

# Merger & Acquisition Focus



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Ask the Advisor

# Don't let fraud derail your deal

You're days away from finalizing an acquisition that's expected to fuel significant growth for your company. But an anonymous tip and follow-up research reveals that your target's CFO was investigated and indicted for financial statement fraud while working for another company. The case never went to trial, but the charges — and lack of disclosure about them — naturally lead you to question what the business you plan to buy may be hiding. The deal, subsequently, is brought to a grinding halt.

A thorough investigation performed by forensic accounting and other financial experts during the due diligence stage could have helped prevent this unpleasant — and costly — end to the transaction. Before you waste valuable time and resources negotiating a deal, do your homework.

## How well do you know your seller?

The majority of occupational fraud is perpetrated by rank-and-file workers and lower-level managers. But, as the Association of Certified Fraud Examiners has concluded repeatedly in its annual *Report to the Nation on Occupational Fraud & Abuse*, fraud committed by owners and executives is the most financially damaging and can, by extension, harm the value of your deal.



Even if a company has fraud policies and internal controls in place, owners and executives can override them. These individuals also have access to financial statements, as well as incentives — such as bonuses for exceeding certain growth targets, or to inflate the company selling price — to falsify them.

So, it's essential to perform background checks on, at the very least, your target's owners, CEO and CFO. A thorough check can uncover an executive's criminal past involving embezzlement, theft, forgery and other types of fraud, as well as involvement in civil litigation. It could also reveal that an individual has falsified items on his or her resumé and other pertinent personal claims.

## What are some common schemes?

Management has myriad ways to artificially inflate its company's value, including:

**Write-off techniques.** The company might take large write-offs when profits are lower to make them appear even worse. This allows the company to reduce expenses and boost future earnings.

**Numbers games.** Companies might record sales early — and expenses late — to create the illusion of increased profits.

**Vendor antics.** A business might provide loans to major customers so that they can make large product purchases and give the appearance that the company's sales are booming.

**Benefits roulette.** A company could declare its pension plan overfunded by juggling proceeds and modifying items such as the interest rates and expected return on assets. The company can't legally remove money from the pension fund, but these tactics can reduce or eliminate its mandatory plan contributions.

Other schemes might involve hiding liabilities, misappropriating assets, overvaluing receivables and securities and overstating inventories.

## What do experts look for?

Because fraud schemes can be complex and difficult to spot, a forensic accountant is a particularly useful addition to your due diligence team. These fraud experts use their accounting, auditing and investigative

skills to detect signs that your target is cooking the books. Red flags include:

- ❖ Increased accounts payable, combined with dropping or stagnant revenues,
- ❖ Excess inventory,
- ❖ Decreasing reserves against bad debt,
- ❖ A large number of account write-offs,
- ❖ Increased purchases from new vendors,
- ❖ The recent introduction of new methods of calculating revenues and expenses, and
- ❖ Excessive tax-driven earnings reductions.

Fraud experts don't only examine financial statements, but also look at business practices that might provide motives to perpetrate fraud and cultural conditions that enable fraud to thrive. For example, domineering and bullying owners and executives are more likely to feel entitled to break accounting rules and coerce employees to participate in such activities.

Similarly, businesses that offer financial incentives for employees to meet high, even unrealistic, sales growth numbers — particularly if employees *are* meeting them — merit a closer look. High employee turnover and worker, customer and vendor complaints are also strong indicators that something is amiss. Finally, if the seller tries to restrict your due diligence

## A due diligence frame of mind

Even before you begin formal due diligence, conduct an initial assessment of how “fraud resistant” your target company is. For example, does the company appear to have effective governance and antifraud policies? What about defined and enforced codes of ethics and strong internal controls that are regularly reviewed and tested for compliance?

When companies have invested time in identifying and solving corporate governance and financial issues, it reduces the risk that those issues will emerge later. Depending on the industry, you may be able to review results from regulatory examinations to help identify potential weak spots early.

team's access to financial data or prevent them from speaking with key employees, be wary.

### Too good to be true?

When buying a company, it pays to be skeptical — particularly if its earnings or selling price seems too good to be true. Keep in mind, however, that inaccurate financial statements may be a sign of incompetence or poor management, not an attempt to mislead potential buyers. A fraud expert can help you tell the difference and ensure that you make a well-informed decision. ■

# Buying damaged goods?

## HOW TO EVALUATE A DISTRESSED COMPANY'S POTENTIAL

**J**ust because you're paying a relatively low price for a financially distressed company doesn't mean you're getting a bargain. Some companies are simply too troubled to turn around. Thorough due diligence and a professional valuation can help reveal whether you're buying a diamond in the rough or whether your potential acquisition's flaws are fatal.

### Troubling signs

To prevent a bad acquisition, know the signs of a troubled company. During the due diligence stage, look for:

- ❖ Debt reduction programs, such as asset sales and equity offerings,
- ❖ Cost reduction tactics, including layoffs,

- ❖ Changes in senior management, especially those with fiscal responsibilities,
- ❖ Changing customer profile activity, extraordinary sales and customer refunds,
- ❖ Strained relationships with auditors, suppliers and lenders, and
- ❖ Pending regulatory matters that could trigger lawsuits related to sales and trading practices or employee issues.

Keep in mind that any one or a combination of these factors doesn't necessarily mean that a company is in financial trouble. If you spot them, however, it's a signal to dig deeper and evaluate the degree of the problem.



It's also essential to pinpoint the cause of the trouble. Once you determine why a business is struggling, you can decide whether you'll be able to turn the situation around.

For example, buyers often assume that troubled companies are dragged down by excess debt and that an infusion of cash or a debt restructuring program will reverse the situation. Debt may be one factor, but dealing with it won't do much good if the company's biggest problem is poor management, labor issues or mature product lines that no longer meet their market's demands.

### Shopping for value

Not all companies are turnaround candidates — or even salvageable in pieces. To determine if your target is likely to respond to either minor correctives or a major overhaul, consider its market share, demographic trends and competitive threats; financial fundamentals, such as revenue growth, cash reserves and debt; new opportunities for growth; and industry conditions and possible regulatory challenges.

Also crucial and frequently overlooked in the initial stages of a deal are the costs required to rehabilitate the distressed company. Financial and operational assessments can help you determine how much the acquisition will cost in the long run.

Finally, consider how well the target company has managed its financial distress. Has it been operating

in crisis mode for some time — holding lenders at bay, stretching cash resources and employing other damage-control tactics to protect its officers and directors? If so, the business may be beyond recovery. Its short-term survival methods may have undermined its long-term prospects. For example, slashing prices to retain customers will make reverting to the previous pricing structure extremely difficult — if not altogether impossible.

### Measure for success

A professional valuator can help you compare the distressed company's current value against its liquidated value to determine if it's worth more up-and-running or liquidated. In some cases, you may be able to sell off, or divest, the nonperforming segments of your target's business while keeping its viable divisions running.

Valuing a financially distressed company can be challenging. Market-based valuations require analysts to compare businesses to comparable companies or transactions, which generally isn't possible when valuing a distressed company.

### *Not all companies are turnaround candidates — or even salvageable in pieces.*

Income-based valuation methods — which rely on historical performance — may be no better. The company's future income, after all, depends on a combination of a workable strategy to return to profitability and the buyer's ability to realize synergies and cost savings.

Typically, valuation methods depend on the selling company's level of distress and sense of urgency. Companies that are only lightly distressed or subject to competing offers can negotiate a better price — or a valuation based on future cash flows. Because a high level of judgment is necessary when evaluating the potential of a financially distressed company, be sure you work with a valuator experienced in analyzing distressed businesses.

### Rewarding ... or not

Acquiring a financially troubled business can be very rewarding — as long as you choose your target wisely. To ensure you're not buying a hopelessly distressed business, perform adequate due diligence and team up with an experienced valuator. ■

# Board appeal

## YOUR DIRECTORS CAN HELP STEER YOU THROUGH AN M&A

**W**hether you're on the buying or selling side of an M&A, your board of directors can be helpful in guiding and advising you through the process. A legally formed board of directors has a fiduciary obligation to try to negotiate the best deal for its shareholders and, thus, may be involved at many stages of the transaction.

For example, a board may seek and evaluate offers or targets and review and discuss proposed deal terms. Typically, boards must approve sale agreements before they're signed. But, regardless of what a board is *required* to do, its involvement is likely to increase the odds of a smoother, more successful deal.

### Reporting for duty

Your board of directors offers business experience, financial expertise and legal knowledge that are particularly helpful when weighing the pros and cons of a major deal. Some members may even have firsthand experience with M&As.



One of a board's primary responsibilities is to protect the interests of the company's shareholders. It's natural, then, for your board to be interested in your merger plans from the get-go. Your board will, for example, likely be concerned that your company retain its core values while pursuing what can be risky strategic goals.

### Buyer protection

Board members of a buying company look for reassurances that the acquisition's rewards will outstrip any risks. To ensure the company doesn't buy a business for the wrong reason — for example, because the target is a “steal” — boards will ask management to justify the purchase. Questions might include:

- ❖ Will the deal result in access to new markets or new products?
- ❖ Will it help you achieve cost synergies or eliminate competition?
- ❖ Are you buying at a fair price given the market conditions?
- ❖ Will the acquisition drain resources? and
- ❖ Is the deal in keeping with your company's long-range strategic plans, such as five-year revenue growth targets?

Work with your board to outline how the deal will leverage your company's strengths and address your vulnerabilities, and how closely the two operations are in terms of industry, culture, geographic markets and business philosophy. Before a deal gets the green light, your board will also consider cost feasibility. An acquisition is a major financial investment, so you should be able to reconcile increased debt with future earnings growth.

### Seller assistance

The seller's board's input doesn't begin and end with the signing of a sale agreement. In the early stages of a deal, a seller's board can evaluate and help explain the benefits of a potential sale to its shareholders and assist in identifying appropriate suitors. It may consult with financial experts to determine the company's worth.

Typically, a seller's board favors the buyer with the highest bid. It may, therefore, play a part in deciding on an auction transaction or help gather detailed data about the selling prices of similar companies. The board may request deal protection provisions but also contractual flexibility that will enable the company to consider competing offers.

### Setting a fair price

Once a deal gets the go-ahead by all interested parties, it's advisable to obtain a fairness opinion from an independent advisor. This opinion can assure a seller's board that shareholders will receive a fair sale price for their investment and buyers' boards that they aren't overbidding.

Buyers' boards will be interested in receiving a summary of due diligence findings with details. They will consider how it was conducted and whether any of the conclusions require additional action — such as requesting a more stringent seller's warranty. And key executives and outside experts who conducted the due diligence should be made available to



board members. They may have questions or need information on matters that haven't been considered.

Sellers' boards typically are less involved in the due diligence process. But if you're selling your company, keep your board informed about how the process is progressing and explain how you're providing your potential buyer with all of the information required to adequately assess the deal.

*Your board will likely be concerned that your company retain its core values while pursuing what can be risky strategic goals.*

### Merging the two

Realizing the benefits of a merger often depends on timely and efficient integration. Sellers' boards generally want to see the integration plan before the deal closes to ensure that there will be no surprises, such as tax liabilities or employment agreements that must be honored.

Buyers' boards also should be provided with the integration plan before the deal's close. Directors look for:

- ❖ A timeline that specifies roles and tasks to be completed before, during and after the transaction is final,
- ❖ Initiatives the buyer will undertake to recover any premium paid for the acquisition,
- ❖ A comprehensive business plan explaining the costs and benefits of the deal,
- ❖ A detailed contingency plan for unforeseen assets and liabilities, and
- ❖ An analysis of the staff and time needed to complete the integration.

An effective integration plan can help reinforce accountability and timeliness.

### Planning for success

Even if you're not yet ready to sell your business or buy a company, make your board of directors aware of their future roles and responsibilities in evaluating M&A opportunities. This will better enable your directors to share their knowledge and expertise when the time comes. ■

# Ask the Advisor

*Q: Can a shareholder agreement prevent conflict among business owners?*



**A.** Shareholder agreements enable owners to plan their company's future — whatever unexpected events might befall it. These agreements assign ownership, set a value for company shares, dictate buyout terms and outline how the company is to be managed. This detailed plan helps to eliminate surprises and minimize disagreements down the line.

## Keeping it inside

Often, businesses draft shareholder agreements to prevent owners from selling their stakes to outside parties or to restrict share ownership transfer upon an early abandonment of an owner's obligations. An agreement typically requires that an owner who wants to sell to someone outside the company give remaining shareholders the right of first refusal, or an option to buy the shares at a certain price.

This first-refusal provision may stipulate that a seller offer shares to the remaining owners at the same price and terms — including financing — offered by the outside party. The other owners typically are given 30 to 60 days to make their decision and arrange financing. If they can't match the outside party's offer, they may have to accept the new partner.

Shareholder agreements also set up a succession plan to go into effect when an owner retires, dies, withdraws or has his or her ownership terminated for cause. When owners die, their shares pass through their estates to their beneficiaries. If there are no buy-sell provisions, beneficiaries aren't required to sell their shares to the company. If they elect to sell them back, they can dispute the shares' value. Or the beneficiaries may choose to sell to an outsider — or to keep the shares and take an active role in the business.

Buy-sell provisions in the shareholder agreement protect remaining shareholders by requiring them or the company to buy back shares from the deceased owner's beneficiaries at a predetermined price per share. Carefully worded buy-sell language also

eliminates tax consequences when a company elects to redeem shares of a deceased owner.

## Other valuable functions

Shareholder agreements might also discuss:

- ❖ Owner compensation, work benefits and retirement benefits,
- ❖ The percentage of shareholder votes required to approve major decisions such as electing directors, transferring or issuing new shares, borrowing funds, or making large capital expenditures,
- ❖ Methods for resolving owner disagreements and disputes — including provisions for the departure of shareholders and procedures for enforced share sales, and
- ❖ Shareholders' responsibility to lend the company money if it can't find conventional financing to buy back shares.

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Attorneys, CPAs and business insurance agents can assist you in drafting your shareholder agreement. This expert advice will help ensure that every owner's interests are represented fairly, and that the agreement will hold up in court if a dispute ever escalates to litigation.

## Plan for peace

Whether your company is still in the planning stages, has been in business for years or is combining with another company, it's a good time to consider writing a shareholder agreement. This document can help you deal with whatever comes your company's way — and preserve the peace while doing it. ■