

What to look for when acquiring a business

An effective Mergers and Acquisition Checklist

Expert knowledge means success



Contents

1. Introduction
2. Mergers and Acquisitions Checklist
7. Further Information

Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

Whether there's a slump or boom in the economy, mergers and acquisitions continue to take place. Businesses which are inherently strong (and who have substantial assets to borrow against (the so-called "leverage capability") continue to look for additional businesses to buy. Often these acquisitions enable them to amortise their operating costs over a wider base, and thus make their existing and the newly acquired business, more profitable.

This Mergers and Acquisition Checklist, sets out the matters which ought to be considered in a proposed acquisition or merger of a business or company that you have already identified.

Cross-Border Acquisitions

Most readers will be interested in mergers and acquisitions in their home country. But, the world is getting smaller and smaller as a result of faster means of travel and communication. This means that doing business abroad becomes an ever-tempting proposition - particularly with currency convergence in Europe. As more and more companies venture abroad, the cross-border acquisition will play an increasingly important role as an alternative to green field start-up operations, joint ventures, and other forms of foreign market entry. An international acquisition may be particularly attractive to a foreign company whose strategy is to gain instant goodwill, distribution and/or management expertise in the relevant local market. Further, this investment strategy will become more popular as developing countries continue to relax their foreign investment.

Why Many Acquisitions Fail

It's a fact, and a disappointment to those involved in the process, that many acquisitions show a downturn in profitability after they have been purchased. This highlights the key role of integration in the process. In 1997¹, Ernst & Young and Warwick Business School investigated the key success factors in the process. The major findings were:

- The need to define a small number of critical success factors for the proposed acquisition.
- The need to bridge the gap between pre-acquisition evaluation and post-acquisition implementation.
- The importance of information systems.

The Ernst & Young report also identified *conflict* as a disturbing factor in the initial period after the acquisition. Rationalisation may make sense to the deal strategists but it can be met with fierce resistance. All too often, the window of opportunity is missed by the acquirer who arrives at the table without the historical or political burdens suffered by the previous owner.

It's important that the acquirer imposes financial control over the company acquired at the very beginning. That way, people know where they stand - strong leadership makes the opportunity to implement change all the easier.

One major area of difficulty identified in the Ernst & Young report was the proliferation of pricing promotions operated by the acquired company - often these promotions were poorly documented and were too complex.

Managing people is seen as a priority for all acquirers - having a communication plan is essential. Equally important is the need for an integration plan. There are four main factors that need to be included in the plan:

- Standardisation of operations;
- Availability of information;
- Knowledge of the target business;
- The role of incumbent management.

The Ernst & Young report stated that 75% of acquirers had addressed suppliers and customers as a key focus in the 90 days following the acquisition. There are usually opportunities at this time for gaining margin improvements and changing supply terms and conditions. The elimination of duplicated head office functions is an obvious cost saving opportunity, as is the reduction in staffing levels - but care has to be taken in handling these issues. They are real "hot potatoes" and can have implications outside of the immediate business.

Mergers and Acquisitions Checklist

History and Business

- Need for independent appraisal of economic factors affecting the business
- Need for independent reports from technical advisers, marketing experts, insurance brokers, actuaries etc.

Industry Review and Economic Factors

- Performance compared with
 - Industry as a whole
 - Competitors
- Development of competition on future of the Company
- Performance in
 - New products
 - Technological research and development
- Industrial relations experience
- Government action – intervention – withdrawal of support
- Validity of the assumptions regarding the future of the industry

Management Information

- Information provided
- Speed of reaction
- Controls operated
- General efficiency

Employees

- Reaction to new ownership
- Availability of labour
- Stability of workforce and competition nearby
- Strike record
- Wage negotiations and likely outcome
- Scope for labour saving

Performance Ratios

- Earning power of the Company's capital compared with other companies in the same industry
- Earning power of operational assets employed
- Earning power of employees (such as sales per employee)

Return on Capital Employed and Gearing

- Cost of borrowed capital compared with current market rates
- Ability to meet interest payments
- Relative risks to equity and fixed interest compared with other companies in the same industry

Constraints on Borrowing/ Maintenance of Liquidity

- Vulnerability of interest payments
- Vulnerability of profits to drop in turnover
- Vulnerability of loan capital
- Vulnerability due to shortage of working capital
- Vulnerability due to failure to renew facilities

Stock Exchange Ratios

- General confidence of market in the Company
- Comparisons with competitors
- Comparisons with Stock Market generally

Inflation and Exchange Rates

- Has operating capability been maintained
- Has return on equity been maintained
- Is there an adequate return on assets at current price levels
- Has working capital been maintained
- Has turnover been maintained
- Has allowance been made for exchange rate fluctuations

Related Party Transactions

- Extent and nature
- Properly authorised and recorded
- Reflect economic substance
- Regularly agreed – correctly eliminated
- Obscured – need for indemnities
- Effect on future cash flow of changes in settlement dates
- Effect on future profits of withdrawal of services
- Effect of calling in related party guarantees

Long Term Contracts

- Management's day to day control
- Prudent accounting policy
- Properly reflected in cash flow projections
- Disputes over completion/Delays in settlements/Costs of rectification
- Cancellation of unfinished contracts

Taxation

- Validity – Difference from standard rate
- Tax charge on forecast profits
- Effect of tax payments on cash flow projections
- Need for indemnities and warranties
- Future reversal of timing differences
- Existence of undisclosed liabilities such as PAYE, reduced cost etc.
- Effect on tax of proposed course of action
 - Change of ownership
 - Withdrawal from group
 - Change in nature of trade
 - Sale of surplus assets

Research and Development

- Adequacy
- Recovery reasonably anticipated
- Costs to completion reasonably calculated
- Effective control

Pension Funds and Redundancy

- Need for actuarial advice
- Future effect on profitability of guarantees
- Effect of present proposals
 - Withdrawing from group
 - Entering new group
- Ex gratia payments - are there specific terms in purchase and sale agreement?

Insurances, Environment and Safety

- Adequate insurance cover – need for independent appraisal
- Danger to environment
- Plans to meet environmental requirements
- Likely effect on future cash flows

Dividend Policy

- Properly paid out of profits
- Adequate cover
 - Profit forecasts
 - Present proposals
- Flow of cash to (or from) parent company

Statutory Accounts

- Regularly prepared and audited with reasonable speed
- Qualified/Unqualified audit reports
- Conformity/Non-conformity with standard accounting practice
- Assess reliability of audit
- Identifying reasons for trends, exceptional, extraordinary items, revaluations, special situations, etc.
- Results affected by acquisitions and/or disposals

Management Accounts

- Methods and control over production
- Review and updating of
 - profit forecasts
 - cash flow projections
- Efficiency of internal control
- Differences from budgets

Accounting Policies

- Suitability for business
- Consistency
- Prudent and commercially acceptable
- Used by purchaser

Turnover

- Company's progress
 - growth
 - share of market
 - number of days to work off order book
 - credit being taken by customers
- Forecast turnover
 - order on hand
 - comparison with last year
 - how do margins compare
- Assumptions built into forecasts
 - trends of orders
 - realisation of proposed increase in selling prices
 - continued state of the market
 - change of fashion
 - support from customers
- Effect on cash flow
 - receipt of cash from debtors
 - length of credit being taken

Production and Margins

Purchases

- Dependent on a few major suppliers
- Dependent on trading relationships which could be interrupted
- Dependent on favourable terms which could be withdrawn
- Can changes in raw material costs be recovered in selling prices
- Assumptions on continuity of supplies being reasonable
- Forecast purchases in line with sales forecasts
 - New products
 - Products to be scrapped
- Seasonal pattern of purchases reflected in projections

Wages

- Reasons for variations in numbers
- Allowance made in forecasts for future increases
- Trends in average wage cost per employee
- Trends in labour costs as a percentage of product costs

Overheads

- Fixed or variable with production
- Reasonable basis of including in stock valuation
- Valid assumptions regarding increases in forecasts
- Irregular pattern of payments correctly reflected in cash flow projections

Other

- Nature and quality of earnings and forecast earnings
- Past performance and future viability of production unit
- Performance of individual products or units

Interest Expense

- Interest paid on each category of borrowing
- Changes reflected in forecasts and projections
- Adequate cover

Other Income

- Properly received in accordance with agreements
- Affected by related party transactions
- Any future variations critical to forecasts and projections

Exceptional and Extraordinary Items

- Correctly dealt with in accounts
- Correctly reflected in forecasts and projections
- In line with acquisitions and disposals
- In line with commencement/discontinuance of product lines

Land and Buildings

- Suitability for trade, expansion, contraction
- Security of tenure
- Future rent reviews – effects on forecasts – find new premises
- State of maintenance
- Need for valuation
- Underlying security for investment
- Sale and leaseback – effect on forecasts

Plant and Machinery

- Reasonableness of capitalisation
- Reasonableness and consistency of depreciation
- State of maintenance
- Adequate usage
- Obsolescence/replacement/effect on cash flow
- Underlying security for investment
- Need for valuation

Patents, Trade Marks, Licences

- Validity and effectiveness of title
- Life and probability of renewal
- Failure to renew – effect on forecasts
- Appropriateness of accounting policy
- Need for independence expert to assess title, values etc.

Investments in Subsidiaries/ Associates

- Degree of control
- Reliance of company on investee
 - Manufacturing capacity
 - Technical support
- Reliance of investee of company
 - Sales outlets
 - Cash support
- Overseas economic and political factors
 - Future ownership
 - Transfer of funds
- Restrictions on sale of shares
- Inter-company guarantees
- Realisable value

Stocks and Work In Progress

- Material and critical to forecasts and cashflow
- Reliability and consistency of counting/valuation procedures
- Probable existence and title
- Conditions, age, rate of turnover
- Suitability of accounting policies
- Adequacy of controls over movement
- Fluctuations and effect on cash flow projections
- Vulnerability of production to shortage of supplies
- Value on forced liquidation

Debtors

- Materiality of individual debts
- Effectiveness of credit control
- Speed of debt collection
- Bad debt experience
- Effect of slowing down of debt collection
- Whether ageing analysis support the assumption on payment
- Collectability of other receivables
- Realisability on a forced liquidation

Cash and Marketable Investments

- Sufficiency of working capital
- Surplus funds for withdrawal
- Safety of readily realisable funds

Current Liabilities

- Control over goods received
- Credit taken from supplies
- Pressing creditors, difficulty meeting demands
- Vulnerability to shortening of credit period by suppliers
- Material unrecorded liabilities and guarantees

Long and Medium Term Liabilities

- Ability to meet interest payments when due
- Gearing – effect on equity if fall in profits
- Future repayments – effect on projections
- Future borrowings – effect on profits and gearing
- Future charge on assets – any assets remaining

Profit Forecasts, Cash Flow Projections and Facilities

Preparation

- Efficient procedures for preparing and reviewing
- Previous success – differences explained

Assumptions

- Are they realistic
- Do line management agree with them
- Have they all been identified
- Is the effect of failure quantifiable

Available resources

- Manufacturing capacity
- Raw material supplies
- Labour supplies
- Adequate stock and WIP
- Established customers
- Confirmed orders on hand
- Available working capital
- Adequate management

Future commitments

- Uncompleted contracts
- Product guarantees
- Contingencies
- Raw material price increases
- Wage increases
- Overhead increases
- Changes in fashion
- Competition causing write down of selling prices
- Exceptional write-offs for obsolete stock, excess maintenance, bad debts, deferred
- Revenue expenditure
- Exceptional expenditure – new products, uncompleted research, uncompleted capital expenditure
- Extraordinary items, re-organisation, redundancy

Accounting policies

- Consistent
- Possibility of change

Interim results

- Adequacy of internal control
- Frequency of preparation
- Integrated accounting systems, particularly stock levels
- Variances from budgets explained
- Comparison with same time last year

General

- In line with information on acquisitions, disposals, new and discontinued lines
- Probable/possible year-end adjustments
- Sensitivity to failure to resources
- Loss of main customers
- Abnormal political or economic risks
- Compare with negotiated facilities

Assessment Relating to Proposed Transaction

- Principal factors relied on by the purchaser
- Probably cost of investigation work
- Probable need for indemnities and warranties
- Need for further consents before proceeding
- Ambiguous accounting matters in agreements

Legal Status of Company

- Business carried on is intra-vires
- No violation of borrowing powers
- Directors' remuneration within powers
- Share transfers properly authorised
- No violation of other restrictions in articles
- All returns made to Companies Registry

Ownership of Company

- Who owns or has right to acquire ownership
- Who controls or has right to acquire control
- Which persons could act together
- Tax status
- Pre-emption rights

Officers

- Independence of the board – dominant directors
- Integrity, suitability, stability
- Control over own remuneration, benefit, continuance in office
- Control over borrowing of money
- Professional standing and independence of advisors

Ownership of Assets

- Legal opinion on validity of titles or tenure
- Representatives or warranties necessary

Minutes

- Regular meetings – properly recorded
- Commitments and guarantees properly authorised
- Recent communications since last audited accounts
- Accounts/Forecasts/Projections – Decisions of authorised committees

Trading Agreements

- Legal opinion or interpretation
- Penalties under agreements
- New ownership might invalidate
- Assumption regarding renewal
- Representation and warranties

Guarantees/Litigation

- Obtain legal clarification
- Effect on forecasts and projections
- Representations and warranties

Other Valuation Factors

- Possibility of Full Listing or AIM
- Recent take-over offers
 - Company
 - Industry
- Progress of research into new products
- Continuity of senior management, health, age, mobility etc.
- Net maintainable profits
 - By products, divisions, subsidiaries
 - Continuing
 - New
 - Discontinued
- Return on operating assets employed
- Surplus or non-operating assets
- Disposal separately of
 - Loss making divisions
 - Profitable divisions
 - Non compatible activities
- Strip out
 - Excess cash
 - Valuable properties
 - Portfolio securities
 - Investments in other businesses
 - Excess land and buildings
 - Unused licences, franchises
- Future cash flows, dividends, capital commitments, working capital needed

Further Information

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

Important Notice

© Copyright 2019, Martin Pollins, All Rights Reserved

This publication is published by **Bizezia Limited**. It is protected by copyright law and reproduction in whole or in part without the publisher's written permission is strictly prohibited. The publisher may be contacted at info@bizezia.com

Some images in this publication are taken from Creative Commons – such images may be subject to copyright. **Creative Commons** is a non-profit organisation that enables the sharing and use of creativity and knowledge through free legal tools.

Articles and information contained herein are published without responsibility by us, the publisher or any contributing author for any loss howsoever occurring as a consequence of any action which you take, or action which you choose not to take, as a result of this publication or any view expressed herein. Whilst it is believed that the information contained in this publication is correct at the time of publication, it is not a substitute for obtaining specific professional advice and no representation or warranty, expressed or implied, is made as to its accuracy or completeness.

The information is relevant within the United Kingdom. These disclaimers and exclusions are governed by and construed in accordance with English Law.

Publication issued or updated on:
1 February 2012

Ref: 174



References:

¹ See "The First 90 Days", published by Ernst & Young and Warwick Business School