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American Institute of Certified Public Accountants

Adventures in Mergers/Acquisitions & Joint Ventures

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By Edward M. Dudley, CPA, CIA, Vice President & General Auditor, ABB Inc., and Roger C. Sass, CPA, CIA, Director—Internal Audit, ABB Inc.

In 1998 there were approximately 9,200 mergers and acquisitions involving U.S. companies. These activities had a value of about 1.3 trillion dollars, representing a 13 percent average annual increase in the number of such individual transactions over the last three years. Joint ventures have become a key method utilized by companies to expand or strategically increase a segment of their business. As a part of this, some companies may want to grow fast and move quickly through mergers, acquisitions and joint ventures, sometimes failing to look at what they are buying or joining into.

Mergers, acquisitions and joint ventures can be methods used to allow companies to achieve company strategies (i.e., diversification, market entry, new technology, etc.). Companies need to carefully consider these approaches because of the large amount of time and monetary investments required, legal concerns that may arise and the potential consequences of possible over-diversification.

Principles of Engagement

In any merger or acquisition planning you need to understand what you are getting into (Do I go ahead? Adjust the price? Walk away?). This is your one shot to understand the business before you close the deal. You also want to reduce any post-acquisition surprises (what will we need to work on after acquisition; integration issues, personnel issues, obsolete equipment requiring replacement, warranty exposures, major contracts, customer base). An important key to remember is "It's not only the numbers!!"

In joint ventures, you need to pursue and understand strategic analysis before you commit (what are you trying to accomplish through the joint venture; does this really meet long-term strategic objectives?). For international joint ventures you must understand the local culture (identify risks, personnel issues) and make sure you understand how you must do business in that local environment. You also need to ensure the joint venture is aligned with your company's Corporate Strategy (What problems may occur in integrating the joint venture into your business?). It's also important to understand the specific competitive environment that the joint venture will be operating in as well.

In addition, selecting the right joint venture partner and what you are getting into with your joint venture partner is very important (will that partner help you with new business and local country issues?). In concert with that potential partner you also need to select the right location to do the joint venture (infrastructure, availability of resources/employees, political environment, etc.).

It is important to form the right team, including experienced professionals, key disciplines, including internal audit (the team needs to have multiple disciplines perhaps engineering, legal, accounting, internal and external audit, human resources, etc., specifically experienced senior staff). You need to set an appropriate scope based on size, and significance of specific mergers, acquisitions and joint ventures, also considering the time factor available to perform your review. It is important to read and understand all potential

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purchase agreements (what are you all acquiring, asset purchase only, assuming liabilities?). Team roles need to be clearly defined (meet prior to review and understand roles and all requirements of review). And of course you must always be persistent and skeptical.

Critical Issues

In any merger and acquisition you need to focus on financial statement issues (what is the potential exposure, understanding what you are buying) and the control environment (understand weaknesses and how this may impact future operations, what are the risks?). Additionally, a focus needs to be placed upon financial and operational integration concerns (will major restructuring and integration be required, how difficult will it be to integrate new acquisition into our business?). Also, information systems issues can be key areas of concern (compatible systems, major integration costs after acquisition, old equipment).

Other issues are marketing (will customers stay? What will it take to support customers?), legal (any pending suits and exposures?), business processes (do good processes exist? any integration concerns?) as well as human resource issues (combining different corporate cultures, handling downsizing of combined organizations and the potential of losing key personnel, differing benefit plans, etc.). In addition, are there any anti-trust regulatory/tax issues requiring analysis?

In joint ventures there are several things to be concerned about, in particular for international ventures: Local bureaucracy and red tape, local staffing, finding qualified people, development and training of local staff, local site evaluation (local availability, raw material availability, personnel availability, infrastructure issues) as well as cultural considerations (the need to understand cultural differences and how to react to them).

Other critical concerns are instituting strong financial and operational controls (usually lacking, especially in emerging markets), potential economic overheating (major financial devaluation), social upheaval, raw material shortages, lagging infrastructures (lack of roadways, waterways, other forms of transportation, etc.) and the financial ability of partners and/or customers of the potential joint venture.

In addition, after the joint venture has been formed, it is important to have continuous risk and life cycle analysis. Joint ventures change the longer you are in them and they go through various changes from start up to maturity. You need to continually monitor, as risks are likely to be different over time.

In planning for a successful joint venture, a decentralized approach to establishing joint ventures (handle at country level, not corporate) may be more appropriate, depending upon circumstances. You need to meet local business needs. It is also important to have integrated joint venture teams and a good skill mix on these teams (to be successful, you must support the local joint venture partner with technical and product skills). Likewise, one must not forget about linked communications, which move through your segments and divisions as well as your corporate headquarters.

Conclusion

Analyzing and understanding what you are getting into is very important with mergers, acquisitions and joint ventures. There are both risks and rewards, which must be carefully analyzed and understood. Of all the issues involved both you and your management should be interested in three (really only one).

"No surprises!!"

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"No surprises!!"

If you follow the premises above you should not get the question "Where were the auditors?" six months after the acquisition, merger or joint venture. The goal is to hear from your senior management "Excellent job!", "The key issues were identified and understood!", and "Job well done!"

Who's Afraid of a Little Conflict? Part I: "The Three Stages of Conflict and Resolution in the Warning Stage"

By Joan Pastor, Joan Pastor and Associates, International

It doesn't matter how well conflict is handled, it will never disappear. Even the best relationships have clashes. Anytime two people get together, there are bound to be some differences of opinion. There is good news, however. Conflict can be managed.

The Greatest Cause of Conflict

Conflict is a process, not a "happening." It is extremely rare for a person to sock someone in the nose unless provoked beforehand.

Many things cause conflict. When asked what they think the

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greatest cause of conflict is, people respond: "misunderstandings," "lack of communication" and "differences of opinion." While all of these certainly exacerbate conflict that already exists, the single greatest cause of conflict is *differing expectations.*

The Three Stages of Conflict

The critical first step for preventing conflict is taking time to get to know one another; to find out what is important to each person. If it turns out that our values lie on opposite ends of the spectrum, at least it's clear what the problem is. In such cases, interaction should be brief and stay on a professional level.

Let's say that you both share similar values/expectations, and you make a commitment. In the beginning, there usually is stability and growth in the relationship. If it is a professional relationship, you see productivity. At some point, however, you notice that something is not quite right, somehow you are not getting along, but you're not sure exactly why. You are now in the *first stage of conflict*. This is the "warning" stage. Often, getting together in a casual setting and talking about the situation can resolve the problem.

If the problem is not handled at this stage, the conflict will grow until the differences in expectations become clear. This is the *second stage of conflict* and is much harder to resolve. It means sitting down with the other person in a more formal manner and discussing each other's expectations. You should try to re-establish trust, which is the first thing to disappear when conflict arises. You need to find real solutions that will endure. If the conflict isn't resolved at this stage, then it will move to a third and final stage.

In the *third stage*, you either start fighting or you start ignoring each other. Either way, it still is possible to resolve problems in the third stage. You should use the same process that was used in stage two—talking out your problems in a professional manner. But you are now trying to resolve the difference under even more duress, and that is more difficult.

How to Resolve Conflict in the Warning Stage

When the warning stage occurs, there are two options: say nothing and observe or get involved right from the start. If you choose the first option and say nothing, it doesn't mean you're pretending the problem doesn't exist. It means you are waiting to gather more information before you approach the person. The advantage here, especially if you keep a log, is that you will have more facts to back you up if you need them. The disadvantage to doing this is that by the time you have gathered enough information, the problem will most likely have evolved into the second stage of conflict.

If you choose the second option and approach the person early on, you should keep your tone casual, and ask the person to join you for a quick (but private) meeting. Then explain how you feel, making sure not to blame anyone. Tell the person you want to get his or her feedback. The key here is to keep things casual.

At this early stage, showing emotions could look like you are making a mountain out of a molehill. If you stay low-key, sometimes you can easily work things out, and the relationship can regain its stability and trust. Sometimes you can't work things out, but at least you made the effort, which looks good in your files no matter what your position is in the company.

If a problem grows beyond the first stage of conflict—that is, simply recognizing that there is a problem—all your best communication, listening and negotiation skills will be needed to resolve it positively.

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The Board of Directors in the Closely Held Business—Part III

By Warren D. Miller, MBA, CPA-ABV, CMA, Beckmill Research, Lexington, Va.

In the previous two installments in this series, we covered a wide range of issues related to outside directors (or a "council of advisers") for a closely-held business. In this concluding piece, we discuss why the owner(s) should be in a voting minority, the mix of insiders and outsiders, committees within the board or council, advantages and disadvantages of outsiders, and corporate governance itself.

Majority Owners in a Board Minority?

If the group of outsiders is to make a substantive contribution, there must be enough of them to outvote the owner(s). Therefore, the owner(s) should be in the minority on the board or council. That might be difficult for those who are used to having their own way.

Why? We have observed many owners, especially those with long tenure, who confuse *having* rights with *being* right. Opposing a majority on one's own board offers the possibility that what is often a benign dictatorship heavily dependent on the vision and viewpoint of one person may, in fact, evolve to become a company that survives for generations.

Few do. The failure to initiate an independent system of corporate governance is a major reason. After all, the first responsibility of any board of directors is hiring (and, on occasion, firing) the CEO. Outsiders can usually make that decision more objectively than a founder/owner who has nurtured his/her "baby" through thick and thin.

Cynics will argue that owners can always call a special meeting of shareholders and vote in new directors. In our experience, however, that won't happen if the owner is committed to the process and if capable professionals who aren't golfing buddies or next-door neighbors comprise the cadre. Those who have built their own businesses (and have the scars to prove it!) can be invaluable.

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The Right Mix of Insiders and Outsiders

Equally important is the number of people on the board or council. It should be as small as possible, but it should be an odd number to avoid tie votes. In our experience, five or seven are numbers that work well. Three is too few, nine is too many.

Including one (and only one) close friend of the owner is desirable. This is the person who can speak candidly to the owner on the golf course, at the gym, or just sitting out in the backyard. We have a client whose second-generation sole shareholder chose to activate a full-blown independent board. But he wanted one close friend on it. The friend, a successful fellow who had built and sold several businesses, has turned out to be the key board member, the one who can talk to the shareholder in ways the other directors cannot.

The temptation for some owners is to stack the board with close friends. We discourage that. The best board members are independent, unencumbered by previous ties to the owner. That independence allows them the freedom to ask the questions that need to be asked and cast the votes that put the business ahead of the family. It is when the family takes priority over the business that family businesses go astray.[1]

Committees and Meeting Frequency

Depending on the size of the company and of the board or council/panel, the group might need to create special committees to address particular needs and issues. Those are often ad hoc; in larger private companies, an audit committee and an executive committee are common subgroups of the board of directors.

Most private boards meet quarterly for a day. One meeting annually might extend to a second day, depending on economic volatility, capital spending, and the like. Top managers, especially would-be successors to the top job, should make occasional presentations to the board or council/panel. This familiarizes the second tier of managers with the board (or council) and vice versa. Over time, the twin notions of independence and professionalism become part of the company's culture.

Tenure and Terms of Office for Directors (or Advisers)

The directors of most public companies serve for three years. In the wake of the hostile-takeover wave of the 1980s, many companies revised their bylaws to provide for staggered terms for directors. Private companies are not subject to hostile takeover, per se, though problems servicing large debt loads can result in lenders' "workout" professionals, in effect, taking over the management of a company.

Nonetheless, we see real benefits in staggered terms for boards of directors or councils of advisers of closely-held companies. For one thing, a director/advisor not attending or making substantive contributions can be eased out at the expiration of her/his term without undue embarrassment. For another, we recommend term limits for directors/advisers. Some readers may wonder why.

On its face, the twenty-second Amendment to the U.S. Constitution mandates a maximum of two terms for our nation's president. However, the Amendment also provides for how to count tenure when a vice president succeeds to the presidency. So long as a vice president does not serve more than two years of a president's unexpired term, she/he can be elected to two full terms (in addition to the two years). A president can, therefore, serve for as long as ten years.

It is our strong belief, which is also supported by research,[2] that what is good enough for the CEO of the largest, freest, and most prosperous nation history has ever known is a worthy guideline for American business, too. Accordingly, we recommend a limit of three three-year terms. Writing that into the corporate bylaws allows for orderly transition, recruiting replacements, and avoiding bruised feelings and wounded egos. It works.

Benefits and Drawbacks of Outsiders

Non-family outsiders offer pluses and minuses. The benefits include external perspectives, viewpoints different from the owner's, financial independence from the owner, experience in arenas where the company is weak, and the ability to speak to the owner as a peer. The absence of hierarchy in the latter is especially important.

However, it takes time for a board of outsiders or a council of advisers to achieve effectiveness. Developing familiarity, confidence, and trust among outsiders who might not know either the business or each other takes a while. In more-insular company cultures, long-time employees may be threatened by, or resentful of, a group of outsiders whom they don't know. Such outsiders will raise questions that insiders long ago quit asking. Their queries will be disruptive—and needed.

Closing Words

A group of outside advisers, whether on a board of directors or a council (or panel), can be invaluable to a privately-held company. This group is a key aspect—some might argue the key aspect—of corporate governance, a topic that gets short shrift in many closely-held businesses. But those who want their businesses to survive beyond one generation must deal with it. Sooner is better than later.

Remember, the higher the growth rate and/or the faster the rate of change in the company's industry, the more such a group is needed. In times of crisis, members provide continuity and stability. They also provide guidance for that most important of questions in any business, family or public—succession.[3]

For more information, contact Warren Miller via e-mail at wmiller@beckmill.com or phone 540/463–6200.

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[1] Family-driven succession disasters at companies such as Wang Laboratories and Crown Publishing are key chapters in the how-not-to-do-it archives of family business history. So, too, are the protracted intra-family courtroom dramas between the Kochs of Wichita, the Dorrances of Campbell Soup, the Binghams of Louisville, and the du Ponts of Wilmington.

[2] See "Stale in the Saddle: CEO Tenure and the Match Between Organization and Environment" by Danny Miller, *Management Science* (1991), Vol. 37, pp. 34-52. This is a fascinating study about how the "fit" between organizations and their environments deteriorate as CEO tenure lengthens, and the declines in organizational performance that result from that deterioration.

[3] For an interesting case study, see my article, "Siblings and Succession in the Family Business," *Harvard Business Review*, January–February 1998, pp. 22+.