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M&A STRATEGIES:
Make a Match Made in Heaven

SMART MOVES FOR BUYERS AND SELLERS —AND WHY IT PAYS TO UNDERSTAND HOW THE OTHER HALF THINKS:

A guide to help you prepare to make the best deal.

By RoseRyan

happily

CONTENTS

04 Sellers & Buyers
06 Target Companies
10 Acquiring Companies
14 Don’t Keep Secrets
16 Relationships Take Work

SELLERS ARE FROM MARS

BUYERS ARE FROM VENUS

> Target companies and acquiring companies: they want to get together, but sometimes they don't seem to be speaking the same language.

That's because they have different reasons for entering the M&A scene. A target company may need a partner to help it continue product development, or its founders may want to cash out their investment without the hassles of a public offering. Another company may be looking to divest of certain business lines that no longer fit with its strategic growth plans. Or an acquiring company may need a target's intellectual property to complete its own development effort; or it may be looking to enter the target's market or acquire its workforce, or eliminate a competitor. Any of these differences can lead to misunderstandings, surprises, and ultimately, a deal that falls through or doesn't deliver on its potential.

Understanding the other party's perspective is key to making sure that doesn't happen. That's why we're rolling finance tips for buyers and sellers into a single guide: when pursuing an M&A deal, it helps to know what your prospective partner is thinking.

TARGET COMPANIES:

PUT YOUR BEST FOOT FORWARD

Your company may not be on the market now, but you never know when that offer you can't refuse might appear. Take the preparatory steps in this guide, and you'll impress potential suitors with your management savvy and initiative. Much of this work will improve your general business health even if you don't get acquired anytime soon, so the effort won't be wasted.

GET YOUR BOOKS **IN SHAPE**

This is the biggest task for many small-to-medium-size companies. A buyer will want to see more than the general ledger. The ability to provide historical financial statements, forecasts, and accurate equity information shows the company can trust your claims about business performance—and the valuation will be closer to your expectations as a result.

Historical financial statements. Ideally, these should be complete—including a statement of cash flows and footnotes—and audited. Public companies commonly require audited financial statements (one to three years, depending on the particulars of the deal) before proceeding with a purchase, and private companies prefer them. This helps ensure against unpleasant surprises down the road, like unrecorded liabilities or assets that are worth less than their book value.

Forecasts. Forecasts provide information about where your company is heading over the next three to five years. Acquiring companies are more interested in where you're going than where you've been. Throughout the diligence process, your historical budgets and forecasts will be compared to your actual results. This provides a good track record of your ability to provide the clearest possible picture of where your company is going. Additionally, acquiring companies are happy to see well-thought-out, supportable forecasts because they can help in valuing intangible assets, including in-process research and development projects.

Equity. Because the acquiring company often buys all outstanding equity and may assume your outstanding options, it is critically important—to your shareholders as well as the buyer—that your equity records are up-to-date and accurate. Reconcile your outstanding shares to the shareholder lists maintained by your attorneys or stock administrator, and make sure all information in your stock option database is up-to-date and supported. Time spent up front will pay off later: discrepancies in equity accounts are a frequent cause of transaction delays.

MAKE SURE YOUR **REVENUE IS RECOGNIZABLE**

Revenue is a wonderful thing—even better than profit in some cases. A proven product makes a target company more valuable to suitors. Deferred revenue counts too, because the acquiring company may be able to recognize some or all of it post-acquisition.

Revenue recognition can be an extremely complex area however, and you may need expert help to get it right. Did you account for your performance obligations correctly and record your contract assets and liabilities accurately under ASC 606? And did you properly evaluate your costs to obtain and fulfill a contract under ASC 340-40 for capitalization?
The acquiring company will be extremely interested in your revenue recognition policies because they may affect your forecasts and future financial results. You'll want to be sure your revenue is recorded correctly—finding out that you haven't correctly applied GAAP could result in a very different revenue picture. Nobody wants those kinds of surprises in the middle of a transaction.

DEAL WITH DOCUMENTS NOW **(OR PANIC LATER)**

When due diligence starts, you'll receive a laundry list of documents the acquiring company needs to see—pronto! These include (to name but a few):

- **Financial records (audited financial statements, forecasts, tax returns)**
- **Corporate documents (articles of incorporation, bylaws, board minutes)**
- **Information about all stock issuances (preferred and common, plus related warrants)**
- **Contracts (major customer contracts, contracts with suppliers, leases, loan agreements)**
- **Employee-related items (org chart, employment agreements with executives, stock option plans and agreements, 401(k) plans)**

Avoid a panic attack by creating a “data room” now. This can be as simple as a secure folder on your in-house network—just scan all executed documents and upload them to the folder. Make sure your network is backed up regularly and everyone knows that new contracts must be uploaded. Alternatively, you can use an outside service to store the documents.

If your contracts are abundant and complex, consider hiring a consultant to design a full-fledged data room with features such as searchability, indexes, and databases.

During the document gathering process, be sure to review any critical technology contracts, such as licenses and similar agreements, for “change in control” language. If you license the core component of your technology from Grinch Inc., which will not allow the license to be transferred to an acquiring company, this could be a problem. If you turn up any such issues, alert your attorneys promptly.

PUT A BLACK TIE ON YOUR **ACCOUNTING PROCESS**

Many target companies think they’re too small to need formal accounting processes. Not true! An accounting process that’s the equivalent of flip-flops and a Hawaiian shirt will leave you ill-prepared for an M&A deal—or even growth. Document your processes for performing all accounting tasks (processing payroll, generating invoices, and so on) and make sure all employees know and follow them.

Acquiring companies often expect to see detailed process documentation, and it also reduces your business risk. Having a written process documentation makes delegation easier and improves operational consistency, enables you to scale faster and reduces risk in the event of staff turnover, and serves as a good starting point for process improvement. Auditors will appreciate the documentation, and it may even result in savings on the audit fee. Documentation is also a good starting point for SOX if your buyer is a public company, which will have to deal with SOX compliance.

ACQUIRING COMPANIES:

KNOW WHAT YOU WANT— AND SEND IN THE ACCOUNTANTS

Acquiring companies share at least one thing with target companies: preparation is key. That applies to the deal-making process (for most participants, the fun part) as well as the often slighted integration process, which is crucial to the acquisition's ultimate success. For best results, know not only what you want from the target company but also what it wants from you.

PLAY THE FIELD STRATEGICALLY

It's essential to approach any acquisition with a clear understanding of what you want from the target company and what you need to do to achieve that goal, whether you're seeking a specific piece of intellectual property, access to a new market, or simply a few key personnel. Understanding why the target company wants to be acquired can be just as important to structuring the optimal agreement—or making a deal at all. If keeping key team members is one of your goals, you need to know up front if the target company's current ownership wants to cash out and move on.

Including an M&A-savvy finance person on your acquisition team can help you spot other potential pitfalls, as well as opportunities. Sometimes structuring a deal differently will achieve the same business goal and avoid or minimize onerous accounting outcomes.

REALLY KNOW YOUR PARTNER –GET THE ACCOUNTING RIGHT

Accountants aren't often the stars of the show, but they play a major role in M&A transactions. That's why it's important to consider your accounting department's bandwidth and skill set. If your team is already working long hours to deal with day-to-day requirements or no one has a strong M&A background, an expert consultant or consultant team could deliver great value. Good consultants will not only get you through this deal but also show your team the ropes so you'll be better prepared next time. Key M&A accounting tasks include:

Valuations. As soon as the deal closes, you need to determine the fair values of the target company's assets and liabilities, including what's on its balance sheet and also intangible assets that aren't. The excess purchase consideration is booked to goodwill. The initial step is obtaining the target company's closing balance sheet and "scrubbing" it. Pay special attention to accounts receivable (to be sure that all potentially uncollectible accounts are identified), fixed assets (fully depreciated items still in use may have value), outstanding debt (to determine if the associated interest rates are at current market rates), and contingent liabilities such as pending litigation.

You'll probably need to engage a third-party valuation firm to assist in identifying and valuing the intangible assets—most companies don't have the in-house expertise to do this and it must stand up to audit. Under GAAP, the target company is not allowed to reflect its technology and intellectual property on its balance sheet. Those intangible assets are part of what you just bought, so a portion of the purchase price must be allocated to them. You'll also need to consider any in-process research and development (IPR&D). If your target company planned ahead and provided you with forecasts, you're a step ahead.

Equity accounting. Stock options (or restricted stock or other equity awards) that are assumed and/or replaced by the acquirer can affect the purchase price, but may also represent stock-based compensation for the acquirer post-acquisition. The terms of the acquiree's stock options, the purchase agreement and other laws and regulations will need to be considered in order to get the accounting correct.

Contingent payment valuation. Did the purchase price include any contingent consideration, such as an earn-out provision? The fair value of that contingent payment must be determined at the time of the transaction and included in the purchase price. You'll need to determine if any of the contingent consideration is tied to employment—if so, that may be compensation expense and not part of the purchase price. This can be a difficult task because it involves both the time value of money and the degree of likelihood that the amount will be paid. Changes in the fair value of the contingent consideration are recorded to the P&L post-acquisition, so getting a good, solid estimate on acquisition is key. Pass the aspirin.

With these tasks completed, you may still be waiting for additional information, but don't let that stop you from recording the transaction. You'll need to determine (and disclose) specifically what is still pending at the acquisition date, and you have up to a one year measurement period to make adjustments to the purchase accounting. Keep in mind that any adjustments found later that weren't disclosed will need to be evaluated as potential errors.

DON'T KEEP SECRETS: LET YOUR PARTNER KNOW YOUR PLANS

> It's sad but true: many M&A transactions that look great on paper don't work out well because of failure to manage the integration process.

Integration takes a lot of time and energy. You'll want to start the planning process well before the deal closes. Pull together an integration team with executive participation from all functional areas, and make sure everyone understands the reasons for the deal and what value you expect to derive from it. Understand the cultural differences between the two organizations, and determine how you will manage cultural change and alignment. Develop a timeline for integration—the longer the integration takes, the riskier it gets. Time spent on integration distracts from your core business, and allows for more opportunity for confusion in the marketplace. Your integration plan should focus on your key value drivers, clear communication, both internally and externally, and build in accountability.

Even if your primary goal in acquiring the target company is to obtain technology or market share, much of the value of what you are buying lies in the people—and the departure of a few key employees can really hurt you.

Hold an all-hands meeting at the target company soon after announcing the deal, before the rumors get out of control. Tell the target's employees what your plans are. If you want to keep people, let them know, and figure out the best way to do that. Identify redundant personnel early and let them know your timeline. If they're important to the transition and integration process, offer them sufficient incentive to stay through that process. Finance and accounting personnel, for example, often possess critical historical knowledge that could be difficult and time-consuming to reconstruct without them.

> Communicate with your own team as well. They need to understand why you entered into the transaction, what your goals are and how this impacts them. Your team may have similar concerns about their fit with the new organization and their role in the success of the transaction.
>
> Communicating clearly and honestly with employees isn't just the right thing to do—it's an important risk-mitigation strategy.

RELATIONSHIPS TAKE WORK

— BUT YOU DON'T HAVE TO GO IT ALONE

M&A deals are exciting. As with any new relationship, though, once the initial euphoria wears off, there's usually some work to do to move to the next level. Knowing that in advance—and preparing for it as outlined in this guide—will greatly increase your chances of forging a happy union (not to mention avoiding an ugly mid-deal breakup). Wondering how you can do all this on your own? You don't have to. RoseRyan can help with forecasting, revenue recognition, due diligence, acquisition analysis, post-merger integration, and more. **Contact us to find out how.**

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HOW CAN WE GUIDE YOU TO TRANSFORM YOUR ORGANIZATION'S PERFORMANCE AND ACCELERATE YOUR PROGRESS **TOWARDS SUCCESS?**

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