

Make a match made in heaven

**Smart moves for buyers and sellers—and why it
pays to understand how the other half thinks**

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Think your company might want to be acquired, now or in the future? Hoping to grow your business through strategic acquisitions? M&A activity is heating up again—make sure you're ready when that unbeatable offer or amazing buy comes along. Whether you're an acquiring or a target company, this guide will help you prepare to make the best deal.

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. On one hand, the 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. On the other hand, the acquiring company may need the target's intellectual property to complete its own development effort, or it may be looking to enter the target's market or eliminate a competitor. 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 will really make you shine.

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 happy to see well-thought-out, supportable forecasts because they can help in valuing intangible assets and in-process research and development (projects under way that have not yet reached technological feasibility). These items don't show up on your balance sheet but will be recorded at fair value as part of the M&A accounting.

Stale forecasts are misleading, so they can be worse than nothing. Be sure to update your forecasts at least annually, and more often if business conditions change or your company achieves a significant milestone. You want to provide the clearest possible picture of where your company is going.

Equity. Because the acquiring company probably will buy all your 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 transfer agent 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.

Bone up on M&A accounting

The target company usually doesn't need to worry about the nuts and bolts of M&A accounting, but having a basic knowledge of what's required can help you avoid misunderstandings.

The current guidelines were originally set out in Statement of Financial Accounting Standards No. 141 (revised 2007), *Business Combinations*, commonly referred to as FAS 141R. When the Financial Accounting Standards Board codified all accounting literature in 2009, FAS 141R became Accounting Standards Codification (ASC) Topic 805, *Business Combinations*. The rules are the same; only the name has changed.

The top issues target companies should be aware of:

M&A transaction expenses. Under pre-FAS 141R/ASC Topic 805 literature, costs directly related to the transaction (such as investment banking, legal, and accounting fees) were considered part of the purchase price and capitalized. This meant acquiring companies were sometimes willing to pay for all or some of the target company's expenses. Now such costs must be expensed as they are incurred, and target companies usually are responsible for their expenses, including audited financial statements if they are required.

In-process research and development (IPR&D). The fair value of any IPR&D must be capitalized until the work is completed, then amortized over the expected useful life of the developed technology. This is where forecasts come into play: the valuation experts will use them in determining both the fair value of the IPR&D and the useful life of the finished product.

Scrubbing the balance sheet. The buyer will “scrub” your balance sheet even if your books appear to be (and are) squeaky clean. No offense intended—they want to make sure that they've identified all your assets and liabilities and that they're allocating the purchase consideration properly. They also want to guard against material issues popping up after the acquisition has been initially reported. When that happens, previously reported results must be updated, and that requires explanations in SEC filings and to investors and analysts.

Contingent payments (such as earn-outs). Don't bank on receiving these potentially lucrative future payouts. Earn-outs are not as common as they once were because of the heartburn they can give acquirers. The buyer must determine the fair value of contingent payments at the time of the transaction: for example, what is the fair value of a \$2 million payment in three years if your company sells 100,000 units of its product or successfully completes a Phase III drug trial or some other milestone? That can be a time-consuming and

expensive calculation, and an incorrect estimate will ultimately show up as a gain or loss in the acquirer's financial statements.

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 of it post-acquisition.

Revenue recognition can be an extremely complex area, however, and you may need expert help to get it right. How do you handle rights-of-return, for example, or multiple-element arrangements, such as services bundled with products? (You can get a sense of current issues from RoseRyan's series of [rev rec guides](#).) The acquiring company will be extremely interested in your revenue recognition policies because they may affect your forecasts and future financial results.

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):

- 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)
- Employee-related items (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 processes

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. Auditors will

appreciate the documentation, and it may even result in savings on the audit fee. Documentation is also a huge plus 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, then allocate the purchase consideration among them. This is known as the purchase price allocation, or PPA. 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 any 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) affect the PPA from the other direction—a portion of their value will be considered part of the purchase price. Typically, you'll need to determine the fair value of the target company's stock options on the date the deal closes, using the Black-Scholes model and appropriate assumptions. The fair value of vested options assumed is considered part of the purchase price; the fair value of unvested options will become compensation expense in future periods.

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. This can be a difficult task because you have to deal with both the time value of money and the degree of likelihood that the amount will be paid. If you guess (make that "estimate") incorrectly, the difference from the amount ultimately paid must be recorded in your statement of operations. 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. Just keep in mind that you may need to adjust amounts later, and any adjustments to the PPA must be done retrospectively to the transaction date. This will require disclosure and explanation in your financial statements.

And that's not all—M&A transactions have a long tail. You'll need to make annual assessments of goodwill for impairment and monitor IPR&D for impairment or completion of the project; at that point amortization of the IPR&D must begin. Remember: the measurement period for PPA purposes is a maximum of one year. If new information becomes available during that period and the PPA has not been finalized, you must consider that information and adjust the PPA if required.

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. 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.

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 Maureen Ryan at mryan@roseryan.com to find out how.

About Maureen Earley: A senior RoseRyan consultant with more than 25 years' experience, Maureen Earley serves as a technical resource for the RoseRyan team. She has significant experience in mergers and acquisitions, IPOs, and follow-on offerings, and regularly advises clients on the interpretation and implementation of new accounting pronouncements as well as existing GAAP.