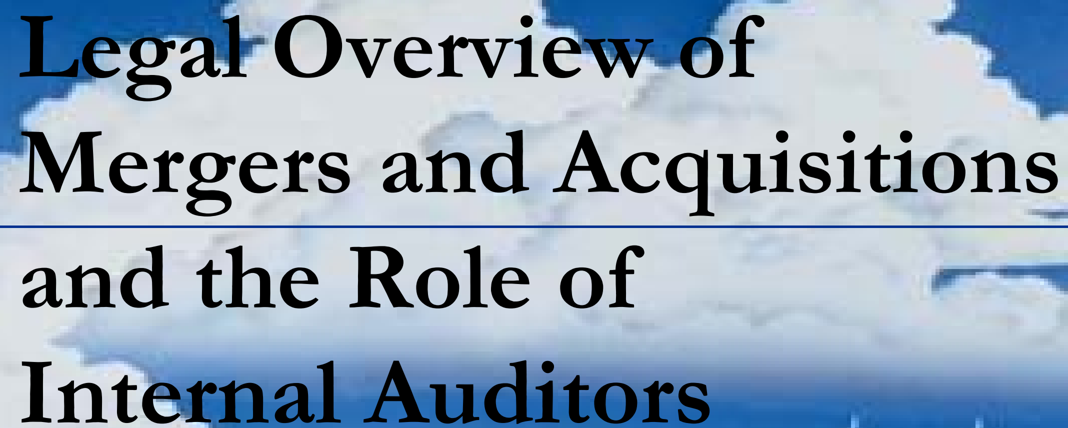
Legal Overview of Mergers and Acquisitions and the Role of Internal Auditors



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STRAIGHT TALK IS GOOD BUSINESS.®

Deterrents to new M&A activity in current economic environment:

- declining economic output
- shrinking margins
- difficult to believe we have hit bottom
- lack of debt financing
- buyers hoarding cash
- increasing role of government

Most Probable Near-Term Transactions

- distressed situations because of failed business models
- sales of core and non-core assets to raise cash
- industry consolidation, which may be forced by government
- opportunistic transactions
- life cycle transactions

Duties of the Board

- Duty of Loyalty – directors must act in the best interest of the corporation and avoid conflicts between duty to shareholders and self interest
- Duty of Good Faith – directors must act honestly and in good faith in the corporation's best interests
- Duty of Care - "prudent person" standard; directors must act as an ordinarily prudent and diligent person would under similar circumstances and on a reasonably informed basis

Important Board Considerations

Board should:

- actively participate in the decision-making process
- seek to inform itself of all relevant factors
- have independent director approval of self-interested transactions
- ratify self-interested decisions with a shareholder vote

Courts Will Consider

- level of diligence exercised by the board
- attendance of meetings
- frequency of meetings
- knowledge of the subject matter
- amount of time spent deliberating
- requests for information from management
- disclosure by management of material facts
- reliance on high-quality advice from financial and legal experts

Practical Application - Strategy Development Stage

- receive communications about deals
- facilitate risk identification and assessment
- advise on potential integration issues

Valuation

- Cost Approach (Adjusted Balance Sheet Approach)
  - begins with historical cost balance sheet
  - restates historical cost to market value
  - valuation analysis is performed for the company's identified fixed and financial assets and liabilities
  - derived aggregate value of assets is netted against estimated value of existing and potential liabilities to derive value

Valuation (continued)

- Market Approach (Comparable Company Approach)
  - based on market valuation of comparable public companies
  - estimates the subject company's value as a publicly-traded entity
  - private companies discounted for lack of marketability

Valuation (continued)

- Income Approach (Discounted Cash Flow Approach)
  - estimates future EBIT based on historical operating performance and anticipated growth
  - factor in taxes, capital expenditures and working capital requirement to determined free cash flow
  - estimates terminal value at end of projection period
  - calculates value as the sum of the present value of the free cash flows and the present value of the terminal value, discounted at the weighted average cost of capital

Valuation (continued)

- Other Considerations
  - Synergies
  - Non-recurring items
  - Cyclicality
  - Minority interests
  - Tax attributes
  - Control premiums

Letter of Intent

LOI is a non-binding agreement in principle and should include provisions addressing:

- how due diligence review should proceed;
- binding confidentiality and non-solicitation agreements that survive;
- payment of the purchase price (timing and amount) and any hold-backs;
- earnouts;
- whether Seller is free to continue negotiations with others (no-shop clauses);
- detailed timelines for various stages of process;
- prohibition on press releases, publicity or notices of any kind without prior written consent of both parties.

What is Due Diligence?

- fact-finding process about the target company
- utilizes both internal and external assistance to identify strengths and weaknesses of the target
- used to assess or confirm a believed value for the target company and the business reasons for the proposed transaction
- should include discussions with key members of management as well as a review of publicly available information
- always conduct due diligence with an eye toward integration

Why Perform Due Diligence Procedures?

- to understand the company
  - how does it make money?
  - who are its partners and significant suppliers?
  - how is information shared in the organization?
  - what control procedures exist?

Why Perform Due Diligence Procedures?

- to discover liabilities and assets
  - hidden liabilities
  - potential liabilities
  - elements of incremental value
  - potential post-acquisition integration issues

Why Perform Due Diligence Procedures?

- to map a path to closing
  – Which contracts will survive?
  – Where are consents required?
  – What permits need to be transferred or assumed?
  – Which contracts will require modification?

Why Perform Due Diligence Procedures?

- form a recommendation as to whether or not a proposed transaction should go forward with or without modifications
  - structure
  - pricing
  - other terms

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Practical Application – Valuation/Due Diligence Stage

- assist with valuation
- assist with due diligence
- facilitate the work of external consultants
- review target's internal audit function
- follow-up

Structure of Transaction

- Stock Purchase
  - acquire all liabilities of target
  - fewer contractual or governmental consents required
  - generally easier to document
- Asset Purchase
  - leave liabilities with target
  - may require more governmental and contractual consents
  - sales tax issues

Structure of Transaction

Types of Consideration

- Cash
  - fixed value
  - may need to be borrowed or raised through loans, debt or equity security issuance
  - potential issues of delay
- Equity Securities
  - attractive to public acquirers with high market valuations
  - attractive to some sellers for tax purposes
- Assumption of Debt
  - ability to assume debt will be limited by debt documents and lenders
  - need to review change of control provisions in all debt instruments
- Seller Financing
  - can bridge valuation gaps
  - needs to be structured properly
- Contingent Consideration ("Earn Outs")
  - best when viewed as a minor portion of total consideration – 10% or less
  - clarity in calculation is key

Purchase Agreement

- Seller wants to maximize valuation and the likelihood of close
- Buyer wants to minimize price and lock up the deal while retaining the flexibility to exit

Purchase Agreement (continued)

Function of the Purchase Agreement:

- identifies principal financial terms
- sets the legal rights and obligations of the parties
- provides a detailed description of the property being acquired
- provides remedies
- allocate risks

Purchase Agreement (continued)

Main Components

- representations and warranties
- covenants
- conditions
- indemnification
- schedules

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Financial Statements Required

Significance Level	Financial Statements Required
20% < individual acquisition ≤40%	most recent fiscal year plus interim periods
40% < individual acquisition ≤ 50%	two most recent fiscal years plus interim periods
50% < individual acquisition	three most recent fiscal years plus interim periods
aggregate of individually insignificant acquisitions acquired since the date of the most recent audited balance sheet filed for the registrant > 50%	most recent fiscal year plus interim periods for a "substantial majority" of the businesses acquired

Significance Tests

$$\text{Investment Test} = \frac{\text{investment in business acquired}}{\text{purchaser's total assets}}$$

$$\text{Asset Test} = \frac{\text{purchaser's share in assets of business acquired}}{\text{purchaser's total assets}}$$

$$\text{Income Test} = \frac{\text{purchaser's equity in the income from continuing operations of the business (before income taxes, extraordinary items and cumulative effect of a change in accounting principal)}}{\text{purchaser's total income}}$$

Exceptions to Financial Statement Requirements

Rule 3-06 - nine months deemed to satisfy one year requirement if:

- issuer has changed its fiscal year
- issuer has made a significant business acquisition
- SEC permits such treatment under Rule 3-13

Exceptions to Financial Statement Requirements (continued)

Rule 3-13 - permission to omit specified financial statements can be granted by SEC

- request must be made in writing to Chief Accountant's Office
- within SEC's discretion to grant waiver considering the following factors:
  - any material impact on the financial statement presentation to investors
  - whether omission will prevent a fair and material disclosure of the financial information with respect to the transaction
  - if omission is inconsistent with the SEC's stated goal of the protection of investors
  - ability of current stockholders or potential investors to evaluate the transaction or its impact to the Company without information omitted

Exceptions to Financial Statement Requirements (continued)

Post Acquisition filings – where financial statements of acquired business are not of major significance:

- previously filed financial statements of an acquired business need not be presented once the acquired operations are included in at least nine months of post-acquisition audited results unless the acquisition is of *major significance*
- test of major significance:

Significance Level	No previous financial statements required if included in audited financial statements of business
70% - 79.9%	≥ 21 months
≥ 80%	≥ 33 months

Practical Application – Documenting the Transaction

- gather information for acquiror (if target)
- prepare schedules (if target)
- review schedules from a risk perspective
- identify and reconcile differing accounting methods

Post-Acquisition Integration

The main objective of this stage is to ensure smooth integration of the operations of the target into the acquiring company to achieve the planned level of synergy.

Practical Application – Post Acquisition Integration

typically where internal audit has the highest level of involvement

- play advisory role
- audit the integration process
- regulatory compliance
- audit planning

Role of Internal Auditors in M&A Process

- Traditional role is to enhance value preservation through a control focus.
- To add value during the M&A process, internal auditors will need to assume a role that is:
  - proactive
  - risk-based
  - consultancy oriented

What do Internal Auditors Need to be able to Contribute to the M&A process in a Proactive Way?

- a good understanding of the various sources of risks presented by the proposed transaction
- knowledge of the operations of the entity being acquired
- good interpersonal skills
- risk management skills

Often Internal Audit is not Consulted in the Pre-Acquisition Stage. Why?

- timing
- target company resistance
- traditional roles
- availability

Best Practices

- head of internal auditing must intend to participate in specialized audit projects
- report directly to the board and audit committee
- identify risk areas, prioritize risk and create an overall risk profile of the target company
- utilize information learned in the risk analysis process as a basis for preliminary recommendations in future audits of post-merger entity
- understand control environment, reporting lines, information systems and structure of target company to enhance integration in the post-acquisition audit