

## Aligning your financial close to the transaction close Effectively executing the dreaded partial period close

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The execution of the fiscal period-end financial close and consolidation processes is one of Finance's most important and visible fiduciary responsibilities. Providing timely and accurate financial statements becomes even more difficult when integrating a newly acquired business—a situation further complicated by the timing of the transaction close and the integration approach.

Some companies attempt to time the transaction close date to correspond to their fiscal month end to avoid complications. Although this is a noble goal, various difficult-to-control factors, such as shareholder approval, funding, and regulatory approval, can cause the transaction close date to move around. (See case study: Trying to hit a moving target.)

It's crucial that your Finance organization knows how to handle the mid-month transaction close from an accounting perspective when an additional off-cycle or mid-month close is needed to create a stub accounting period and to align fiscal periods. Analysis of publicly available data showed that about 80% of more than 300 transactions (deal value over \$1 Billion) completed globally during calendar year 2008 were closed during the middle of the month.

This article explains the drivers behind a mid-month close, cut-off options, and the decision process you should consider when evaluating your options.

### Assess the drivers for your financial cutoff

As of the transaction close date, a clean cutoff is required in order for the existing business to shut down and the new company to begin operations as a new entity. A clean cutoff is expected to facilitate:

- Accountability for recognizing financial performance (such as reconciliations between shipments and attributes related to the cash conversion cycle).
- Determination of the purchase price of an acquisition based on balance sheet attributes.
- Ability to perform required asset valuation and purchase price allocation activities.

- Identification of tax obligations of acquirer and target.
- Establishment of clear ownership of existing debt obligations assumed by the new company.
- Creation of auditable financial statements with appropriate controls, balances, and detail.

### Case Study: Trying to hit a moving target

Coordinating a deal close date with a fiscal month end is usually not possible. It's not unusual for a target close date to move several times before the deal actually closes. In this real-life scenario, the communicated transaction close date moved three times before the deal finally closed. This is how the complications unfolded:

- **Shareholder approval:** Shareholder meetings are typically not set in stone. In this company's case, the meeting was moved out a week due to reasons unrelated to the transaction. This caused the target close date to move correspondingly.
- **Funding difficulties:** Due to uncertain economic factors, difficulties in repatriating cash from foreign entities, and debt issuance related to the acquisition, the acquirer fought to push out the transaction close by two weeks, which was the second delay.
- **Regulatory approval:** When it comes to government or regulatory approval, deals are often at the mercy of the regulating bodies. Although the acquirer received Hart-Scott-Rodino clearance from the U.S. Department of Justice, the members of the European Commission asked the acquirer to delay the filing for an additional month while they reviewed the details of the deal and its industry impact. This hurdle caused a third delay in the close date.

Delays caused by shareholder approval, funding, and regulatory approval contributed to the movement of the transaction close date on three separate occasions, eventually pushing it out by two months.

For Finance, it is almost always preferable to have the transaction close date align exactly with a period end close; the preparation, planning, and documentation associated with a mid-month close can be daunting. If you can satisfy all the organizational requirements, avoid a mid-month close if you can. However, more often than not there are legitimate and sound business reasons why this situation simply cannot be avoided.

Typically, the drivers for a financial cutoff fall into two groups: accuracy and reasonableness.

### Examples of the need for an accurate cutoff

**Acquisition price based on the ending balance sheet:** In a deal between two pharmaceutical companies, the acquirer purchased a manufacturing business from the target, including fixed assets, inventory, and prepaid leases. They needed an accurate cutoff to ensure that the valuation (and thus the purchase price) corresponded with assets on hand as of the transaction close date.

**Carve-out of a business from the parent company:** In the same deal, the target owned the financial performance of the business up to the transaction date, and the acquirer assumed responsibility thereafter. They needed pro-forma financial results reported in the respective public filings of the acquirer and target companies.

### Examples of the need for reasonable cutoff

**Full merger (or 100% acquisition):** For tax and statutory reporting requirements, there must be an end point when the individual companies shut down and the newly formed company begins operations. In this case, as long as there is a directionally correct cutoff, and financial results and tax obligations are reported reasonably, the cutoff should be acceptable.

**Independent audit requirements:** Auditors provide assurance/opinion on financial statements as of a certain date. The rigidity of the cutoff may depend on the internal controls in place and other factors influencing the auditor's comfort level. These will dictate whether a reasonable cutoff is acceptable.

**Non-public companies:** Since the audience of external financial reporting may be limited to non-regulatory agencies (lenders, joint venture partners, etc.), the acquirer's management team members have more discretion to dictate their desires for the cutoff date.

It's important that you first understand the drivers behind your company's transaction. These will determine which cut-off options are available to you.

### Evaluate your financial cut-off options

If you find that there's no way to avoid a mid-month transaction close after assessing the transaction drivers, then you must evaluate your options. We commonly see two options, listed below, for dealing with a mid-month M&A transaction. Each option has its advantages and disadvantages. (See box: Cut-off Options, Pros and Cons.)

**Mid-month hard close.** Perform all the steps as you would during a normal month-end close cycle: cutoff financial activities on the transaction date, close out the ERP and related sub-ledgers and feeder systems, perform accruals, and publish a set of financial statements for the period ending on the transaction date.

**Mid-month soft close.** Use the prior fiscal month-end financial statements as a starting point and build forward, using transactional data and required balance sheet adjustments up through the transaction close date.

	Advantages	Disadvantages
Mid-month Hard Close	<ul style="list-style-type: none"> <li>Financials are accurate.</li> <li>Existing internal controls are leveraged.</li> <li>Normal close and consolidation cycle are consistent.</li> </ul>	<ul style="list-style-type: none"> <li>Systems testing and set up work.</li> <li>Finance staff must perform an additional close cycle.</li> <li>Offline, manual processes may have to be utilized to compensate for system limitations.</li> </ul>
Mid-month Soft Close	<ul style="list-style-type: none"> <li>Few changes are needed to regular month-end close cycles.</li> <li>Few adjustments are needed to existing systems.</li> <li>Fewer resources are required.</li> <li>Approximate estimate of ending balances and results is directionally correct.</li> </ul>	<ul style="list-style-type: none"> <li>Financials may not be 100% accurate</li> <li>Additional controls may be required to satisfy external audit requirements.</li> <li>May not be acceptable for financial reporting on stand-alone entities.</li> </ul>

### Selecting the most appropriate option to adopt

So how is the choice made? The Finance and IT organizations must work together to evaluate options since the one ultimately chosen can dramatically impact the work effort of both groups. Here are the questions that must be answered.

**Hard or soft close?** The first criteria should be the degree of accuracy needed and the risk of not closing the books correctly, which can lead to inaccurate financial statements, weakness in controls, and loss of historical and comparative data, among other things. Answering this question can help you quickly decide on the need for a hard or soft close. Generally, the need for a high degree of accuracy and desire to mitigate overall risk will dictate the choice of a hard close.

**What are the risks?** The next step is to prioritize the cut-off options by weighing the risk of an inaccurate close. An incorrect accounting close could lead to inaccurate financials being released to the public, future restatements, and loss of historical and comparative data, etc.

**Can Finance and IT handle it?** Weigh each option based on the demands it will place on Finance and IT and decide whether the organizations have the bandwidth available for implementation. For example, a close with high IT involvement would lead to a more automated close process, whereas heavy Finance involvement with low IT support would lead to a manual close process.

**What are the other risks?** Weigh the risk of each cut-off option using the following criteria:

**Impact on business operations:** How will the business (non-finance groups) be affected? Will they have to do anything different to accommodate the option? Will it affect the order to cash or procure to pay processes in any way?

**Impact on financial close:** What is the level of effort required of the Controllings staff? Will there be a need for offline/one-off processes to accommodate the option?

**Adjustments to financial systems:** How will the ERP need to be adjusted? Can the ERP accommodate adjustments without code changes? What is the level of testing required? Will it put the ERP at risk and necessitate a robust backup plan? Are there other boundary systems or databases impacted?

**Resources required:** What are the additional technical, finance and business resources required to execute this option? Where will the monetary and people resources come from? How much time will there be before the next close?

**Impact to other systems:** How does this option affect other systems besides the ERP? Can the other systems accommodate this option? What is the level of testing?

**Level of effort and time to implement:** How long will it take to implement the option? Will it cause undue strain on staff and take focus away from other pressing needs related to the acquisition or normal course of business?

Mechanics and the overall workload for executing a mid-month close can vary based on the decision for a hard or soft close. So it is important to carefully consider all the available options and requirements for necessary changes to the close process and related systems before you go down any path.

**Case Study: Choosing a mid-month close option**

Two companies in the media and entertainment industry agreed to a merger. They choose a transaction close date in the middle of a fiscal month; it was up to the Finance organization to execute this mid-month close.

Several options of hard and soft closes were identified, including copying the target’s ERP, changing the calendar date in the ERP, and even potentially stopping the shipment of products during the first 10 days of the month.

Key considerations included limiting the impact on the business stakeholders, close process, and boundary applications. In addition, due to the timing, the acquirer considered the availability of key resources and the effort that would be required to make complex changes to the financial systems. After carefully evaluating all of the options, the decision was made to perform a soft close by cloning the ERP production environment.

Below is a summary of the process they followed to perform the soft close.

These steps allowed the acquirer to continue ongoing operations with little impact to their ERP production environment while preserving historical pre-merger data.

**Pros**

- Created a ‘clean balance sheet’ for the mid-month transaction close date
- Provided the ability to run reports pre- and post-merger dates
- Offered an audit trail for pre- and post-merger dates
- Allowed the Finance organization additional time to perform close activities without impacting the ERP production environment

**Cons**

- Required additional set up in the financial systems for allocating PTD and YTD balances for pre-merger historical data
- Required extensive testing by the Finance team
- Required updates to system-generated reports

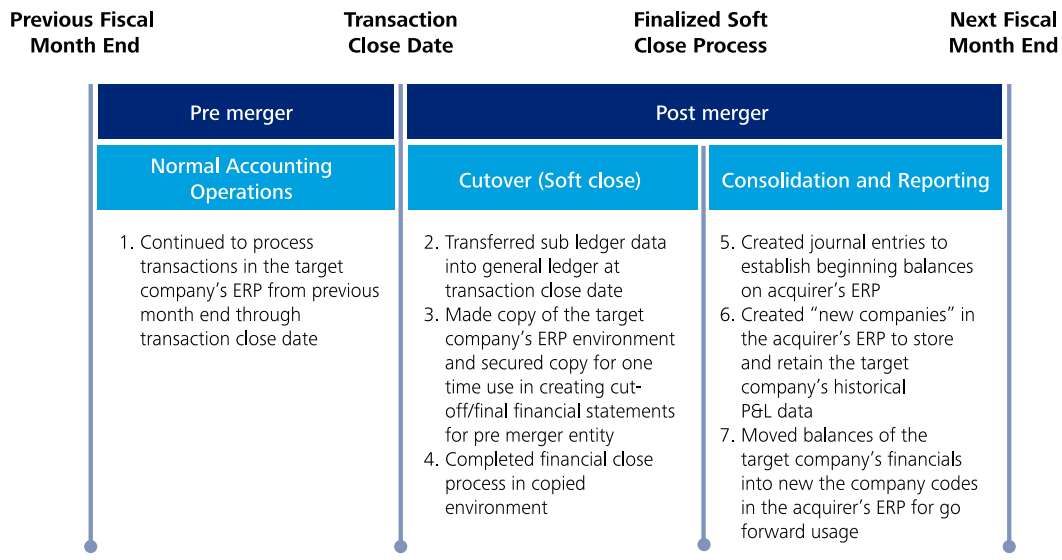
**Lessons Learned**

Keep these tips in mind as you consider implementing a mid-month transaction close date:

**Decide early.** Clearly identify all the options and make your selection early in the process. This will allow time to change course if the option goes awry during the early stages of planning and execution.

**Be sure to test.** System changes and newly designed processes should be tested. Typically, the fiscal month end prior to the transaction date is a good time to perform a dry run/mock close.

**Don’t underestimate resource needs.** These are uncharted territories for you and your staff. Even if you’ve been through other transactions, no two deals are alike. Closing the books will be tougher than expected—so plan accordingly.



**Keep an eye on internal controls and reporting.** Although the mid-month close process will only be performed once, be sure that acceptable controls and reporting are in place. Otherwise, you may be left with historical comparative reporting and reconciliation challenges for many months to come.

**Document, document, document.** Document the new process so it is transparent, clearly understood by everyone involved, and available to internal and external auditors during their next quarter-end fieldwork.

Have a backup plan in place. Nothing is worse than having all your eggs in one basket. Make sure that if your first choice option fails, you have something to fall back onto. Remember, transaction close dates frequently change at the last minute.

### Summing it up

More than likely, you'll be faced with executing a mid-month close related to a M&A transaction, no matter how hard you may try to avoid it. Upfront planning is the key to successfully pulling off this important and highly visible feat.

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