

Financial Consolidation After a Merger Choosing the right approach for the job

By Trevear Thomas, Miles Ewing, Patricia Kloch and Mayci Cheng

While the current economic environment and the credit crunch has significantly slowed down the Private Equity Merger & Acquisition (M&A) market, this is hardly the case for strategic buyers who have cash and are looking for strategic growth opportunities. While it may be counter-intuitive to focus an article on M&A given today's gloomy economic forecasts, it is highly likely that healthy companies who have not been serial acquirers to date may decide to take advantage of some great buys of businesses from companies who are not so well positioned and whose market value may be at an all time low.

For Finance executives preparing to "take the plunge" for the first time, few tasks in business are as challenging – or ulcer-inducing -- as the first financial close after a merger. As a CFO, you're under pressure to get it done fast. Of course, you're also expected to get it right. It's the main event – and everybody's watching. Investors. Analysts. The media. Trip up and everyone will assume your company doesn't know what it's doing. They might even conclude that the whole merger was a big mistake.

In tackling the challenge, one of your most critical decisions is deciding what approach to use for the job. Should you rely on a legion of analysts armed with spreadsheets? Add a "consolidated" company code to your current ERP application and build a mapping interface? Implement a specialized consolidation tool? Bite the bullet and integrate both entities onto a common ERP system? Or take a hybrid approach in which you use a combination of an integrated tool and spreadsheets.

The right approach is critical. But which approach is right? The answer depends on your situation. You need a solution that addresses your immediate needs for the first close, but you also need a solution that can support the company's long-term strategy. This article offers a practical and time-tested framework to consider in your efforts to make a smart choice.

Challenges of a first close

The first close and consolidation after a merger presents a wide range of challenges. Many of these challenges seem pretty straightforward, which ironically is part of the problem. Investors and analysts think this stuff is easy and don't expect any delays or mix ups. But once you start to work through the actual details, even the simplest task can turn into a huge nightmare that can make it difficult to close the books accurately and on time.

Speaking of time, that's something that is likely to be in desperately short supply when you're preparing for your first consolidated close as a new entity. The best case scenario is when Day One of the merger occurs right after the end of a quarter. This gives you almost a full quarter – including a couple of monthly closes – to work out the kinks. The worst case is when the merger goes into effect just before quarter end, giving you only a short time beyond Day One to get things right.

The trick is to get it done quickly while providing sufficient controls to maintain an adequate level of information quality, accuracy and data integrity. This will mean having a plan to attack three key areas: 1) aligning accounting policy and process; 2) integrating financial data; and 3) enabling the consolidation.

Aligning Accounting Policy and Process

A primary integration "must" for finance is aligning accounting policies and processes. The first order of business will be to identify which policies are different, and where different, which will have a material impact on the consolidated financials. For example, the two companies may have different policies for recognizing revenue or valuing inventory. The material differences need to be ironed out before the books can be consolidated the first time. Other immaterial policy differences can wait until the dust settles and addressed in a systematic way as part of the post Day One integration efforts.

In addition to policies, fundamental differences in process must also be aligned. Something as seemingly simple as calendars can become a challenge if, for example, one company closes its books on a 4/4/5 calendar and the other does it at the end of the month, or when two companies have different fiscal year ends. Or, when you need to have a close completed within five days of period end, but the company being acquired takes twenty. In cases such as these, a common calendar and closing cycle will need to be defined and a process will need to be developed to combine the financial data on a comparable and timely basis before the first close.

Factor in the possible differences in other consolidation policies and processes such as inter-company eliminations, overhead allocations, and tax provisions, and there's a good chance you'll be reaching for the antacid.

Integrating Financial Data

Your next challenge will be to gather and integrate all of the necessary financial data – and find a place to store it. This might sound trivial, but

it can become complicated if the data for one or both companies is scattered across a number of legacy systems and spreadsheets or is buried deep within isolated business unit and functional silos.

Once the data is obtained, the integration challenge generally requires a careful mapping or rewriting of the Chart of Accounts (COA) and financial data structures. Much of this involves reconciling different data definitions. Although two data fields might map to each other – and might even share the same name – they don't necessarily mean the same thing. For example, there is often a disparity in the types of expenses that are classified as Cost of Goods Sold (COGS) versus Sales, General and Administrative (SG&A). And in some cases, the level of detail needed to get both companies on the same accounting basis simply doesn't exist and may need to be estimated until future system changes make it possible to capture the detail.

The mapping can become complicated when a US company acquires a company outside the US. It can be a struggle for the acquired company to provide financial data for SEC and US Generally Accepted Accounting Principles (GAAP) reporting requirements if it currently reports under a different accounting standard like the International Accounting Standards Board (IASB) International Financial Reporting Standards (IFRS). There may be an ongoing need to have dual mapping and to produce consolidated financial statements in both US GAAP and IFRS until the US adopts IFRS as is currently being proposed by the SEC.

This can become heartburn if the only people who actually know what the numbers mean or what the underlying policies and processes are have left the company – or been let go – as a result of the merger. Getting early knowledge of who those critical resources are, and having a plan to retain them will be critical to helping keep the ulcers under control.

Enabling the Consolidation

Once the material policies have been addressed, the data gathered and the mapping created to support integration, the final step is consolidation and reporting. There are multiple approaches by which a company can enable the consolidation of financial data. Companies approach these challenges differently based on their situations and strategies. Some examples below demonstrate different approaches.

Example 1 – Existing ERP (Short-Term) / New ERP (Long-Term)

A multi-billion dollar manufacturer sold a \$3B division to another manufacturer. The division had to function as a standalone entity for a year after the deal prior to full integration into the buyer. To complete the financial consolidation in the standalone division, the selling party implemented a cloned version of its existing ERP system. Within a year, the buyer had implemented a new ERP system for the ongoing financial consolidation. This process ultimately achieved cost reduction in finance and provided a robust basis for common reporting.

Example 2 – Existing ERP (Short-Term) / New ERP (Long-Term)

An international services company spun off four divisions in an effort to realize the equity value and integrate them as a single \$2 billion corporation with greater scale than the standalone divisions. To achieve its goals of rapid financial integration, they created offline mapping and loading tools to load trial balance financials into the existing ERP of the largest division for consolidation. The mapping process achieved was a quick path to consolidation, but left existing financial systems in place and provided little common reporting.

Example 3 – Specialized Tool (Short and Long-Term)

A private equity buyer that has a strategy of consolidating fragmented industries always implements a best of breed consolidation / reporting tool with its first acquisition. This provides a rapid path to consistent consolidation and reporting as other companies in the industry are acquired and easily integrated through a mapping process into the consolidation / reporting tool. However, this approach limits some of the immediate cost synergies.

Example 4 – Existing ERP (Short-Term) / Specialized Tool (Long-Term)

A multi-billion dollar company acquired a division of a large conglomerate. The conglomerate decided to maintain a large controlling stake in the combined company. The new organization had to comply with US GAAP and IFRS reporting requirements. The company implemented a cloned version of its existing ERP system and aligned the fiscal year in the ERP and also in a specialized consolidation and reporting tool. The existing ERP system was adopted for the first quarterly close and consolidation. The specialized consolidation and reporting tool was used to generate reports for meeting financial and management reporting requirements. This process accelerated the integration of financial systems which in turn led to synergy capture in finance while reducing the risk from loss of critical talent.

Example 5 – Existing ERP and Specialized Tool (Short-Term) / New ERP (Long-Term)

To counter the profitability impacts of the weakening market in their industry sector, two global companies spun off a common business unit with eroding margins to combine them to gain economies of market size and scale, and became parent investors of the new company formed from the merger. The new company, headquartered outside of the U.S., needed to produce consolidated financial statements under IFRS and also under US GAAP for the parent's to be able to record their investment interests. The new company implemented a partially cloned version of one of the parents ERP systems supported by Transition Service Agreements (TSA's) for transactions done by both parents on behalf on the new company. They also implemented a specialized consolidation and reporting tool where they make adjusting "top side" entries to enable parallel consolidation under both sets of books in the short-term until they can implement a new integrated ERP in the longer-term.

Understanding your options

The consolidation tool you choose can significantly increase your chances for a successful first close. Or it can do just the opposite. As a CFO, you have four major options:

Manual processing with spreadsheets

Export output from disparate financial systems and then use spreadsheets or PC databases to perform manual processing and consolidation. This approach is typically the fastest and cheapest solution to implement in the short-term but can create issues from a control and accuracy perspective and is rarely ever a long-term solution.

Existing ERP

Make relatively minor modifications that allow the current ERP general ledger to be used as the consolidation platform (e.g., adding a new company code for consolidated data). This requires mapping from the old structure to the new consolidation structure, with your current ERP system becoming the data repository for summary level business information and consolidated financials.

Specialized Tool

Take advantage of advanced business intelligence tools for consolidation, reporting, and integration across multiple, disparate systems. This may be a tool you are already using, or it may be one you choose to implement after the merger. Existing core financial systems and data warehouses remain intact.

Integrated/New ERP

Implement a new ERP system, or reconfigure your existing ERP application to create an integrated platform that provides a single source for all transaction data and consolidated financials. This approach typically maximizes the capture of financial synergies over the long-term.

Each of these options involves certain trade-offs. The trick is to choose the trade-offs that make the most sense for your unique situation.

Short-term versus long-term

The solution you choose to support the first close after the merger may be different than the long-term solution; however, just because the interim solution is temporary doesn't mean you should ignore the opportunities to achieve longer-term benefits.

When choosing a tool to tackle your first close, it's important to think about your long-term objectives because they may affect what you do in the short-term. For example, if your company plans to continue growing through multiple acquisitions, you might want to invest in a specialized consolidation tool that is designed to make consolidation of different system platforms easier.

If you are a US company, at some point in the near future you will need to consider the implications of adopting the IFRS accounting standards. A merger can be an excellent catalyst for accelerating the move to IFRS and avoid having to "do things twice" – once for the integration, then again for the move to IFRS. Given the amount of change that takes place in any significant merger, and the impact on systems and processes, it may be more cost effective in total to create your financial system strategy only once. That doesn't mean that the entire system strategy has to be implemented in time for the first close which would be an unrealistic and risky strategy to say the least. However, some things can be implemented into the design, such as considering the changes for the move to IFRS during the detailed review and potential overhaul of the COA.

However, if the merger synergy targets were based on an assumption that systems would be simplified to a single ERP in the long-term, then it might make sense to start your ERP integration sooner rather than later. Typically this scenario would result in using your existing ERP for consolidation in the short-term and then moving as quickly as possible to an integrated ERP as the long-term solution.

The type of company doing the acquisition is another key decision factor. If the acquirer is a financial buyer such as a private equity firm, it's likely the infrastructure to support the close and consolidation will need to be created from scratch. This generally leads to an immediate investment in a new ERP to keep the mature company operating without a hitch. However, given the impacts of the current economy on cash flow and borrowing capacity, coupled with budget and spending cuts to align with decreased revenue, short-term cost will likely be a higher priority for the decision today than it was previously.

For strategic buyers, the size and complexity of the deal can also have a big impact on the decision. For example, if a deal essentially doubles the size of the business, there's a good chance that the increase in transaction volume and complexity will require a new or significantly upgraded ERP system in the long-term. Given the size of the deal, there is also a good chance that the acquired company will need to continue running its old system for awhile. Large deals also tend to involve public companies, which reinforces the need for tighter controls and more accurate, timely and flexible detailed reporting. In the short-term, these requirements typically point toward a more automated and controlled consolidation tool. In the long-term, they point toward a more flexible consolidation tool that will enable parallel reporting to conform to both IFRS and US GAAP during the transition period.

These examples are designed to illustrate some of the factors that may affect your short- and long-term tool decisions. The right answer will vary from one company and situation to the next.

A way to decide

The four major options can be combined in a variety of ways to address a company's short- and long-term needs. However, we believe only six of the combinations are actually worth considering. The following framework summarizes the primary advantages and disadvantages for each combination.

Figure 1: Framework for Evaluating Consolidation Tool Options



To determine the best fit for you, each option should be evaluated against a set of criteria: short-term cost, total cost / long-term synergy, total implementation time, resource impact, complexity, flexibility, centralization, and level of control. As the table indicates, various combinations of key attributes may make one option superior to another given the environmental constraints, limitations, and attributes. For instance, if the acquiring company aims to optimize long-term efficiency and reduce total cost, then integrating the ERP solution may present a more meaningful approach (column 5). It is also worth noting that if the acquirer already has a consolidation tool in place, it can choose to use the same tool in the

short and long-term or purchase a new specialized tool (column 3). Using the existing tool of course would demand fewer resources, minimize costs, and enable a quick implementation. However, the company may select a new specialized tool if doing so enables improved consolidation capabilities, the adoption of IFRS, or if the company plans to grow through future acquisitions and wants to leverage a best of breed tool to support this acquisition strategy. Ultimately, if a company already has a specialized consolidation tool in place, option 3 presents the most likely scenario. In cases where a specialized consolidation tool is not already in place, the decision may not be as apparent and would require some consideration.

A fitting solution

The first financial close after a merger is always stressful -- and probably always will be. However, choosing the right approach can help keep problems to a manageable level. To be effective, your solution must address the short-term need for a fast and accurate first close, while supporting the business' long-term merger synergy and growth strategy. Once you understand the options and trade-offs – and your company's unique requirements – you are in a better position to select the right strategy.

Contact:

Trevar Thomas

Principal
Deloitte Consulting LLP
+1 713 982 4761
trethomas@deloitte.com

Miles Ewing

Principal
Deloitte Consulting LLP
+1 206 716 6419
miewing@deloitte.com

Patricia Kloch

Director
Deloitte Consulting LLP
+1 206 716 6137
pkloch@deloitte.com

Mayci Cheng

Senior Consultant
Deloitte Consulting LLP
+1 415 783 4605
maycheng@deloitte.com

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