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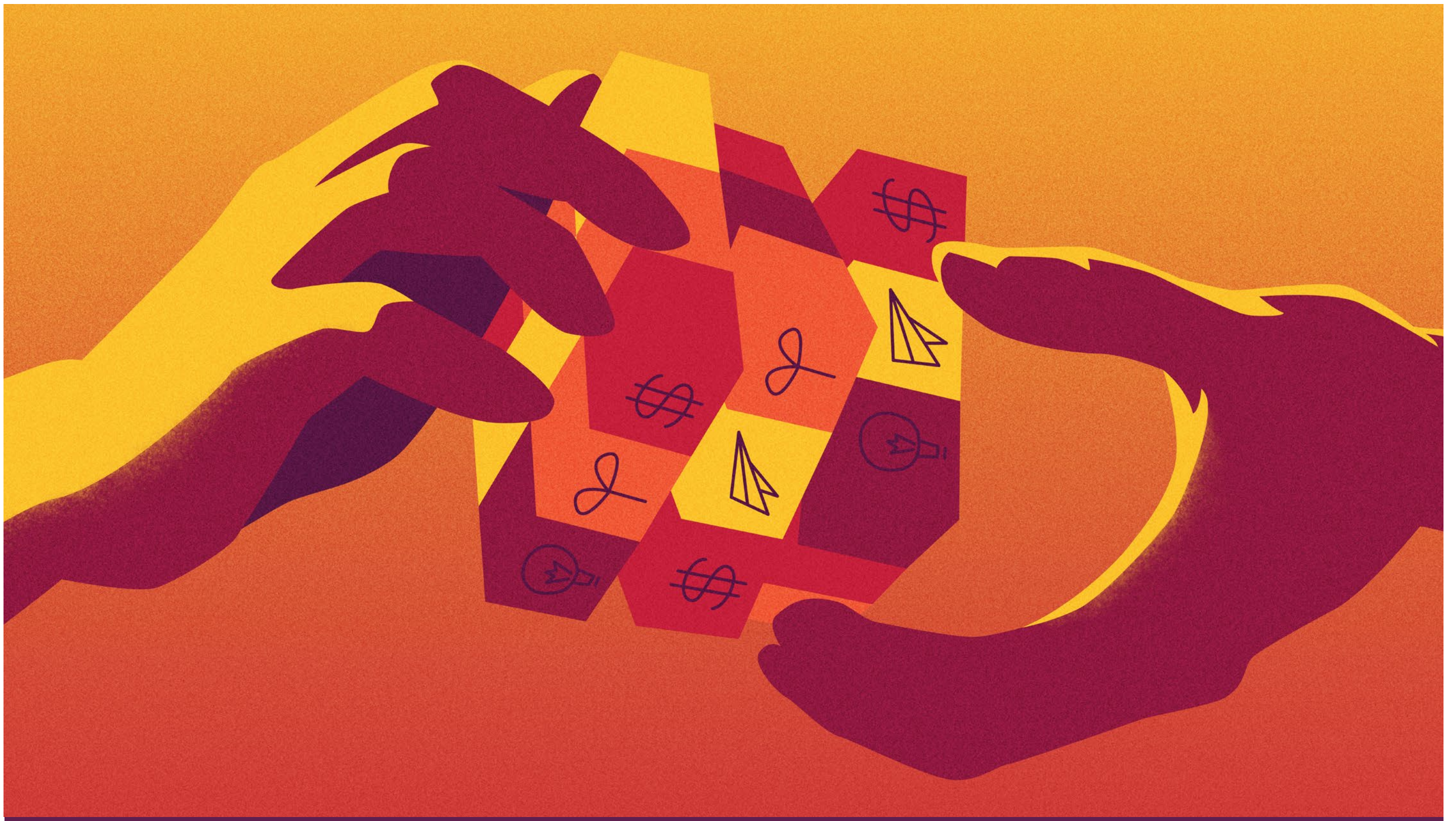

M&A: Get what you bargained for

Here's how to make sure your prize acquisition isn't a lemon in disguise

By Kerry Kerr

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Looks great–but how's the engine?

M&A deals are a thrill. You're expanding your capabilities, entering a new market, boosting your company's presence. You've already looked under the hood—do you really need to spend more time poking around inside the engine and mapping out how you're going to drive the thing? Yes. Go into a deal with eyes wide open and be prepared for integration. You'll minimize the chances of making a bad buy, develop a clear picture of the acquisition's strengths and weaknesses, and gain the insight needed to catch early signs that a risky acquisition is veering off course.

Integration typically takes a lot longer than acquirers think it will—and that's especially true if preacquisition evaluations and integration planning have been less than thorough. Unforeseen problems will arise. The trick is to ensure that they're not overly material in nature.

To-do lists for the truly diligent

Due diligence—don't turn the page, this means you! Many people think of due diligence as what the lawyers do, but they cover only contracts, the purchase agreement, intellectual property and related legal issues. If you're really being diligent—and the most successful acquirers are—you'll examine your pending acquisition from all angles. Exposing issues early leads to a smoother integration process and less friction with the acquired company's management and shareholders.

Our advice: Create an internal acquisition team to manage the process, and make sure you have experienced acquisition talent (internal or external) on hand. The team should include members from your legal, finance, human resources, IT, sales and marketing and operations groups. Here are the basic to-do lists beyond legal review:

Finance

- Assess the reliability of accounting records.
- Examine the balance sheet for unrecorded liabilities.
- Assess the accuracy of receivables, key fixed assets, inventory, payables and the like.
- Search for significant departures from GAAP and estimate their impact on the balance sheet.
- Investigate income statements for the current year and past three years, focusing on revenue trends and expense categories, and construct a year-over-year trend analysis.
- Delve into revenue recognition issues and request explanations for atypical expenses and trend deviations.

Human resources

- Assess the talent (staff and management), decide whom you want to keep, and figure out how to keep them.
- Pinpoint key ways your acquisition's benefits and employment-related plans differ from yours.
- Understand employment laws and tax requirements for new geographic areas.

IT systems

- Assess the level of sophistication of your acquisition's IT systems.
- Assess any software, networking and hardware compatibility risks, and determine how they'll affect integration.

Sales and marketing

- Assess the ability of your acquisition's sales team to integrate with your team and achieve targeted forecasts. Can they deliver on your expectations?
- Do the acquisition's existing compensation plans fit within your organization's compensation model? Variations in commission plans can cause significant integration issues. Changing a compensation model is never an easy task, especially if it happens midyear.

Finding synergy with systems

Here's a key fact: Integrating the company into your existing ERP system will not happen as quickly as you think it should. You'll most likely need some kind of bridging solution until a full integration is complete. (We've developed templates to bridge the financial reporting gap and create an easy transaction upload from the acquired entity into your software systems.) You'll probably also need bridging processes to assist in areas such as revenue forecasting, consolidation and inventory control.

Operations

- How do you intend to operate the entity after acquisition?
- Can the acquisition's existing staff accommodate your post-acquisition plan and deliver on your expectations?
- Are there any production issues related to your acquisition's products or services? How will these affect the integration path?

It's probably obvious that this level of diligence takes some time. You'll need several weeks or months between term sheet execution and actual close to flesh out any due diligence issues.

Key question: why are we doing this again?

In the excitement of closing a deal (and the exhaustion of due diligence), people often forget the reason for the acquisition—bringing value to your company. Unrealistic revenue forecasts are the norm, but acquirers rarely analyze their targets' forecasts with any rigor. The consequences can be ugly.

Typically, forecasts are prepared quarterly by the target company's management team and reviewed by the acquirer's management team. Our experience with these forecasts is that they are aggressively optimistic—and it's human nature to leave the forecast in place until it's too late to achieve it.

Another factor is a side effect of the deal itself: An acquisition takes time, creates added responsibilities and can be disruptive to the business. All of those factors can depress post-acquisition financial performance.

While no one expects a perfect forecast, unachievable predictions can result in serious friction within management, staffing cuts within the acquired entity, and overall disappointment with the entire deal. To head off problems, request three- to five-year revenue forecasts, compare them to past and current year performance, and closely analyze their achievability. Have a finance pro pull off the rose-colored glasses and don the green eyeshade. (Is the acquisition really going to make half of this year's forecasted revenue in November and December?) For each post-acquisition monthly close, compare actual figures against forecasts, particularly for revenue and operating expenses. The finance person should analyze, understand and explain every significant deviation from the forecast using supporting schedules and comparative period performance analysis.

Keeping a close eye on the post-acquisition results can help identify issues and enable change to ensure the best possible success. And the careful reflection can sharpen the forecast evaluation and financial modeling skills you'll need for the next great business acquisition.

Let's talk

As you go about questioning forecasts and the latest facts and figures, this is also the opportune time to do some talking yourself. You've got two companies in flux and whispers and concerns being debated around the office Keurig machine. Communicate early and often with your existing team and the team you're in the midst of acquiring. What can you tell them about your go-forward strategy—and namely, who you plan to retain? Externally, you'll want to share similar information with the marketplace to make sure any pending deals go your way before your competitors swoop in to take advantage of this transitional time.

Green light, go–but maybe not as fast as you'd like

The purchase agreement is signed and consideration changes hands. You've bought yourself a promising new product or service. Congratulations!

No matter what the size of the company you're acquiring, now it's time to assemble an acquisition integration team with members from both sides of the deal experienced in all areas of due diligence. In terms of activities, remember that integration involves more than systems and producing consolidated financial results—true integration includes company policies, internal controls, values and corporate culture. In terms of effort, the most common misconception we see is "Oh, this won't be that hard—it's just a little company." But it's usually the tiny ones that are hardest to swallow.

Small may be beautiful, but it's rarely neat and tidy

Small, privately held companies tend to have unsophisticated accounting systems, overlooked GAAP issues, unrecorded liabilities and zero experience with very short high-pressure financial closing periods. Many have never been through a financial audit. Most small firms prepare financials to support the preparation of year-end tax returns by an external tax accountant, and accounting records are maintained by staff with limited formal accounting training. That means complex accounting issues are often misunderstood and overlooked.

Your small acquisition will need help to cope with short financial closing periods, to integrate your operating policies and procedures, and to deal with GAAP compliance. Here are some typical issues we see with small acquired companies:

Inadequate reserves. These include inadequate or missing bad debt, warranty, sales returns, and slow-moving and obsolescence reserve accruals. Often in small companies the gray, subjective areas of accounting don't get attention, or they get the wrong kind of attention.

Revenue recognition issues. Incorrect revenue recognition processes tend to be huge issues for small companies. Most significantly, they impact projected revenue forecasts, especially when those forecasts are produced using improper GAAP financial processes. This results in big misses on quarterly projected revenue forecasts.

Timing is everything

Public companies nearing the end of a deal should be especially careful about timing. If you complete a transaction late in the reporting quarter, you could run into difficulty with completing the required accounting adjustments to the acquired entity's books and developing financial transaction reporting processes from them. Instead, aim for your first reporting period be a month that doesn't fall near the end of a quarter. That will give you time to clean up the books and reporting processes without putting everyone into crisis mode.

Incomplete debt accounting. Improperly recorded loan obligations and amortization are common. We often see warrants issued in connection with debt that have improper accounting or no accounting at all!

Equity issues. Problematic stock administration is common in private companies, but a good legal team can usually eliminate any equity issues through the purchase agreement. For example, you may be able to avoid equity issues by crafting the purchase agreement to terminate stock option plans or other equity-based compensation with execution of the purchase agreement. Opting for an asset purchase can also eliminate thorny equity issues.

Dispatching a finance pro to the acquired company to operate as the acquisition integration CFO or controller will save you time, frustration and possibly money. This is a natural job to outsource, especially if your staff resources are fully booked, since it's typically a bridge role. This resource serves as a liaison between the accounting teams for each organization, reducing the stress of the close process, ensuring a timely close and working with both organizations to resolve any difficult accounting issues that arise.

Bridge the gap

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Look to this person to develop templates to support the closing process and the posting of accounting transactions from the acquisition's accounting software into your accounting records. Once the templates are stabilized, you can train the acquisition's accounting staff to complete the closing, eliminating the need for the bridge resource. Depending on the acquired entity's staff capabilities, this transition typically takes four to six months.

Big means complicated–and then some

Larger acquisitions have issues too, of course—they're just not as unexpected for most acquirers as those that arise with small companies. Top issues involve international operations, areas of compliance and multiple divisions you'll have to integrate.

International facilities. In many cases, reporting must be produced in both local and US GAAP formats, requiring duplicate sets of accounting records. This makes it difficult to integrate your acquisition, since you can't eliminate the old set of books until local reporting requirements are satisfied, and the local accounting team often struggles with complex US GAAP requirements. You'll also have to understand and incorporate local payroll requirements, social programs and government guidelines regarding vacations, leave, sick time and so on.

Regulatory filings and compliance. Larger acquisitions can generate additional reporting requirements such as pro forma financial statements, 8-K filings, SOX compliance and so on.

Size and scope. Acquiring a big company usually involves multiple divisions and products, and a large number of employees. In many cases you'll have to integrate on a division-by-division basis, and you may have to relocate production activities. It may be easier to let the acquisition operate as a division with all preexisting functions left in place. No matter what, big means bigger, and typically bigger takes longer to integrate.

Conclusion

Making sure that you get what you bargained for, and you can bring it in without too much drama, is labor intensive—but oh so worth the effort. Follow the guidelines in this report, and the fruits of your labors should be a successful acquisition integration: Clean-up of accounting records goes smoothly and is completed within the first couple of reporting periods. You achieve (or come close to) revenue and production goals. And you absorb your purchase in a reasonable time frame (within 12 months for small acquisitions, potentially much longer for larger acquisitions, depending on their size and scale).

Don't have the finance staff on hand to make it happen? No sweat. Our experienced M&A experts know all the tires to kick, and they've seen (and dealt with) just about everything that shakes loose.

About the author

Kerry Kerr managed acquisition integration and financial activities for many international and domestic entities acquired by publicly traded and privately held clients at RoseRyan. Before joining our consulting firm, he spent 20 years as the CEO and owner of a privately held Midwestern software organization.

About RoseRyan

RoseRyan takes dynamic companies further, faster, by delivering specialized finance and accounting solutions at every stage of your company's growth. Versed in Silicon Valley's rapid pace and unique business environment, our consulting firm has helped 800+ companies achieve success since 1993. No matter the size of your company or the scale of your next endeavor, RoseRyan has the wide-ranging solutions you require to accelerate growth.

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