, in the above-mentioned formulation, contractual provisions must provide protection for working capital stripping and the pre-payment of long term debt (using the proceeds of asset sales). There would also be exposure to the renegotiation of capital leases so that they qualify as operating leases. Many other opportunities for maximizing the sale proceeds for the vendor can be available, depending upon the particular circumstances.

Another reason why you cannot ignore the balance sheet in an earnings-based approach to valuation is the fact that, in certain transactions, a binding agreement of a purchase and sale is entered into, to be followed by an interim period during which third party consents, regulatory approvals and shareholder approvals are obtained and which may last for up to six months. During this time, the business continues to be operated for the benefit of the vendor and, supposedly, with a view to maximizing its long term value (since there is no guarantee that the transaction will proceed). The vendor will be concerned that capital expenditures, research and development, marketing expenditures and the like will negatively impact available cash for distribution prior to closing, while the benefit of those expenditures will not be a factor in calculating the purchase price. A similar concept is a large expansion of inventory in a seasonal business. An earnings-based purchase price formulation may not be reflective of the additional investment in the business represented by the inventory build-up prior to the peak sales season.

Earn-outs create further drafting challenges. Earn-outs are used as a financing mechanism for the purchaser, since a portion of the purchase price is paid out to the vendor over time based on future cash flows of the acquired business. An earn-out formulation is also useful where the parties to an asset or share purchase transaction are unable to agree on a fixed price due to different perceptions of the business' ability to achieve revenue or profit targets.

Protecting the vendor which is subject to an earn-out requires extensive and sophisticated drafting. Even then, it is appropriate to advise the vendor that there can be no guarantee that all of the methods available to the purchaser to run the business so that the benefit of the activities fall outside the earn-out period can be provided for. Earn-outs work best where the selling parties remain with the business and continue to exercise ongoing operational authority (subject to certain parameters for the protection of the purchaser that would be settled as part of the purchase agreement). For example, a purchaser's desire to reorganize the business, causing great disruption to short-term operations, will be contested by the vendors on the basis that they have a short, highly delineated period in which to demonstrate earnings.

Some of the drafting considerations are as follows:

- What revenue stream is subject to the earn-out?
- Is the earn-out balance sheet-based or earnings-based? (i.e. the normalized earnings used in calculating the purchase price will cover a 12 month period straddling the date of closing). If so, the disputed income or expense items are magnified in terms of their impact on the parties, due to the purchase multiple applied to the normalized earnings.
- If debt is a deduction, there must be an exception for the benefit of the vendors for capital expenditures (otherwise they would not wish to incur any capital expenditures and would instead pay down debt). The purchaser would therefore need to have some reasonable approval authority over capital expenditures.
- Will the earn-out be subject to a cap?
- Will the transaction be subject to a purchase price minimum or will there be a claw-back (reverse earn-out) if anticipated earnings are not achieved?

2. *Defining GAAP in the Agreement of Purchase and Sale*

All of the above-noted purchase price formulations reflect the importance of accounting, bookkeeping and auditing principles. As indicated earlier in this article, GAAP is not a self-applying term. Accordingly, in order to protect the reasonable expectations of the parties, in addition to some of the tips outlined above, the agreement should define the application of GAAP to the purchase price formulation.

As the examples cited above illustrate, GAAP often fails to provide specific and unique guidance. In addition, its principles and procedures may even be inappropriate in the context of a specific agreement. That is why, in drafting one, it is always prudent to specify exactly how GAAP will be applied and, where applicable, spell out appropriate modifications to it.

Serving to further complicate matters is the need to factor into an agreement some degree of flexibility, recognizing that circumstances change and that it is impractical, if not impossible, to address every conceivable contingency.

That said, however, the following checklist from an excellent Deloitte & Touche publication covers some of the more significant issues that should be identified and addressed when using GAAP as the basis for establishing costs and income for purposes of an agreement: [21]

- Identify possible variations in GAAP that might be material and specify the options that will be allowable.
- Identify the GAAP requirements for all costs that could be material and ensure the accounting treatment is appropriate. Where it is inappropriate, specify the appropriate modifications.
- Specify the effective date for GAAP that is to be used – such as the date the agreement is signed.
- Specify how materiality will be established.
- Specify whether costs and income will be determined as part of the amounts for an entire reporting entity or as if a separate entity existed for purposes of the agreement. In the former case, specify how the portion of the costs and income applicable to the agreement is to be established. In the latter, define the reporting entity and ensure the party responsible for reporting is able to account for it properly.
- Where current costs can vary significantly from historical cost, specify the basis for cost measurement and how those measures will be determined.
- Specify whether the cost of equity will be an allowable cost and, if so, how it will be measured.
- Specify the assumed capital structure if interest costs will be recognized as an allowable cost.
- Specify whether writeoffs will be an allowable cost and, if not, whether the amortization of costs will be based on original historical costs or the amounts after writeoffs.
- Specify whether losses will be an allowable cost.

- Specify the recognition policy for costs usually expensed when incurred but that benefit future periods. A purchaser would want to encourage a vendor to maintain a "business as usual" policy and continue R&D, marketing and capital asset replacement programs.

- Specify the period over which assets will be amortized, along with the methodology used to do so.

- Specify how changes in accounting estimates will be dealt with – whether adjusted prospectively or retroactively.

- Specify whether accounting errors will be reflected in costs and income, and, if so, the period in which they will be recognized.

- Specify what types of costs will be allowable and the basis for allocating them.

X. CONCLUSION

Successful completion of a merger or acquisition transaction requires a multi-disciplinary approach to the process. The Chief Financial Officer of the acquiring or selling company can add significant value to the process because of his or her unique skill-set and experience base. Indeed, many of the most material aspects of the transaction process require significant input from individuals who have the financial and analytical background to be expected of a Chief Financial Officer.

In this paper, I have focused on certain aspects of an M&A transaction where CFOs can particularly add value. These are in the areas of financial due diligence, financing for the transaction, communication with the market and the structuring of purchase price formulae. There are many other areas where a CFO can also make a significant contribution.

By asserting themselves and playing an active role in the transaction, from its initial formative stages, CFOs can greatly assist in ensuring that an M&A transaction achieves the financial goals set by the operational executives and that the transaction avoids the "synergy trap".

**APPENDIX "A" TO
THE STRATEGIC ROLE OF THE CFO IN M&A TRANSACTIONS**

BY BRIAN LUDMER

LIMITING THE EFFECT OF REPRESENTATIONS, WARRANTIES AND INDEMNITIES – "LUDMER'S TOP 25"

Here's a list of the "Top 25" ways to limit exposure on representations and warranties when you are selling a business. It will be rare to win all of these battles in a single deal (in fact they represent a compilation of "best practices" from many deals). Try to suggest alternative language which should meet the basic objectives of the purchaser, rather than merely identifying problems with the purchaser's draft agreement and attempting to rely on superior bargaining power.

1. Do a very thorough job on the disclosure schedules (which, in effect, are qualifications to the representations), including interviews with senior officers and mid-level employees of the vendor and the vendor's professional advisors (be sure to include officers and senior employees of subsidiary companies and foreign professional advisors to the company and its subsidiaries). Consider bargaining for the ability to update or improve schedules during the period between execution of the definitive agreement and the closing, with limited recourse. See comments in paragraph 5 below regarding the questionable loyalty of the seller's employees.

    - Canvass the views of the seller's third party advisors such as insurance brokers, IP, pension and labour counsel and the external accountants. Typical corporate, governmental and litigation searches should be completed by the seller against itself and its affiliates.

    - Search for unregistered encumbrances such as PMSI clauses contained in standard-form purchase agreements.

    - Include on the litigation disclosure schedule the list of litigation being defended by the seller's insurers. Note that, since policies often provide defence cost coverage which is broader than liability coverage, the fact that a particular matter is being defended by the insurers does not mean that there will be full coverage (i.e. deductibles/co-insurance requirements/exclusions - e.g. gross negligence, drunk driving, environmental).

    - Read all material contracts.

- Note that where a seller refuses on ethical grounds to make a representation and warranty because of lack of knowledge of the matter, it is typically still asked to indemnify the purchaser with respect to the particular matter and the comments below regarding limiting the effect of indemnities would still be applicable. Attempt to identify as early as possible in the negotiation process which disclosures the purchaser will insist on being indemnified for, as there may be an opportunity to mitigate the exposure under the indemnity given enough time and the opportunity to re-negotiate third party arrangements prior to the announcement of the transaction.

2. Obtain a general exclusion for matters in respect of which an accrual, reserve or contingency is reflected on the existing financial statements of the seller or in respect of which the purchaser is given a credit as part of the post-closing audit and purchase price adjustment process. In addition, the financial statements representation should merely track the language of the auditors' report (to go further and state that they are "true and correct" imposes a full prior-period indemnity on the seller). For accounts receivable, state that while the reserve was established in accordance with GAAP, "no representation is made that the net book value of the accounts receivable will be collected subsequent to closing". Particularly in deals where the pricing is not related to interim financial statements, ensure that the interim financial statement representation is very "soft".

3. Obtain an exclusion for matters otherwise disclosed under the agreement or in the schedules, even though it was omitted for a particular representation and warranty. Purchasers will want to ensure that the language of the exclusion requires that the particular problem or exposure is listed in the Schedules, rather than risk that a mere reference to a type of asset or activity would foreclose all remedies that have any relation thereto in any context.

4. Obtain a general exclusion for matters which the purchaser ought reasonably to have been aware of, based on disclosures in the course of the due diligence process (in respect of which there should be a detailed record). Failing that, obtain a representation by the purchaser that it is not aware of any breaches of the seller's representations as a result of its due diligence. Note that as a result of extensive due diligence and divided loyalties of employees of the acquired company (a typical purchaser strategy during the due diligence process is to attempt to co-opt the seller's employees), at some point in the transaction the purchaser will know more about the target than the vendor, particularly if the target is an independently-managed subsidiary of a foreign parent. The purchaser's confirmation that it is not aware of any breaches should, in a deal with an interim period, be reconfirmed on closing (i.e. the purchaser can't close and sue on breaches known at closing). Purchasers will insist on retaining the ability to refuse to close and sue for their expenses.

   - In particular, have the purchaser "buy-in" to the accounting discretion exercised by the seller in finalizing its financial statements (through the release of auditors' working papers and conferences between the external accountants for the company and the purchaser). All of these matters should then be scheduled to the agreement and the purchaser deemed to have accepted them.

- The treatment of potential exposure for tax reassessments that have been fully disclosed to the purchaser over the course of due diligence should vary slightly for the benefit of the purchaser. The parties should settle on the wording of the areas of tax exposure and counsel should deliver privileged communications to their respective clients as to what has been disclosed and deemed to be accepted by the purchaser.

- For transactions where the purchaser is already familiar with the company (such as one shareholder buying out another), extend the "deemed knowledge" of the purchaser to: (i) matters reflected in the minutes of directors meetings which the purchaser's representatives would have been entitled to attend; (ii) matters conducted at the request of the purchaser; and (iii) communications between the company's advisors and the purchaser.

5. Limit statements to the "actual knowledge" of the seller (particularly where there are references to "pending or threatened" matters). As to potential legal proceedings, awareness should be limited to proceedings which might "reasonably" be commenced. Consider defining "knowledge" as being that of certain specified officers and employees of the seller and, possibly, of the parent company. State whether a review of all the books and records of the company is required (i.e. whether matters reflected in the books and records are deemed to be within the knowledge of the particular employees). Confirm that no enquiries need be made with governmental authorities or outside professional advisors as to their knowledge. The employees assisting in the transaction may shortly thereafter become employees of the purchaser. Accordingly their allegiance is sometimes in doubt. To buttress the definition of "actual knowledge" referred to above, attempt to obtain a certificate from such employees that they have reviewed the representations, warranties and schedules and are satisfied with the accuracy thereof. For the same reason, representatives of the parent of the seller (or counsel) should sit-in on all due diligence meetings between employees of the business being sold and representatives of the purchaser. Purchasers may request the addition of "after due enquiry" for specific representations.

6. Try to use "fabric softeners" such as: (i) "[... in aggregate] materially and adversely in relation to the Company and its Subsidiaries taken as a whole" (for example, to be used in the "absence of changes since ..." representation). A purchaser may wish to define "materially" (often 5-10% of the deal); and (ii) "reasonable" or "reasonably".

7. The survival clause – representations, warranties and indemnities are typically limited to claims made within 2-3 years after closing.

   - In particular, where a matter such as environmental exposure or intellectual property exposure could be settled by an allocation of risk tied to further investigations which could not be completed prior to closing, provide that the particular representations and warranties expire at the conclusion of a reasonable period which would allow for Phase 2 environmental testing or a world-wide patent search, as examples. Any matters which would come to the attention of the purchaser after the period for the specified testing or searching would not be allowed. Negotiation would therefore have to take place with regard to the scope of the post-closing investigations and who would be responsible for the cost. Negotiation will also take place as to whether there is ongoing responsibility for matters not necessarily obtainable from the search. Responsibility of the vendor should be limited to remediation of the proposed problem and should not extend to lost profit or opportunities on the part of the purchaser.

   - For taxes this is typically 60 days after the last day on which a tax assessment for the prior period could be rendered (with an exception if there has been fraud or fraudulent misrepresentation in the preparation of federal/provincial/local tax returns or in any information given to governmental authorities under taxation legislation) .

   - Matters in respect of which "fraud" can be proven often go on for whatever period is allowed in the *Limitations Act* (Ontario) (arguably even if there is no explicit statement on the point). Avoid using the term "fraudulent misrepresentation", as this involves the concept of "recklessness" (rather than wilful omission) and therefore creates much uncertainty.

   - Certain "fundamental" representations should <u>not</u> be time-limited (e.g. title to shares and assets -which can be found within various representations- and matters pertaining to the tax structure of the transaction).

8. Set a cap for the indemnities in the aggregate and sub-caps for particular indemnities. Consider sharing the risk (i.e. a 50/50 split of future claims over the *de minimus*) either globally or as a means of settling specific representations (this is a good response to the typical purchaser's argument concerning "risk allocation"). The limits could also decline with the passage of time. Similarly, if the purchaser has contracted for an escrow of funds to serve as security for the vendor's representations, funds could be released in stages and the vendor could suggest that the indemnities be limited to the escrow fund. There should, at a minimum, be a cap limited to the cash portion of the purchase price, which could rise as payments of principal on the balance of sale ("VTB") are made (i.e. exclude outstanding VTB and exclude non-cash consideration).

9. Where there is more than one vendor, make the obligations several (on a proportionate basis) rather than joint and several.

10. Establish a *de minimus* level before which no claims can be made (this can be in the aggregate and a sub-limit per claim). This is often 1-2% of the purchase price and is called the "basket clause". Consider asking for the *de minimus* amount to be "free" - i.e. only the amount of claims in excess of the *de minimus* amount can be claimed (rather than a claim for all damages once aggregate claims exceed the *de minimus*). There can be separate *de minimus* amounts for various matters (e.g. all prior period taxes are typically for the account of the seller and basket clauses should exclude representations limited to knowledge). Note that, unless this is made explicit, separate specific indemnities will not benefit from the *de minimus* clause (which typically refers only to breaches of representations). The clause should not apply to covenants (i.e. covenants relating to assumed contracts, the balance of the purchase price, accounts receivable re-purchase obligations, etc.). *De minimus* clauses will often not apply to representations as to "knowledge" or which are otherwise heavily qualified, as a matter of principle.

11. Pay attention to the drafting of the indemnity clause.

    - Indemnities should only be on an "after tax basis", as the problem may be deductible to the purchaser (note that this works both ways, as indemnity clauses are now typically grossed-up for the tax which the purchaser or company would have to pay upon receipt of the indemnification payment - GST , QST and HST applies here as well). Consider fixing a deemed tax rate for these purposes, as the tax status (i.e. profit/loss position) of the purchased company could change as a result of the subsequent operation of the business by the purchaser. If substantial tax losses are being left behind (including those generated by the transaction) try to get the ability to shelter any tax reassessments from the past against such losses (note that only non-capital <u>business</u> (as opposed to property) losses will survive a change of control and certain taxes (e.g. Part XIII withholding taxes, property taxes, GST and sales taxes etc.) can't be offset against such loss carry-forwards). No indemnification for taxes should be made to the extent that the increased tax burden was reserved for on the closing financial statements. Further, the net value of any benefit that results, directly or indirectly, from the post-closing assessment should reduce the amount of the indemnity obligation (for example, should a deduction be denied in one year, but permitted in another year through capital cost allowance or otherwise, then the net present value of the future deduction should be credited against the seller's indemnity obligation). The seller should have control of the settlement process with the taxation authorities for those periods for which it is responsible (see discussion below) and should be entitled to any future refunds accruing to the purchaser/purchased company if assessments for those periods are successfully defended in future.

- As indicated in the immediately preceding point, consider the income tax consequences applicable to the indemnification payment itself (as well as GST, QST and HST issues). A seller will want to specify that any such payment is deemed to constitute a deductible type of payment and the purchaser will want the payment characterised as a reduction of the purchase price *ab initio*, with the parties obligated to re-file tax returns, etc. Sellers will often be agreeable as this will at least reduce the proceeds of sale for tax purposes.

- Consider establishing a definition of "Loss", which would serve to limit exposure with regard to professional fees ("reasonable"), consequential economic loss (scope of foreseeable losses) and confirm that no indemnification will be made for lost profit or other opportunities as a result of the problem which is being remedied. This latter point is particularly important, for example, if a problem arises concerning the purchased intellectual property which results in lost sales or if a purchaser refuses to close as a result of a failure of a condition (e.g. representations/covenants).

- Where applicable, limit the extent of indemnities to the portion of the company not already owned by the purchaser (i.e. if a 30% shareholder which has been relatively passively involved in the company is buying out the 70% holder which had actually been running it, only 70% of losses should be indemnified for, since the purchaser had already been exposed to losses as to its 30% interest in the company). Similarly, limit indemnification to the portion of the purchase price not represented by remaining VTB payments (see discussion in paragraph 8).

- Indemnification from the seller should be considered a remedy of the last resort. The purchaser should be obligated to continue to maintain appropriate insurance and to claim against company insurance policies if the matter is otherwise insurable. The purchaser should also be required to exercise other remedies that might be available (such as claiming over against a third party that might have supplied components for the products of the company that was purchased) before seeking recourse from the seller under the representations and warranties.

- In addition, the indemnifying party should be subrogated to any rights of the purchaser or the company being purchased to pursue an insurance company or third party for compensation, in the event that the purchaser was not able to recover from them.

- Try to avoid full prior period indemnities. Argue that the business is being sold "as a going concern" and all businesses have a few "warts". This is essentially an argument of risk allocation for contingent liabilities (known and unknown).

- Provide that the purchase agreement cannot be assigned without consent (which can be arbitrarily withheld). The purchaser should not be able to "flip" the acquired company and pass the seller's exposure on to a third party. Purchasers will argue that they bought and paid for the representation and warranty pattern and what they do with it is their business.

- Provide for seller control of third party disputes (particularly tax - possibly even control of the preparation of the terminal tax return) and for the purchaser's indemnity to be reduced (to the extent of consequential increased cost) if, through its fault, the seller does not receive notice of any potential claim for indemnification in time to effectively contest the determination of any liability susceptible of being contested.

- Provide for sufficient co-operation and record maintenance for the seller to properly assert defences to third party (including tax) claims. Purchasers will ask to be reimbursed for related expenses.

- Carefully consider advisability of arbitration procedures and local jurisdiction for dispute settlement.

- Purchasers will want to provide for the indemnity to be grossed-up for applicable GST/HST/QST.

- Carefully review the indemnity obligations against the negotiated qualifications to the representation and warranty pattern and verify whether the business deal is appropriately reflected in the indemnity pattern. For example, a full prior-period contract or environmental indemnity (the effect of which is to supersede any qualifications in the related representation and warranty pattern) might not be appropriate if the purchase price was reflective of the risks involved. Note, however, that purchasers will often demand specific indemnities where the seller has qualified representations to its knowledge (see discussion at paragraph 1).

12. Where real estate is involved, representations should be limited to that typical for stand-alone real estate transactions (i.e. title is not warranted - though a statement of beneficial ownership of whatever title a nominee subsidiary holds is often given). Watch for references to real estate terminology in the definition of "Encumbrance", which might create confusion if the intent is not to speak to title. Only negative comfort should be given, in the form of qualifications such as "to the actual knowledge of ...". Be careful about any other representation concerning "property" and "conduct of the business", as these can be construed as relating to real property (see paragraph 13). Don't represent that "leases" exist if a particular location is being operated under an "offer to lease", as the purchaser might subsequently assert a right of indemnity concerning lease negotiation costs. Be clear as to whether representations are being given re status as owner, lessor,

lessee, sublessor or sublessee. Avoid representing status regarding municipal by-laws and compliance with leases in relation to actions of the tenants or subtenants. Try to qualify disclosure regarding repair and maintenance work by some standard of materiality, as day-to-day work (including municipal work orders) is common.

13. Make sure that exposure is not created under "general" representations, notwithstanding the highly negotiated disclosure under more specific representations.

- Watch for representations as to compliance with laws and governmental requirements generally, as exceptions will have to be created for the more specifically negotiated clauses concerning particular legal aspects (such as real estate, pensions, licensing, etc.). Further, a materiality qualification is warranted.

- Similarly, representations as to the status of "property" should be restricted to <u>tangible</u> property and not IP. Representations as to "marketable" ownership of property used in the business must be qualified by: (i) references to real property leases and equipment leases (even if there is no PPSA registration); (ii) the terms of licenses themselves (in the case of licensed IP); (iii) restrictions on assignment or loss of certain rights on assignment contained in leases and contracts; and (iv) exceptions to real estate title.

- Where applicable, the seller should argue that the transaction primarily relates to the acquisition of specific assets rather than an ongoing business (or that the purchaser intends to fundamentally transform the business) and that, therefore, representations concerning the seller and the seller's business can be avoided.

14. Give consideration to qualifications for specific assets or operations:

- In addition, title to assets should be qualified by a standard list of "permitted encumbrances" (such as common law and statutory liens). Special exceptions are required for title to real estate, leases and IP.

- Statements as to assignability of contracts and intellectual property often raise concerns.

- Equipment can be purchased on an "as is/where is" basis or "having regard to its age and normal wear and tear excepted".

- Inventories always contain some obsolescent or damaged goods and are subject to significant valuation issues which should be addressed.

- The purchaser should be asked to rely on the manufacturer's warranty. Include a waiver of express and implied warranties and conditions under the *Sale of Goods Act* (Ontario) and similar legislation.

- If assets or operations relate to foreign jurisdictions, obtain appropriate advice from local counsel (note that even certain terminology must be reviewed, such as the addition of "legal hypothec" as a type of "Encumbrance").

- Consider exclusions for assets not "used for the conduct of the Business" (i.e. redundant or discontinued assets).

15. Restrict the definition of "Contracts" that have to be specifically disclosed by establishing a threshold tied to the remaining contract term or the ability to terminate a Contract on notice or based on a dollar threshold. (Note that the concept of "assumed contracts" in an asset transaction should be left as broad as possible so that the purchaser assumes all of the on-going obligations of the business, even if not specifically identified). Be very careful with representations as to the status of Contracts. There are always some defaults and therefore a materiality threshold is warranted. A representation that there is currently no default is effectively a broad "prior period indemnity", which may not be appropriate in the circumstances. Sellers should attempt to exclude ordinary course omissions, deficiencies and over-due payments where formal written demand has not been made. Compromise language is as follows:

> "The Corporation has not received formal written notice pursuant to its material Contracts that the other party or parties thereto intend to exercise their rights to cancel such material Contracts or commence legal proceedings, in each case as a result of default or alleged default of the Corporation thereunder. The Corporation has not received formal written notice pursuant to its material Contracts pursuant to which the other party or parties thereto which are account debtors of the Corporation demand repayment of monies already received by the Corporation pursuant to such material Contracts or indicate an indication to offset against future payments due by such account debtors claims in respect of a default or alleged default of the Corporation thereunder."

16. "In the ordinary course of business". There is some jurisprudence concerning this phrase. (Sometimes purchasers will wish to reduce the effect of this phrase by adding "consistent with past practices and not individually or collectively materially adverse").

17. "In the seller's opinion" (particularly re: representations containing subjective elements, such as: (i) future prospects or possible future problems; (ii) "adequacy" of property, facilities, insurance, etc.; (iii) materiality; (iv) whether conditions imposed on licenses, etc. are unduly burdensome; (v) that the purchased assets constitute all property "useful" to the business "as presently contemplated to be conducted"; and (vi) relationships with customers and suppliers and whether there has been any "intimation" of a change).

18. The "Just Say No" defence or "Satisfy Yourself" (which can be used, for example, in response to a request for summaries of leases, insurance and other contracts to be scheduled, a statement that the company holds all permits, registrations and licenses necessary to carry on its business and that no governmental consent is needed to complete the transaction and in connection with statements concerning the future, general economic conditions or pending changes to laws regulating the industry). This can also be justified in situations where the price reflects a distress sale and is typical in certain situations such as a purchase from a receiver.

19. Crystallize unwritten understandings with customers and suppliers regarding rebates, pricing and volumes. Crystallize unwritten understandings with employees as to bonuses and other entitlements.

20. If there is an "interim period", consider specifying particular representations the breach of which can only give rise to a claim for damages and which should not be a basis of avoiding a transaction.

21. The concept of "in good standing" may not have any meaning in specialized areas of law (such as pensions and intellectual property).

22. Intellectual property representations and indemnities require specialized expertise and should be limited to third party rights in the particular jurisdiction, not world-wide. Similarly, tax, real estate, labour and environmental representations and indemnities require specialized expertise.

23. Purchasers sometimes ask for a general representation which would have the effect of making all of the specific representations and warranties redundant. There are typically two aspects to the clause. One would indicate that all of the representations and warranties do not "omit to state any fact necessary to make the statements therein not misleading". The other would state that other than as disclosed there are no other facts known to the seller which should be disclosed in order to make any of the representations not misleading or which would otherwise be material to the purchaser in evaluating the purchased business. These should be absolutely resisted as they increase the potential for disputes in future and provide an easy mechanism for a purchaser to off-set deferred payments. The purchaser should be asked to craft additional specific representations and warranties concerning matters important to it. This should not be a burden imposed on the seller.

24. "except for such consents, licenses, approvals as have been obtained or the lack of which do not, in the aggregate, materially impact the business of the Company" – use this language in relation to disclosure of required permits and consents. Purchasers will often want to add: "...been obtained irrevocably and unconditionally (or subject to disclosed

conditions, restrictions and undertakings which the purchaser judges to be not materially adverse in the aggregate or impractical).

25. "which have not been satisfied, remedied, etc. in all material respects" - use this language in relation to disclosure of past environmental or other breaches of law and past judgments, as this reduces the disclosure obligation.

APPENDIX "B" TO
THE STRATEGIC ROLE OF THE CFO IN M&A TRANSACTIONS

BY BRIAN LUDMER

POCKET GUIDE TO SUCCESSFULLY INTEGRATING ACQUISITIONS – WINNING AFTER THE DEAL

Successful post-deal management has now been recognized as an essential part of the M&A process. The area has now become a subject of academic and professional study with the goal of generally defusing the knowledge gained, at considerable expense and disruption, in previous transactions. Based on my experience and research, the highlights of this growing body of knowledge can be summarized as follows:[22]

Lesson One: Statistics show that companies can learn how to conclude profitable acquisitions, learning from the mistakes and successes of the past.

When IBM purchased telecommunications equipment maker Rolm Corp. in 1984 for US$1.5 billion, it promised to give the subsidiary plenty of room to operate. However in short order Rolm was crushed by the IBM hierarchy, causing hundreds of millions of dollars of losses. Building on that experience and many other acquisitions with varying degrees of success, IBM has learned how to more successfully integrate its acquisitions and has been praised by industry analysts for its more open-minded and supportive attitude towards Tivoli Systems, a US$743 million acquisition in 1996. Rather than engulf Tivoli in IBM's US$13 billion software arm, IBM handed its systems business over to Tivoli's management. With the package came more than 700 IBM employees and products with US$0.5 billion in sales.[23] Similarly, IBM's 1995 acquisition of Lotus saw IBM grant its subsidiary unique autonomy in order to ensure that the transition was smooth and that the key Lotus Notes development team would stay with the company. To ensure that Lotus' culture would be protected, John M. Thompson, IBM's Senior Vice-President for software, assigned an executive reporting directly to him to manage all communications between the two companies during the transition period. Lotus' benefits policy was respected and, in fact, portions thereof adopted by IBM. Most importantly, senior IBM executives displayed great patience at every crucial juncture, acceding to the wishes of the acquired company during a rather volatile period when connections were being made and relationships formed.[24]

GE Capital was founded in 1933 as a subsidiary of the General Electric Company to provide consumers with credit to purchase GE appliances. Since then, the Company has grown to become a major financial services conglomerate with more than 50,000 employees worldwide (nearly half of them outside the United States) and 1997 earnings of approximately US$3.25 billion. The businesses that generate these returns range from private label credit card services to commercial real estate financing to aircraft leasing. More than half of these businesses became part of GE Capital through acquisitions. Substantial expertise has been developed in the planning, structuring and integration of acquisitions. In effect, GE Capital has recognized that there are predictable issues in any transaction that can be anticipated long before the transaction closes. Post-transaction audits of financial performance and operational and integration issues help to shorten the learning curve. Acquisitions are now a core competency of GE Capital.

Lesson Two: Acquisition integration is not a discreet phase of a deal and does not begin when the documents are signed. Rather, it is a process that begins with due diligence and runs through the ongoing management of the new enterprise.

M&A transactions proceed through a number of fairly predictable stages: selecting possible acquisitions, narrowing the field, agreeing on a first-choice candidate, assessing compliance with regulations, convening preliminary discussions, formulating a letter of intent, conducting due diligence, completing financial negotiations, signing the agreement, making the announcement and closing the deal. Traditionally, it was thought that integration would begin after the deal closed. Business development specialists, working with business leaders and finance experts, saw most of the deals through the closing. After the documents were signed and the closing gifts exchanged, managers were expected to take over and begin the integration process. Unfortunately, in most cases, that approach to integration was less than effective. Integration was slow and costly. There were constant surprises about peoples' reactions to being acquired, information uncovered as part of the due diligence process had not been passed through to the operational executives (leading to further surprises) and financial returns were often hindered by delays in putting the companies together.

There is now recognition that the planning process for an integration should be started much earlier and, in effect, run concurrently with the due diligence process. When Amoco Canada Petroleum Company Ltd. acquired debt-ridden Dome Petroleum Ltd. in 1996 for $5.5 billion, then the largest merger in Canadian history, a team of consultants worked with them for about 12 months, from the point the deal was announced until it received final approval. By the time the transaction closed the organization structure had been laid out, key management policies and procedures and practices decided, each of the senior executives knew their position and responsibility and a comprehensive communications strategy had been put in place.[25] Similarly, in Tyco International's 1997 acquisition of ADT Ltd. (referred to in "Lesson Eight" below), the decision to reorganize management by region rather than function, trim administrative staff, and move the combined fire protection unit to Florida was worked out before the deal was announced.

Ensuring that there is an ongoing process of the sharing of information between the functional captains of the various due diligence teams (including finance, operations, systems, human resources and sales) and the operational managers who will be running and integrating the acquired business, can contribute to the following:

- Better decisions as to whether to proceed with the acquisition:

For example, if it is determined during early stage CEO to CEO discussions that significant differences in basic management styles and values would make integration a difficult and contentious process, then it might be better not to pursue the transaction notwithstanding favourable financials. For example, in a "merger of equals" transaction (such as the recent proposed Canadian bank mergers) where, theoretically, neither party to the transaction receives a control premium and neither party relinquishes control, issues such as composition of the board and board committees, the split of the Chairman and CEO positions, the selection of the combined senior management team and the allocation of duties among them, the location of corporate headquarters and other key operations, the new company's name, and the rationalization of separate corporate cultures (including attitudes towards compensation, employee benefit and incentive plans, management styles, use of technology, operating priorities and future business strategies) must all be canvassed and common ground determined.

1998 was not only a memorable year for completed mergers and acquisitions, but also for the deals that did not get done. The decouplings began in January when American Home Products and SmithKline Beecham could not tie the knot. It took SmithKline only days before it announced a US$70 billion deal with Glaxo (a company it had reportedly been flirting with before American Home!). But by late February the SmithKline and Glaxo deal was off. Later in the year American Home and Monsanto announced that they would merge, but that US$34 billion deal was pulled in mid-October.[26] Ego and pride (the split of money and power) are at the root of many broken deals. It is obviously better if these incompatibilities are determined prior to the announcement of a deal.

- Advance notice of potential integration problems that can be avoided by proper planning for the acquisition:

  In one GE Capital transaction, the due diligence team learned that employees of the soon-to-be acquired company were concerned that they might lose their traditional shopping-discount benefit at the retailer's stores. GE Capital persuaded the retailer to continue the discount for one year after the acquisition and also agreed to make up the difference of the lost benefit in subsequent years through cash bonuses, thereby turning a potential problem into a positive experience that led to boosted morale, greater receptivity to other changes and higher productivity. Similar issues also arise where the employees of the acquired business benefit from the stock option plan of the seller and the sale would trigger early expiration of those options. Recognized early on, the buyer might request that an extension of the expiration dates be made a term of the deal or the transaction would have to be adjusted for the cost of replacing that incentive.

Merger integration consultants have also concluded, based on experience, that rapid implementation is essential. During the first several months after a transaction everyone is expecting change and is prepared to deal with it. Dragging the process out further results in loss of focus and undue anxiety. Of the expected synergies in a transaction, some will be realized, some will be tried and abandoned and some will simply be forgotten or ignored. Analysts have stated that up to half the value in an acquisition can be lost simply by failing to take full advantage of the organizational opportunities initially created by the transaction.

The integration plan should yield a focused strategy with definite goals for structures, operations, functions and processes that are to be re-engineered as well as a timetable and benchmark for achieving the desired goals. To the extent possible progress and outcome should be measurable. Change efforts should be prioritized and initial efforts focused on the steps that will have the most meaningful impact. By acting quickly on priority initiatives, management can capture value and establish positive momentum. Early integration action will yield the required synergies at an earlier time (thus enhancing value) as well as take advantage of a window for acceptance of change that is often available as a result of employees expecting change and needing direction and, perhaps, initial enthusiasm. Delay in implementing the integration model creates a risk that the potential value from the identified synergies will be ignored or forgotten. Productivity drops sharply during periods of speculation and uncertainty. The organization can take advantage of this instability by acting decisively on merger priorities and building a new momentum. The post-merger integration plan must be sufficiently detailed and with identifiable milestones for accountability. Appropriate resources must be in place (both management and investment) and the integration team focused and with a clear set of priorities.

Lesson Three: Integration management is a full-time job and needs to be recognized as a distinct business function, just like operations, marketing or finance.

In M&A transactions, often the due diligence team (which has developed the deepest knowledge of the new company and has the best insights into what would be needed to integrate after the deal closes), disbands after the deal is struck, its members returning their regular jobs or moving on to the next transaction. The operational managers of the purchaser typically focus only on the integration of their particular business units. The senior managers of the newly acquired business, who have the most incentive to integrate and learn how to be successful with their new owners, often do not have sufficient knowledge of the new owner, its resources, its business targets or its integration requirements. Further, they tend to be preoccupied with running the acquired company and also with a host of personnel issues engendered by the uncertainty created by the merger.

As indicated above in connection with the IBM acquisition of Lotus, the solution is the appointment of an “integration manager”. The job description for this position would include the following:

- facilitate and manage the integration activities by working closely with the managers of the acquired company to make their practices consistent with the acquirer’s requirements and standards;

- create strategies to quickly communicate important information about the integration effort to employees;

- assist the acquired company with functions that might not have existed before, such as risk management or quality improvement;

- assist the executives of the acquired business to understand the corporate structure and services provided by the acquiring company as well as the acquiring company's business cycle, reviews, strategic planning, budgeting and human resource assessments;

- assist the managers of the acquired business by filtering requests for information from the acquiring company that often follow a completed transaction;

- brief executives of the acquired company about the newly acquired company to help them understand how it works.

Most importantly, an integration manager can help to bridge cultural differences between the two entities. Culture is not the organizational structure, nor is it systems, objectives, strategy or product lines and it is not just management style. Simply put, organizational culture is the explicit and implicit way things get done: the formal and informal rules of behaviour and process in an organization which help it accomplish its work.[27]

Many transactions have foundered as a result of insensitivity to conflicting cultures. For example, when Merrill Lynch & Co. purchased British brokerage Smith New Court Plc in the fall of 1995, the U.S. practice of analysts and traders being physically and procedurally segregated clashed with the British practice of analysts who share an open floor with their firm's traders, keeping in close contact and feeding them information. The difference in style was also reflected in the reports produced by the American and British analysts.[28]

In talent-driven businesses like investment banking, professional partnerships and media, conflicts are inevitable in any merger. To successfully integrate, the merging companies must be prepared to learn that their way is not necessarily the better way. The best way to integrate is to form a new culture; to take the best of the old and turn them into the new. Culture is often blamed for past failures and yet still managed by accident. It is better to design the culture that is desired by selecting leaders with the desired value and designing decision processes that mirror desired culture.

Failure to address cultural issues will prevent the achievement of the synergies expected in the transaction and accelerate employee departures. Often underestimated in any business model is the true cost of employee turnover. This can include: (i) lost productivity while the position is vacant; (ii) recruiting costs (advertising and/or agency fees); (iii) screening costs (reviewing resumes and responding to enquiries); (iv) interviewing costs (time spent to contact candidates and arranging, preparing and conducting interviews); (v) time spent negotiating a job offer with the successful candidate; (vi) training costs; and (vii) the cost of reduced efficiency as the new employee learns the job.[29]

Sensitivity to cultural differences can yield positive results. When Home Depot acquired the Aikenheads hardware chain in Canada in 1994, Home Depot chose to maintain the Canadian management. Only two transfers from the United States took place. Therefore, change impacting the Canadian employees was communicated by the Canadian managers they were familiar with, after input from the affected Canadian employees. Similarly, several years ago, as GE Capital began to make more acquisitions outside the United States, it became clear that a number of unrecognized cultural issues were getting in the way of fast and effective integration. Those issues were rooted in differences in corporate culture but were magnified and complicated by differences in national culture. For example, in some companies, deference to authority prevented managers from challenging and questioning (and thus enriching) GE Capital's ideas about how to grow the new business. In other cases, GE Capital found that newly acquired leaders did not comfortably accept the autonomy that comes along with empowerment. To deal with those issues, GE Capital worked with a consulting firm to construct a systematic process of cross-cultural analysis, leading up to a structured three-day "cultural workout" session between GE Capital and the newly acquired management team.

Properly completed, post-merger integration teams will involve equal representation from the purchaser and the acquired company and adopt an attitude that both sides can learn from each other in the transaction. This was the attitude taken by IBM in its successful acquisition of Lotus.

Lesson Four: Decisions about management structure, key roles, reporting relationships, layoffs, restructuring and other career-affecting aspects of the integration should be made, announced, and implemented as soon as possible after the deal is signed – within days if possible, based on integration planning that had been commenced during the due diligence process.

It is inevitable that "in-market mergers" (where you have an overlap in geography and business or function) involve a significant expectation of cost savings through downsizing.

Further, it is inevitable that employees of the acquired company will be concerned about their personal security and if issues are not addressed immediately, levels of productivity, customer service and innovation quickly deteriorate as employees focus on their own needs rather than those of the company. In the recent acquisition of PolyGram by Seagram, the extensive delay between the time of announcement of the deal and its closing (due to multi-jurisdiction anti-trust clearances) left PolyGram executives not only nervous but despondent at losing their independence as a public quoted company. The PolyGram business was beginning to underperform at the time in any event, but the distraction of the pending transaction caused a further deterioration in performance. Sought-after artists would only sign if assured of the support of senior executives and the identity of the continuing executives would be in doubt until the transaction closed.[30]

Similarly, as indicated above, competitors will attempt to poach valued employees and customers during the period of uncertainty, taking advantage of rumours of business changes that are sometimes unfounded.

Delaying the inevitable restructuring and downsizing of an in-market merger to avoid alienating the acquired employees until the "right time", is a strategy doomed to failure.

Rather, as Anthony Webb, the President and CEO of Royal Trust, discovered in the course of Royal Bank's acquisition of that business: "If you are going to introduce a radical change, do it as rapidly as possible. There is a window of about six months when you can re-engineer the organization. During that stressful period, employees welcome action-almost any kind of action-and it helps reduce the level of uncertainty. But if the upheaval continues beyond that period, it only aggravates the uncertainty.

Individuals who will be negatively affected must be treated with dignity, respect and compensated in a way that shows the remaining staff that new management is fair, even generous.

Lesson Five: Quickly Deal With Those Likely To Interfere In The Integration Process.

In any merger, there are some employees who cannot cope with the ambiguity and uncertainty or refuse to do their part in making the integration process successful. Some commentators have indicated that one of the reasons for Sony's problem media acquisitions and the integration problems Merrill Lynch experienced in Britain as indicated above, relate to the acquiring company's executives being too nice, in effect wasting time trying to accommodate colleagues who would not become team players. The lack of decisiveness gave free play to grousing and grumbling.

Lesson Six: Communicate, Communicate, Communicate

The first element of post-deal communication requires the personal presence of the senior executive of the acquiring company at the premises of the acquired company or at the place of closing to make the point to the acquired management that the purchaser admires and respects them, dearly wanted to acquire their company and acknowledges their experience and expertise so that they need not fear losing all autonomy. In effect, the purchaser should be stating that it is proud of its acquisition and hopes that the acquired company feels the same way. Promises will be made and must thereafter be kept.[31]

A crucial springboard to successful integration is the manner in which restructuring is carried out. The acquiring company needs to be straightforward about what is happening and what is planned. The most appreciated statement is the truth (including stating whether an answer is not yet known or decided).

Communicating a clear and unambiguous strategic direction where the expected benefits are measurable and the timing clear, is essential to get the combined organization focused on the future instead of the past. Milestones must be set and accountability mechanisms established. In doing so, the acquired company's employees will be energized by a sense of purpose as a result of understanding that they are now part of broader organizational mission.

Through effective communication, a purchaser can ensure that the policies, practices and standards required to be incorporated into the way the acquired company does business (from quarterly operating reviews to risk policies to quality and integrity procedures) are quickly disseminated.

In post-merger integration, there is no such thing as excess communication. Information must be abundant, clear and communicated up, down and all around. Employees must be kept informed of all steps in the process. If employees are being terminated, publication in advance of termination pay policies and outplacement assistance is essential.

Information flow must be two ways. The purchaser's employees must learn about the acquired business and its employees. Senior management must become aware of and react to rumours before they get out of hand. Further, the middle and lower level operational employees of the acquired business will often have valuable operational input that should be made available to senior executives of the acquiring company before mistaken operational decisions are made. A classic example of a failure to solicit operational advice from the acquired company is the merger of the Union Pacific and Southern Pacific railways in the United States in 1996.[32]

Choosing people to fill the new organization structure before the new business goals and organizational design have been developed, understood and debated by senior management will often cause problems. Further, the process of how individuals are chosen to fill spots in the new organizational structure must be viewed as fair by the potential candidate and the person's subordinated group (as well as the selections).[33]

Lesson Seven: Failure to anticipate problems arising from competing unions or vastly different pay and benefit schedules and failure to address management retention programs can profoundly affect integration.

Compensation policies are an important component of the human resources considerations in post-merger integration.

Since the retention of key personnel is inevitability a criteria for a successful transaction, focus should be placed on this area early in the due diligence process. Typical stock incentive plans for companies result in acceleration of vesting of options and acceleration of grants of stock in the event of a change of control, often even if the managers are not terminated. The cost to the acquired company of these acceleration incentives (as well as any golden parachute payments that may be triggered on the transaction) is an important part of the due diligence and valuation process.

However, potentially more important is the fact that once the benefit of the long term incentive plans is captured there are no longer any ties binding those employees to the acquired company. The merger of Lockheed Corp. and Martin Marietta Corp. has generally been considered a successful transaction occasioned by fundamental changes in the defence sector. New incentive plans had to be put in place as a result of payments triggered to about 460 Martin Marietta managers under then existing plans. In the Deutsche Bank acquisition of Bankers Trust Corp., delays in the integration process and the inevitable cultural difficulties of this cross border transaction have required Bankers Trust to indicate that upon closing of the transaction there will be early payment of the 1999 bonus, in addition to the establishment of a pool of between US$400 million and US$500 million that Deutsche Bank had agreed to pay to retain key Bankers Trust employees after the take-over (a "golden handshake"). However, there has been little if any communication with the affected producers as to who will participate in the bonus pool. (Although Bankers Trust is technically a commercial bank, it has virtually transformed itself into an investment bank in recent years, hence the emphasis on bonuses.)

BankAmerica's troubled acquisition of Security Pacific in 1991, referred to above, saw what was initial styled as a merger of equals deteriorate into what some referred to as "ethnic cleansing" as Security Pacific officials were dismissed or left in droves after Security Pacific credit losses came to light. Now, BankAmerica Corp. is seeing an exodus of senior executives as it tries to integrate the September 1998 merger of NationsBank Corp. and the old BankAmerica. As recorded in the Wall Street Journal over the course of the fall, at least 14 of the 45 highest ranking executives at the old BankAmerica have resigned or otherwise left since the US$43 billion merger was announced in April. Favourable "change-of-control" incentives were available to 1,134 executives of the old BankAmerica as a result of the transaction. For other employees similar transactions often involve favourable retirement or severance packages generally offered to the middle and lower ranks in order to downsize through voluntary departures. Unfortunately, it is often the more valued employees, those with career and personal options, who take advantage of these programs, rather than the poorer performers who have fewer choices.

While a detailed discussion of the factors involved in integrating compensation plans is beyond the scope of this paper, it is important to note that the decision as to whether to integrate compensation and benefit plans will depend in large part on the corporate structure and business processes of the merged company. Operational units may have very different pay environments (depending upon geographic region, industry segment or historical practice). Mergers of banks and investment dealers, with the inherent stark differences in compensation practices, is one example. Regulatory reasons (such as pension plan concerns) may also result in the maintenance of existing arrangements.

Lesson Eight: The Integration Process Involves Far More Than The Human Resources Concerns Outlined Above. Other Aspects Of Financial And Operational Integration Must Be Focused Upon.

A strategic fit with a potential acquisition target is a pre-requisite to a successful transaction. However, failure to focus on systems integration can also de-rail a transaction.

For example, when paper giants Domtar and Cascades announced plans to merge their corrugated fibreboard divisions in January 1998, little time was spent on information technology. Eventually it was discovered that Domtar's centralized HP 9000 main frame was incompatible with Norampak's (the Cascade subsidiary which was party to the merger) de-centralized AS-400 mini-computers.[34] The costing, pricing and ordering systems were unrelated and based on different data and formulas. Further, the technology teams from the two companies failed to settle on a clear vision for the systems technology to be used.

Integrating systems departments after a merger or acquisition is never easy. First, there are the purely technical problems. For example, how do you get electronic-mail systems on incompatible hardware systems to talk to each other while you decide which one to keep? Or, if you decide to go with one general ledger system, how do you get data from the redundant system onto the surviving one? Those who have been through the process agree, though, that paying attention to the people issues is the best way to ensure a smooth transaction. In effect, the merger transition team should include representatives from the information technology departments.

While rationalizing expensive systems departments is typically one of the expected economies of scale in a merger or acquisition transaction, rushing the hard decisions as to which hardware and software applications are most appropriate may lead to making the wrong choice or alienating one of the two groups. Further, when you carry out a conversion as part of the systems integration you have to make sure that you understand both information systems inside out, otherwise the costs can become prohibitive.

In the Sandoz/Ciba-Geigy merger to form Novartis, referred to above, it seemed that information technology integration would be simple, since the Canadian subsidiaries of both partners used the same software on AS-400 mini computers. However, a closer look showed that each system was based on different and incompatible versions of the same software. What's more, the Ciba-Geigy system was combined with manufacturing data, making it next to impossible to transfer data to the Sandoz system. In short, it took eight computer specialists eight months to combine the two distribution systems into one.

Similarly, integration of the internal accounting systems and report generation process as well as associated functional responsibilities must be contemplated early on. The merger of accounting systems was one notable glitch (with competing fiefdoms advocating their own historical systems) in the otherwise successful merger of Chemical Banking Corp. and Manufacturers

Hanover Corp. in 1991. Similarly, in Tyco International Ltd.'s US$6.6 billion acquisition of ADT Ltd. in 1997, Tyco's decision to cut in half the US$120 million budgeted for new computer systems and consultants lead to fiery objections during the four month period between the announcement of the deal and its closing.

Other areas to be focused on by the integration teams are:[35]

(i) integrating reputational and other intangible resources (corporate and trade names as well as product brands);

(ii) integrating corporate mission statements;

(iii) integrating management systems; and

(iv) ensuring ongoing fulfilment of obligations and services to customers, suppliers and the public.

Lesson Nine: Occasionally Take a Breather.

Companies with active acquisition programs or which swallow a significant acquisition often have to retrench while the acquisition is integrated. Limited management resources and the distractions that the integration process brings to the conduct of the business in the ordinary course result in a situation where the purchasing company's lack of resources would make further acquisitions problematic.

With the passage of time, the integration can be completed, synergies captured and the target company can begin to contribute to the global organization, allowing for additional growth.

Even GE Capital, where acquisition and integration of businesses has been made a core competency, is not immune from the risk of over-extension. With the recent departure of Gary Wendt, focus is now being placed on implementing parent General Electric Co.'s "Six Sigma" program (a massive company-wide restructuring program that is in its third year at GE). As recently reported in the Wall Street Journal, GE was shocked at how much potential remains to be realized at GE Capital. In effect, many of the acquired businesses had not been fully integrated and the Six Sigma program will complete the process of realizing the value from the acquisitions.

END NOTES

[1] See “Convergence Hi-Tech Style”, the Financial Post, October 24-26, 1998, pg. 21.

[2] See, generally, “Post-Merger Integration: How Novartis Became Number One”, Lawrence M. Fisher, Strategy & Business, Second Quarter 1998 Edition, pg. 70.

[3] See: (i) “The Growth Imperative: The Role of Mergers and Acquisitions in Creating Shareholder Value” Kenneth W. Smith, Insight Conferences, September 27, 1995; (ii) “The Synergy Trap”, Mark L. Sirower, The Free Press, 1997; (iii) “Big Deal”, Jennifer Wells, Report on Business Magazine, July 1998; (iii) Smith & Hershman, “Making Mergers Work for Profitable Growth”, a Mercer Commentary, 1997; and (iv) “The Art of M&A Integration”, Alexandra Reed Lajoux, McGraw Hill, 1998, Chapter 1.

[4] See, for e.g., “Premium Price”, Fortune Magazine, January 11, 1999 pg. 99.

[5] “A Little Prevention Goes a Long Way”, Richard Gooding, Ivy Business Quarterly, Summer 1998, pg. 17.

[6] See “Dofasco’s Big Missed Adventure”, Report on Business Magazine, June 19, 1991, pg. 31.

[7] “How High is Your Return on Management?”, Robert Simons and Antonio Davila, Harvard Business Review, January-February 1998 at pg. 71.

[8] “Bon appétit!”, Forbes Magazine, November 2, 1998.

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