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CFO Insights

Deal or no deal: Can busted M&A deals be avoided?

It is one of a CFO's worst nightmares. A possible acquisition is identified; initial due diligence is completed; a price is negotiated; an acquisition deal is signed; and then for some unforeseen reason, the deal falls apart. Why? And, more importantly, could the nightmare have been avoided?

There are a variety of reasons for M&A deals to terminate. Negative shareholder reaction. Antitrust concerns. Unexpected market forces. But no matter what the cause, a busted deal is costly in terms of time, money, and lost opportunity. How often does this actually happen? According to recent data from Standard & Poor's Capital IQ, last year some 639 deals — where the target, buyer, or seller was U.S.-based — were terminated.[1] And new academic research finds that there may be one factor explaining the frequency of M&A deals going bust: the target's low quality financial reporting.

That research, conducted by Professor Hollis Skaife from the University of Wisconsin-Madison (a Deloitte Fellow and Scholar[2]) and Daniel Wangerin of Michigan State University and scheduled to be published in the leading academic journal *Contemporary Accounting Research* in its Spring 2013 issue,* assessed the quality of targets' financial reporting. In the study, the researchers introduce a metric called the "LQFR score" that captures low quality financial reporting. That score correlated with higher deal premiums in the initial offer as well as a higher likelihood of deal renegotiation and terminations (factors that potentially wipe out those higher premiums) for some 1,638 deals announced between 2002 and 2008.[3] And in their sample, 15 percent of publicly announced M&A deals ended up failing[4] — with the marginal effect of LQFR increasing the likelihood of failure more than nine percent.

In this issue of *CFO Insights*, we will introduce the research by Skaife and Wangerin and consider what impact low quality financial reporting may have on the outcome of M&A deals. In addition, we will highlight the elements of the LQFR score that help explain why some deals go bust.

What you don't know can hurt you

One of the strengths of the U.S. capital markets is the relatively little restriction on M&A. Other markets, for example, restrict foreign ownership or have different policies related to hostile takeovers. But in the United States, acquirers looking to increase their market share, enter new markets, or diversify their operations can size up targets and take ownership approaches that range from simply gaining a toehold to a hostile takeover.

For the potential acquirer, though, pursuing a deal takes a bit of a leap of faith. If a target is a U.S. publicly traded company, a buyer's initial assessment of the potential benefits of the acquisition is based on publicly available information, such as Securities and Exchange Commission filings, analyst reports, or press releases. For the most part, the acquirer receives limited private information prior to negotiating a price and announcing the deal. But through transactional due diligence after signing the acquisition agreement, the buyer gets to affirm that the financial reporting warranties made by the target are in accordance with U.S. Generally Accepted Accounting Principles (GAAP).

*The full research study — "Target Financial Reporting Quality and M&A Deals that Go Bust" — is to be published in the Spring 2013 edition of *Contemporary Accounting Research.*

It is at that point, Skaife and Wangerin contend, that targets with low quality financial reporting often are exposed — and where deals can go awry. Transactional due diligence, for example, gives the acquirer a window into the target's financial records (e.g., accounting estimates, revenue recognition policies, significant valuation accruals) and contracts (e.g., lease agreements). In addition, acquirers get to compare the representations made in the acquisition agreement to the original data and test their veracity. And if in those reviews a breach is discovered, then the acquirer has the option of renegotiating the deal or walking away.

What Skaife and Wangerin's research found is that targets having low quality financial reporting (calculated by a five-part metric and regression analysis) increases both the likelihood of deal renegotiation and contributes to the possibility of deals going bust. In addition, the study — which is the first to explore financial reporting restatements in M&A — found that failed targets that had low quality financial reporting also had a higher propensity to restate their financials in the wake of the failed deal.

For CFOs, the implications may be far reaching. When a target has low quality financial reporting, it contributes to greater uncertainty about the company's expected future earnings, as well as potentially greater operating risk for the acquirer, thereby increasing the acquirer's cost of capital. Consequently, CFOs should be prepared to aggressively root out low quality financial reporting prior to a deal and to weigh its influence on their final decision about whether to proceed with the offer — and at what price. (see sidebar: "Evaluating Financial Reporting Quality: Questions CFOs Should Ask.")

What is *LQFR*?

But how do you tell if a target has low quality financial reporting? The research introduces a specific measure — *LQFR* — that combines variables previously associated with less-reliable financial reporting and then relates *LQFR* to deal outcomes and financial statement restatements by the failed target. Specifically, *LQFR* includes:

1. **Magnitude of discretionary accruals**[5] — This measure captures both unintentional errors, which result in more noise in financial statements, and earnings management, which results in biased financial statements. So, for example, if companies are accelerating revenues, it may suggest that their financial statements are less reliable.

2. **Likelihood of a weakness in internal control**[6] — Recent research suggests that companies with ineffective internal controls over financial reporting have less reliable financial information. Accelerated filers are required under Sarbanes-Oxley Section 404(b) to have their external auditor attest to the effectiveness of their internal controls, and report material weaknesses in internal controls in their 10-K filings. Non-accelerated filers are exempted from SOX 404(b) internal control reporting requirements, so there is no public disclosure of material weaknesses in internal controls. However, based on prior research, Skaife and Wangerin estimated the likelihood of companies having material weaknesses in internal controls — which is a function of, for example, the number of segments, engaging in foreign sales, reporting losses, incurring restructurings, and resignations of the independent auditor — and included this in their LQFR score.

3. **Off-balance sheet liabilities**[7] — Acquirers are usually concerned with liabilities that may not be on the target company's balance sheet because once the deal settles, they may be held responsible for those liabilities — or, at minimum, those liabilities appear on the parent's consolidated report. As such, off-balance sheet liabilities could potentially put the parent entity at risk of violating debt covenants, renegotiation of debt, or constrain future borrowing. An estimate of unreported or under-reported liabilities is included in Skaife and Wangerin's LQFR score.

Evaluating financial reporting quality: Questions CFOs should ask

One of the takeaways from the Skaife/Wangerin research is that CFOs should gain a good understanding of the target's financial reporting and internal control structure early in the M&A process. Evidence of low quality financial reporting or flaws in the control environment can lead to increased transaction execution risk. Even without the ability to fully assess the target, CFOs can identify potential issues driven by low quality financial reporting early in the M&A process, says Steve Joiner, managing partner for the Southeast M&A Transaction Services group at Deloitte & Touche LLP. He suggests asking the following sample questions:

1. Have your auditors noted any significant or material weaknesses in your financial reporting or internal control structure? If the target has not been audited, would the target agree to be audited prior to closing?

2. During prior audits, what adjustments and reclassifications, if any, were proposed to the financial statements? What were the causes of those adjustments and reclassifications and were they corrected? Also, were the adjustments and reclassifications reflected in the interim financial statements?

3. Were material out-of-period earnings or expenses recognized in the last 12 months? Why were these earnings/expenses not accounted for in the appropriate periods? In the past, have accounting errors been identified that required restatement of your financial statements?

4. How detailed is your budgeting and forecasting process? Historically, have your budgets been reasonably accurate?

5. How do your general and administrative (G&A) costs compare to competitors? Is your company truly leading in efficiency and controlling costs or are corners being cut?

"The target obviously has a responsibility in the deal process to provide reliable financial statements," says Joiner. At times, though, a target will not have the financial reporting capabilities to produce such statements, he adds.

With public targets, it is often easier to root out red flags associated with, say, quality of earnings or the uses of working capital, since they generally have robust financial reporting processes in place to comply with regulations and to meet the timely reporting requirements. But whether the target is public or private, buyers can protect themselves through broad due diligence and also utilize protection vehicles, such as seller representations and warranties provided in the purchase and sell contracts. In these cases, targets will represent, for example, that their reserves are properly stated in all material respects. The buyer also can require that a certain amount of the proceeds be held in escrow until accounts can be properly verified or until contingencies lapse. Of course, says Joiner, "Buyers can always walk away from the deal if they are not satisfied the information required to support their investment decision is reliable."

Finally, the CFO, through his or her team, also has a responsibility to the buyer's stakeholders that the target has been adequately assessed and evaluated, including the financial reporting aspects. "As the organization's financial leader, CFOs should validate that the desired value metrics of the target – cash flows, customer base, geographic diversity, etc. – are in order," Joiner observes. "In addition, they should be comfortable that the basic information provided is appropriate to move forward with the deal." Achieving this comfort level begins with asking the relevant questions as early as possible in the process.

4. **Analysts' forecast error**[8] — More persistent earnings ultimately translate into more constant cash flows. Skaife and Wangerin include the absolute value of analysts' forecast error in their LQFR score, as lower forecast errors reflect more precise, persistent earnings.

5. **Analysts' dispersion**[9] — Based on prior research, Skaife and Wangerin incorporate analysts' earnings forecast dispersion into their LQFR score as greater analysts' forecast dispersion is a proxy for greater information uncertainty.

The first three measures are intended to capture noise and/or bias in financial reporting that affects the representational faithfulness of the target's financial statements. Greater magnitudes of these measures indicate less reliable, less relevant, low-quality financial reporting. The last two measures assess the precision of the target's financial information where greater analysts' forecast error and dispersion signal lower quality financial reporting. A company's LQFR score is calculated as the average of the decile-ranks of the five financial reporting quality variables. The average is computed as the sum of the firm's decile-ranks of the five measures divided by the number of financial reporting quality measures where data is available. The beauty of the LQFR score is that it does not require targets to have all five proxies of financial reporting quality (e.g., the LQFR score can still be calculated for the target company without analyst coverage). As such, LQFR can be calculated for almost any potential target.

Implications for CFOs on both sides

The research found other indicators of failed deals, as well. For example, hostile bids, deals with multiple bidders, and deals where the acquiring company has a minority interest (toehold) prior to the announcement were more likely to be terminated. In contrast, deals where the offer is made directly to target shareholders (tender offers) and where the target and acquirer operate in the same industries were more likely to be completed.

Still, the power of LQFR to predict failed deals speaks to the importance of obtaining detailed financial information as soon as a potential target is identified. There are no rules that forbid an acquirer from seeing covenants or revenue recognition policies before the acquisition agreement. And if the potential target is interested in getting a deal done, transactional due diligence can be escalated or accelerated. Basically, it does not hurt to ask.

Similarly, it behooves CFOs of target firms to improve the quality of their financial reporting in order to secure a smooth deal. The last thing you want to do as a target is enter into a potential M&A that fails. Aside from the possible restatement issues if you are publicly traded, your shareholders may be disappointed when the deal goes south.

Finally, the use of the LQFR score is not limited to M&A applications. It could potentially be used by CFOs in other situations, such as in evaluating joint ventures or in supply chain management. In those settings, the same formula can assist in making resource allocation or contract decisions.

Ultimately, a cost/benefit analysis

Potential acquisitions present multiple strategic opportunities such as expanding geographic locations, diversifying operations, or capturing market share. And for CFOs, it is easy to focus on the potential benefits and the financial upside. But what the Skaife and Wangerin study shows is that some targets may present greater costs than benefits. By identifying targets with low quality financial reporting early, however, CFOs can factor the potential added costs — of additional liabilities in consolidated reporting or less certain cash flows from target or combined operations — into either the deal price or tempered expectations of long-term benefits of the M&A and decide if the deal is one they should continue to pursue.

Primary Contacts

Hollis A. Skaife
Professor – Accounting and Information Systems/
Deloitte Scholar
University of Wisconsin, Madison
hskaife@bus.wisc.edu

Daniel D. Wangerin
Assistant Professor of Accounting and Information Systems
Michigan State University
wangerin@bus.msu.edu

Steve Joiner
AERS Partner
Deloitte & Touche LLP
sjoiner@deloitte.com

Ajit Kambil
Global Research Director
CFO Program
Deloitte LLP
akambil@deloitte.com

Deloitte *CFO Insights* are developed with the guidance of Dr. Ajit Kambil, Global Research Director, Deloitte CFO Program, Deloitte LLP, and Lori Calabro, Senior Manager, CFO Education & Events, Deloitte LLP.

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Endnotes

[1] Standard & Poor's Capital IQ, December 2012.

[2] The Deloitte CFO Program Fellows and Scholars Initiative develops Deloitte Partners/Principals/Directors ("Fellows") and attracts professors ("Scholars") from Deloitte strategic universities to increase the eminence of Deloitte by publishing CFO-relevant thoughtware.

[3] "Target Financial Reporting Quality and M&A Deals that Go Bust," *Contemporary Accounting Research*, Spring 2013, forthcoming, pages 12-14.

[4] "Target Financial Reporting Quality and M&A Deals that Go Bust," *Contemporary Accounting Research*, Spring 2013, forthcoming, pages 12-14.

[5] Dechow, P. M., R. G. Sloan, and A. P. Sweeney. 1995. Detecting earnings management. *The Accounting Review* 70 (2): 193–225.

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[8] Lang, M., and R. Lundholm. 1996. Corporate disclosure policy and analyst behavior. *The Accounting Review* 71 (4): 467.

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