Cashing Out at the Top:

The IMA® Committee on Ethics and Raef Lawson, CMA, CFA, CFP, CPA, Ph.D., VP of Research and Professor-in-Residence, are proud to announce that William F. Miller, CPA, Ed.D., has won the Best Case Award in the fifth annual Carl Menconi Case Writing Competition for his case, "Cashing Out at the Top: Selling a Company with a Bill of Goods." The competition is named in memory of Carl Menconi, who held leadership positions in IMA for many years and served as chair of the IMA Committee on Ethics. The objective of the competition is to develop and distribute business ethics cases with specific application to management accounting and finance issues and that use the *IMA Statement of Ethical Professional Practice* as a reference or guidance tool. The winning case and teaching notes are available for use in a classroom setting. IMA academic members may obtain the teaching notes from Tara Barker at tbarker@imanet.org. Others who want to use the case and notes for additional purposes should also contact Tara.

By William F. Miller, CPA

In November 2005, Contrarian Corporation's owner and founder, Theodore Monet, realized that his company was quickly outgrowing his abilities to lead it. To help transition the seven-year-old company from a small regional firm to a nationally recognized one, Monet hired a number of new executives, including John Stuart as president and Joe Hart as the new CFO. With the help of these new managers, Contrarian grew from having $30 million in annual revenue to just under $100 million in a little over two years.

In early 2007, recognizing the success and value of the company, Monet decided to sell Contrarian. He received written offers from eight potential acquirers. Monet chose to go with the highest bidder, a publicly traded company whose bid was 5%, or $5 million, higher than the next-highest bid.

Due Diligence

When one company makes an offer to purchase another, it does so based on a general review of the operations, and the offer is subject to a more in-depth review of all aspects of the company being acquired. This detailed review is known as due diligence. Depending on the size of any given deal, this process can take anywhere from a couple of weeks to a year or more to complete. Due diligence for the acquisition of Contrarian was estimated to take 90-120 days from offer acceptance to deal funding.

During due diligence, the acquiring company (suitor) looks at all aspects of the target company: It reviews historical, current, and projected future performance; interviews customers; meets with the company's senior management; and performs a detailed review of the product and or service the company produces or provides. The suitor typically hires a CPA firm and a law firm to help it complete this process. The hired professionals will have a list of documents they want to review and will identify the customers and employees with whom they want to meet. To perform this analysis, these professionals create a SWAT team of sorts that includes members from the suitor's operational departments, such

Selling a Company with a Bill of Goods

as Finance, Operations, IT, and Human Resources. The depth and breadth of this review is rather fluid and will change based on the size of the deal and what the team finds during the process.

The due diligence review provides the suitor with comfort regarding the decision it has made to buy the company and the price it has offered to pay. The process also protects the target company from litigation after the deal is closed by allowing the suitor access to any document it requests and needs to make an informed decision.

The due diligence process is unique in that the goals of the suitor aren't the same as those of the seller, and they are often at odds with each other. The seller wants due diligence to go smoothly and not have anything occur that might result in a reduction of the agreed purchase price. The suitor, however, wants to pay as little as possible for the company, and the due diligence process provides an opportunity to uncover a problem and potentially lower the price. This process is designed to be somewhat adversarial in nature and can result in an "us vs. them" relationship.

The process is similar to selling a home. The home seller is obligated to disclose everything negative about the home prior to a purchaser making an offer, and most homebuyers make an offer contingent on a formal inspection of the home being done. The home inspector goes through the home, looking for potential problems with plumbing, electrical, structure, etc., then prepares a report. After seeing the report, the buyer then removes the inspection contingency from the offer, modifies the offer based on the report, or simply walks away from the deal.

Often, home sellers will spruce up their properties in preparation for selling it. They might paint the walls, get new carpet, caulk cracks in drywall and paint over them, cover up water stains caused by previous damage, and so forth. The goal is to maximize the price they receive.

Due diligence works much the same way in that the seller is motivated to maximize the sale price. The difference is that the home inspection process is much more cut-and-dried than that of due diligence of a company. Due diligence is extremely complex, and the data being analyzed can be interpreted very differently by two different parties. The stakes in selling a company are also much higher, not only in terms of the money involved, but there also are typically many more stakeholders impacted by the sale of a company: shareholders, clients, vendors, employees, parties involved with the transaction, etc.

During the due diligence process for Contrarian, the company experienced some months where it fell short of budgeted revenue figures. The suitor raised concerns over this performance and doubled its efforts to ensure that it was making a sound decision and paying the appropriate price for the investment. As a part of this expanded due diligence, the suitor requested updated financial projections.

Financial Projections and Estimates

Both the suitor and the target company typically prepare financial projections. These are estimates that employ a practiced methodology to project anticipated results—such as a company's revenue or profits—over a given period. The creation of a projection is an art form of sorts. A sound projection often combines historical trends, current information, and some guessing as to the likelihood that something will occur. The process of preparing a revenue projection is very similar to budgeting in that you start with absolutes, like signed contracts. You then look at the sales pipeline, which is a listing of all the target deals that are in the sales process. You apply a probability factor to each deal in the pipeline and add this estimate to projected revenue. Finally, you add in estimated revenue from yet-to-be-identified customers.

Monet's Reaction

Upon getting this request for updated projections, Monet had meetings with all of his executives to ensure that the suitor only received information he approved. One of those meetings involved John Stuart and Joe Hart, Contrarian's president and CFO, respectively. At this meeting, Monet told them that he wanted financial projections prepared that would in effect overstate expected annual revenue by more than $10 million. He told the executives that the terms of his contract with the suitors indicated that he had no obligation to be truthful in regard to financial forecasts. To prove his point, he pulled out the contract and read a particular section to the two of them. The contract stated that the suitor should place no reliance on any projected financial information. This is typical language included in contracts of this nature to describe any numbers derived through a subjective process, i.e., any numbers that don't represent actual results. The language protects the target company from future litigation should those estimates or projections be incorrect. It places some responsibility on the shoulders of the suitor to verify (through due diligence) the accuracy or reliability of any such information, but it doesn't give the seller the right to lie or make numbers up. Monet was in effect asking the president and CFO to create a projection they knew to be inaccurate and unlikely to be achieved.

Monet then threatened Stuart and Hart with their jobs if they didn't agree to his demands. Stuart said he would be happy to do as asked. Hart took a slightly different approach, saying that while he would be happy to prepare whatever projections were requested, he would only give them to Monet and Stuart, not to the suitor. Hart made it clear that if they subsequently gave the projections to the suitor, it was their decision, not his. He also stated that if the suitor asked him about the projections, he would say where the numbers actually originated and that he didn't believe Contrarian could achieve that revenue.

The meeting took no more than 10 minutes from start to finish. There was no conversation about alternative courses of action, and the three of them didn't discuss whether the request was unethical and more than likely illegal. Nor was there any discussion of potential consequences. Monet had an agenda, and he followed his script. He delivered his message quickly and aggressively and then ended the meeting.

Hart's Solution

Hart walked away from the meeting wondering how he had gotten himself into this situation. He talked with other members of the senior management team and found they all had similar meetings with Monet. Hart was between the proverbial rock and the hard place. If he didn't comply with Monet's request to prepare the forecast, he risked losing his job and potentially putting his career in jeopardy should Monet badmouth him in the business community. But if he did comply with the request, Hart felt he would be aiding Monet in an attempt to defraud the suitor.

In the end, Hart chose to comply with the request in his own way. He prepared two sets of projections: the set that Monet had asked for and a set that Hart felt was attainable. He sent both projections to Monet and Stuart via e-mail. In the message, Hart specified that he felt the second set of numbers was attainable while the first set wasn't.

Monet's Undoing

Monet subsequently gave the unrealistic projection to the suitor. Monet had meetings with the other senior executives to ensure they would support the new projection. He also discussed the projection with the suitor in detail. Monet's plan worked. The due diligence team never asked Hart about the updated projection. The suitor relied on what Monet and other executives had to say about the viability of the numbers. The deal closed, and Contrarian was sold at the original offer price. Upon closing, Monet walked away with close to $100 million dollars.

Within three months, however, the suitor filed a claim against Monet for fraud, seeking a refund of $15 million, contending that the valuation was overstated due to the reliance on inaccurate financial information. Hart became a leading witness for the suitor. Monet had to pay approximately $10 million to the suitor and almost $5 million in legal fees. He was never heard from again. **SF**

William F. Miller, CPA, Ed.D., is an assistant professor of accounting at the University of Wisconsin, Eau Claire. He is an IMA Member-at-Large. You can contact him at (715) 836-5434 or millerwf@uwec.edu.