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Ethical Implications of Friendly Takeovers: A Financial Manager's Story

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A Case Study: Ethical Implications of friendly takeovers: A Financial Manager's Story

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Introduction

In 2001, Bernadette Michaels was promoted to her dream job, Finance Manager at Home and Personal Care Products, a global corporation based in the UK. As a Certified Management Accountant CMA® and a Certified Public Accountant (CPA), Bernadette was a trusted employee known for her attention to detail. In this new role, she would be responsible for integrating the financial and accounting functions related to all mergers and acquisitions. This meant that she should be responsible for setting the overall tone and direction for the integration of personnel, corporate cultures, financial processes and information technology systems that track and categorize the financial accounts of the company. As an ethical person, Bernadette soon found herself unprepared for the different corporate cultures she would soon encounter. Often, the acquired firm's approach to compliance with financial rules and regulations was at odds with what Bernadette believed was ethical and appropriate.

During an acquisition there is a great deal to do in a relatively short period, the context is typically very unfamiliar, and there may be a conflict between financial control and business growth. There was intense pressure in the company to generate growth through acquisitions; therefore, there was not always sufficient time to address areas of concern related to financial processes and controls. Periods of acquisitions are hectic and there were increasing demands placed on Bernadette's time from both her work colleagues and bosses. Bernadette was aware that a good performance on her part would be an opportunity to be noticed by her CEO and could propel her career forward. She was also acutely aware that a failure to prioritize many of the new demands placed upon her from the different companies around the world could result in important tasks being delayed or left undone. Bernadette began to receive requests during the acquisitions from people she had never even heard of at the corporate headquarters. The tax and treasury departments were constantly calling her and she was often forced to prioritize these requests or face the danger that important tasks are delayed, or worse, never are done.

In accounting, the most important task is to ensure that corporate assets are secure (Frankel, 2008, Tarasovich, et.al, 2008). Over the course of ten years, Bernadette would be faced with four significant acquisitions with a cost ranging from $1 to $25 billion. Her company acquired a prestige fragrance company, another company that manufactured cosmetics and fragrances and two major food manufacturers. Although due diligence was performed[1] by the external auditors for all the acquisitions, the biggest challenge was to ensure that the acquired companies came together with the parent organization in an ethically appropriate manner. This means that the company acquired act in accordance with the values of the parent company. Home and Personal Care conducts all operations with honesty, integrity and openness and requires all employees to comply with the laws and regulations of the country in which they operate.

In a merger or acquisition transaction due diligence is a process of verifying and confirming information received about the acquired company is accurate. It is a method companies and auditors use to gather more information regarding the financial statements of the acquired company. They use this information to determine if the company acquired is presenting financial information fairly. The amount of due diligence can vary depending on materiality of the acquisition and the time allowed.

Bernadette had been through several integrations before and knew that during the initial period, employees of both the acquired company and the acquiring company were often concerned about losing their jobs or being moved to different job post integration. Employees are also often

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stressed or frustrated due to the additional work required of them when two different companies integrate. There is often also a clash of corporate cultures and values. Workplace ethics are especially vulnerable during such strategic transitions. Research shows that employees in organizations undergoing mergers or acquisitions often observe ethical misconduct and feel pressure to engage in questionable business practices at rates that are nearly double those in more stable organizations (Boatright, 2010).

Company Descriptions and Case Background

Home and Personal Care Products is a global manufacturer of consumer products based in the United Kingdom. The company has deep roots in markets around the world giving it a wealth of knowledge and international expertise about local consumers. Its' top twelve brands generate sales of 1 billion US dollars and the top twenty brands account for 70% of sales. The company operates in several product areas including skin care, deodorant, ice cream, tea, spreads, hair care and household cleaning and is a global leader with brands that are number one and two in their markets. The company employs more than 170,000 people.

The company is a conglomerate, its' strategy focuses primarily on the acquisition of existing brands, rather than the development and introduction of new ones. Firm rivalries drive the acquisition strategies of competitors, thus, several of the company's acquisitions were a direct result of a competitor acquiring a similar business or product line. Home and Personal Care Products only targets companies with strong market positions and financial strength in order to develop growth and innovation in the home and personal care market. It has a reputation of operating with the highest standards of corporate behavior towards its employees, consumers and society. The corporate mission included the statement, "Our management team must operate with integrity and respect for the many people, organizations and environments our business touches."

Home and Personal Care Products places a great importance on professionals being resilient and agile in adapting to different cultural norms and behaviors in different companies. As an integration manager, Bernadette realized early on that she would need to adapt her management style and organizational decisions in order to build credibility with and gain the trust of the newly acquired or integrated employees.

Home and Personal Care Products' employees are also well aware of the company's code of business conduct. Employees conduct operations with honesty, integrity and openness, and with respect for the human rights and interests of all employees. The company places great emphasis on ensuring accounting records and supporting documents accurately describe and reflect the nature of the underlying transactions. The company is committed to diversity in the work environment where everyone feels responsible for the performance and reputation of the company.

A list of the company acquisitions are included in Exhibit I. Two of the companies it acquired were in the cosmetics and fragrance segment. The first was a manufacturer a pricey line of lotions and fragrances found mostly in department stores and boutiques. Several years later the company acquired a leading manufacturer and marketer of cosmetics and hair care products, as well as deodorant and other skincare products. The products were lower-priced well-known lines that were sold mostly in drugstores and supermarkets. Finally, two food companies were acquired. One company was a leading ice cream manufacturer with some of the more recognized brands in the United States. The second foods company was a global foods conglomerate a

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maker of well-known brands in mayonnaise, peanut butter, soups, and many other food categories.

In spite of the enormous pressure to achieve the synergies forecasted in the business case, it was important for Bernadette to be certain that there was no unethical behavior on the part of the project and management team responsible for the acquisition and integration of these companies. The pressures to achieve synergies can often result in people problems, cultural value, and ethical differences that impede the smooth integration of the two companies. Synergies in acquisitions are not achieved in over 70% of acquisitions, as reported in *The Complete Guide to Mergers and Acquisitions* (Galpin and Herndon, 2008) making this a real and important consideration in any acquisition or integration.

For each acquisition, Bernadette needed to ensure that the newly acquired assets were secure. In addition, she had to ensure that the acquired companies were not employing inappropriate accounting practices in order to inflate their sales or earnings. In other words, that the acquiring companies were not "cooking their books."

Securing the Assets – Acquisition I

The first accounting issue she encountered was during the acquisition of a prestige fragrance company. The company was located several hours away from Bernadette's office, therefore, she would travel to the location several times a week and stay in a local hotel. In the early days of the company acquisition, Bernadette was the only representatives of the parent corporation on site. She often felt like an outsider and quickly realized that one of the critical success factors was her ability to manage herself. She also knew she had to begin forming relationships and talking to the people at the new location so she would better understand the business. There was much uncertainty in the minds of the employees she encountered. She scheduled a meeting with the company Controller as her first order of business.

Controller Jeffrey Anderson

Bernadette met the Controller, Jeffrey Anderson, during her first week at the new location. She came prepared for the meeting with the parent company accounting manual, chart of accounts, code of conduct and an accounting project plan for valuation of the company's assets. These documents, however, were of little interest to Mr. Anderson. While he was polite and professional, his management style was clearly dictatorial. Jeffrey Anderson had joined the Prestige Fragrance Company twelve years before and had worked his way up in the company with several promotions. He was a CPA with a background in a major accounting firm. He played a key role in the company's growth to a $1 billion dollar public company. He was well respected by the Board of Directors and was not happy that he would now be part of a small division in a much larger company. Mr. Anderson's right hand employee was a Financial Accounting Manager named Allen Carpenter. Allen was also a CPA and CMA and had been with the company for ten years. Allen was very concerned about his future career path now that the company had been acquired.

Safeguarding the Assets

Bernadette knew that one of her first actions was to make sure that the assets she had now become responsible for were secure. She reviewed with Mr. Anderson her preliminary observations of the acquired assets and the unusually high proportion of "Other Assets" on the balance sheet. She knew that often items in this category are over looked by management because they are non-core assets. While Mr. Anderson did provide a list of the "Other Assets" in the acquired balance sheet, as part of the due diligence, it was difficult to examine and understand the nature of each of the items on the list and their relevance to the operations of the company. Bernadette was keenly aware that her lack of expertise in the prestige fragrance industry might hinder her understanding of the underlying transactions. She was also aware that appearing to question the newly acquired company's accounting practices would not be a first step in her efforts to ingratiate herself with the Controller and his staff.

After her first meeting with Mr. Anderson, she conducted a more detailed examination of the "Other Assets" and found that many marketing expenses had been capitalized. In this business, the controversial and expensive commercials, both print and television, were used to raise consumers' awareness of the prestige fragrances. In some cases, the company pushed the envelope with provocative and suggestive advertisements. These costs were material to the financial statements, in some cases several million dollars. Concerned about what she discovered, Bernadette decided to discuss the matter with Mr. Anderson. He told her, " Since the ad campaigns were material to the financial results, even though the commercials had already aired, they would benefit future sales." He suggested that Bernadette not worry about the issue she found.

Bernadette was also concerned about an account entitled "Other accrued liabilities" as it also relied heavily on estimation and judgment. Again, she went to the Mr. Anderson and asked for the standing journal entry supporting documentation for this account. He replied, "You don't understand our business and the need for proper provisions to account for legal and other reserves. These journal entries are standard practice and you would know that if you understood the volatility and uncertainty of the prestige fragrance business." Bernadette scheduled a meeting with Allen to review her concerns and gain a further understanding of the supporting documentation. Allen also explained, "Our business is unique and these are typical entries for our industry. You do not have the background or understanding of these accounts. I provided you an excel spreadsheet supporting the balances. What else do you need?"

Bernadette believed it was her responsibility to raise these accounting issues with the acquisition oversight committee, comprised of the CFO's and CEO's of both businesses. Her challenge was to review the more conservative accounting policies of Home and Personal Care Products and make it clear to the CFO of the acquired company why she did not believe these costs should be capitalized. She was also concerned about the lack of supporting evidence of the accruals. Mr. Anderson had been running the business for years and surely knew the history of accruals and provisions required to manage the business. Bernadette's position was difficult. She had to challenge Mr. Anderson's position without alienating the acquired team and losing the trust of both him and the finance team.

Bernadette cancelled all her appointments the next few days and tried to reflect upon the main issues that had arisen during her meeting with Mr. Anderson:

- The acquired company did not appear to comply with generally accepted accounting principles but these practices had been going on for years. Was she correct in her interpretation? Were the company's records unfairly presenting the financial statements?

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- The company had been issues an unqualified audit opinion. Should she pursue this investigation with the audit team? What would be the ramifications on her actions with the acquired company's team? Would they continue to trust her?
- What further details might the acquired company accountants provide that would assist Bernadette during her investigation of the records?

Planning and Reporting – Acquisition II

Bernadette was settled in to her role as the Financial Accounting Manager for the combined businesses, when in 2004 Home and Personal Care Products announced another acquisition of a $1 billion cosmetic and fragrance manufacturer, based in Chicago. Having been through a major merger and acquisition before, this one would be much easier. After her first meeting with the members of the new company, she realized this acquisition was going to be very different.

The Challenge - The Local Planning Process and Team

This time Bernadette's challenge was that she was brought in well after the acquisition had been finalized. Although Home and Personal Care was clearly the surviving entity and the much larger company, the target company acquired was not receptive to a finance employee intervening in their operations. It was already the second quarter. Bernadette had to start the budgeting process and, at the same time, report second quarter results for the combined companies. She met with the acquired company's Controller, John Evergreen, who was responsible for financial planning and reporting. Mr. Evergreen was appointed to the Controller position only a few years earlier having spent the majority of his career at a competitor. He did not have a detailed budget planning process nor did she establish ownership with the budget stakeholders. In addition, when Bernadette examined the list of the plan assumptions, they had only allowed for the best-case scenario.

Again, as the representative of the parent company, Bernadette would be viewed as an outsider rather than a trusted colleague of the close-knit acquired company team. The annual budget was a closely guarded document that was viewed as a financial plan and not a comprehensive business plan. Bernadette was concerned that the lack of a detailed planning process might lead to earnings being inflated or losses disregarded. She was also concerned that most departments did not appear to be a part of the annual budget process. When she spoke to some of the employees, most were not aware of the "big picture" perspective of the company operations. She decided to use this as an opportunity to show the members of the acquired company that there could be advantages of working with her and the parent company.

The local management team of the acquired company, however, did not trust Bernadette and some were convinced she was a spy sent to report their activities back to headquarters or assess potential talent. The Assistant Controller of the organization, Laura Reinhardt, was one of Bernadette's main contacts in the acquired company so she decided to take her to lunch to see if she could gain a better understanding of the culture and environment. Laura's background was with a big four accounting firm and she was recently promoted to Assistant Controller several years earlier.

Bernadette began with a list of questions for Laura such as "Who takes responsibility of the final planning figures?" "How realistic do you believe the budget is?" "How often do you prepare reports of progress against the budget?" "Do you understand the processes that you are modeling in your budget?" Bernadette began to realize that many of these questions were unfamiliar to

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Laura. Was there a lack of control in the existing planning process and did the budgets really reflect local management's goals, or were they even involved in the process? Bernadette looked at this situation as an opportunity to build relationships with local management and the senior members of the leadership team. She realized her challenge was to help them develop a realistic budget which truly represented the business and facilitated both planning and performance monitoring. Bernadette knew that a new financial planning process would uncover if the business being acquired was mismanaged or if there were areas where controls were weak or worse, non-existent.

Information Security – Acquisition III

Several years' later Home and Personal Care Products acquired a premium ice cream manufacturer with creative flavor names based in New Hampshire. They needed to preserve this company's market niche, which was based in no small part on the image of social responsibility and activism. This company gave ten percent of their profits to charity. They also created many business opportunities for depressed areas and disadvantaged people. The company used environmentally friendly packaging and paid a premium to local dairy farmers who did not give their cows growth hormones.

This time Bernadette was certain she would have fun working on the acquisition. During her first visit there, she noticed skateboards, dogs, and a very casual laid-back atmosphere, making this corporate headquarters very different from the one she had just left. She met with the Controller who told her the company was in the process of beginning the implementation of a new Enterprise Resource Planning (ERP) software to manage the financials of the company. Bernadette was concerned that the company might not require the same high-level implementation standards as Home and Personal Care Products, but the Controller was adamant that the implementation was on track to begin just one month after the acquisition.

The Controller, Paul Hammerstein, was promoted up the ranks of the company, having begun his career in information technology. He witnessed the company's growth from a locally manufactured ice cream brand made in a small garage, to a brand that was now nationally recognized as a premium ice cream. Mr. Hammerstein explained to Bernadette during their first meeting that the company's information technology infrastructure was failing to meet the demands of the company's recent growth in sales. He was extremely convincing in assuring her that "the implementation of the new system will help reengineer our business processes and help support the company's dramatic growth in sales." He told Bernadette that, "the new ERP system is clearly aligned with the company's strategy, structure and processes, and the project was under the control of the IT organization." After all, he tried to convince Bernadette that though she understood financial processes only an IT professional could really understand a complex ERP system like the one they were implementing.

Bernadette had prior experience implementing the ERP system and was aware that it was often a challenging and complex project. She realized during her second visit that capturing the data she need to prepared combined financial reporting and prepare the acquisition balance sheet was going to be difficult. The company began the implementation of a software package that was not integrated with their other operations. The IT and Accounting implementation team was made up of employees of the acquired company where the culture was much more laid back with decentralized decision making authority. Access to the system was controlled by the finance team of the acquired company and, therefore, Bernadette could not access user profiles. User

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profiles play a significant role in security of information allowing employees to access only information, applications, and functionality required for their specific jobs.

When Bernadette approached the Mr. Hammerstein, he told her not to worry and that he had total control over the financial statements. His financial accounting manager would provide all the financial reporting that she needed and the new system, although delayed, would eventually be sufficient to comply with our company's financial accounting policies and procedures. He assured her that no key personnel involved in the new system would leave and that she would be able to work with the employees to satisfy any issues of information security. Again, Bernadette faced a difficult choice. How could she ensure the acquired company's financial statement preparation will not be compromised?

Acquisition IV – Authority Levels

It was now 2011, and having three major acquisitions under her belt, Bernadette believed that she had surely seen everything. She was promoted to Assistant Controller of Home and Personal Care Global Products when a $24 billion acquisition of a major foods manufacturer was announced. This acquisition would make her company one of the world's dominant packaged goods company. With such a significant acquisition, she was certain that she quickly would be assigned to integrate the financials of the two businesses.

This company was also located several hours away from the company headquarters. She would again be spending her time in a local hotel and managing the acquisition while away from home. Her first order of business was to set up a meeting with Mark Romanowski, the company Controller. Just as she had done in past acquisitions, she went to the meeting with her normal arsenal of company documents. Mr. Romanowski was unlike the other Controller's she had met in the past. He was very receptive to her visit and even sent her an email that said, "I would like to arrange a two hour meeting with you to discuss the financial policies and procedures of your company and compare them to our existing accounting manual." Bernadette was elated. Surely, this time the acquisition would be uneventful.

During her very first meeting with Mr. Romanowski, he provided Bernadette with the company accounting manual and table of authorities. He asked her to review the documents and meet with him in a few days to determine if there was anything in conflict with the parent company's policies or procedures. Bernadette was pleased with his cooperation. What she was not prepared for, however, was the very detailed Table of Authorities' schedule he gave her. The document was forty-five pages of detailed positions and names of individuals who were able to commit company resources and funds. When she questioned the finance team and some of the other departments, she found that it was not well understood by either the staff or the management. She found that while it was well documented it was not monitored effectively for compliance.

Bernadette decided to dig a little further and validate some of the agreements supporting the accounts payable transactions. She knew from her past experiences that a poorly defined table of authorities might lead to instances of unethical supplier agreements where the details were not disclosed and only visible to the controller of the acquired company. Bernadette scheduled another meeting with Mr. Romanowski upon completion of her review. Mr. Romanowski continued to be cooperative. He assured Bernadette that a very detailed table of authorities was the best way to ensure everyone in the organization would knew their authority levels and there would never be any unauthorized transactions.

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CASE REQUIREMENTS

Acquisition I - Securing the Assets - Prestige Fragrance Acquisition –

Q1. In the first acquisition of the Prestige Fragrance organization, identify factors influencing the use of inappropriate or aggressive accounting practices during periods of mergers or acquisitions.

Q2. Discuss the issues facing the Bernadette when challenging existing policies and procedures of the acquired company.

Acquisition II – Hair and Skin Care Manufacturer - Planning and Reporting

Q3. Once the determination was made that the budget submitted by the acquired company Controller was too optimistic what actions should have been initiated by the acquiring company's finance team?

Q4. If the budget was prepared using only the best case scenario, what might the acquired company finance manager have suggested to make the budget a more realistic forecast?

Q5. What actions outlined in the Institute of Management Accountants (IMA) Statement of Ethical Professional Practice might have helped identify appropriate actions in resolving the ethics dilemmas presented in this acquisition.

Acquisition III – Information Security - Ice Cream Company Acquisition

Q6. What alternative actions could have been taken to prevent the loss of key financial information during the merger?

Q7. What actions outlined in the Institute of Management Accountants (IMA) Statement of Ethical Professional Practice might have helped identify appropriate actions in resolving the ethics dilemmas presented in this acquisition.

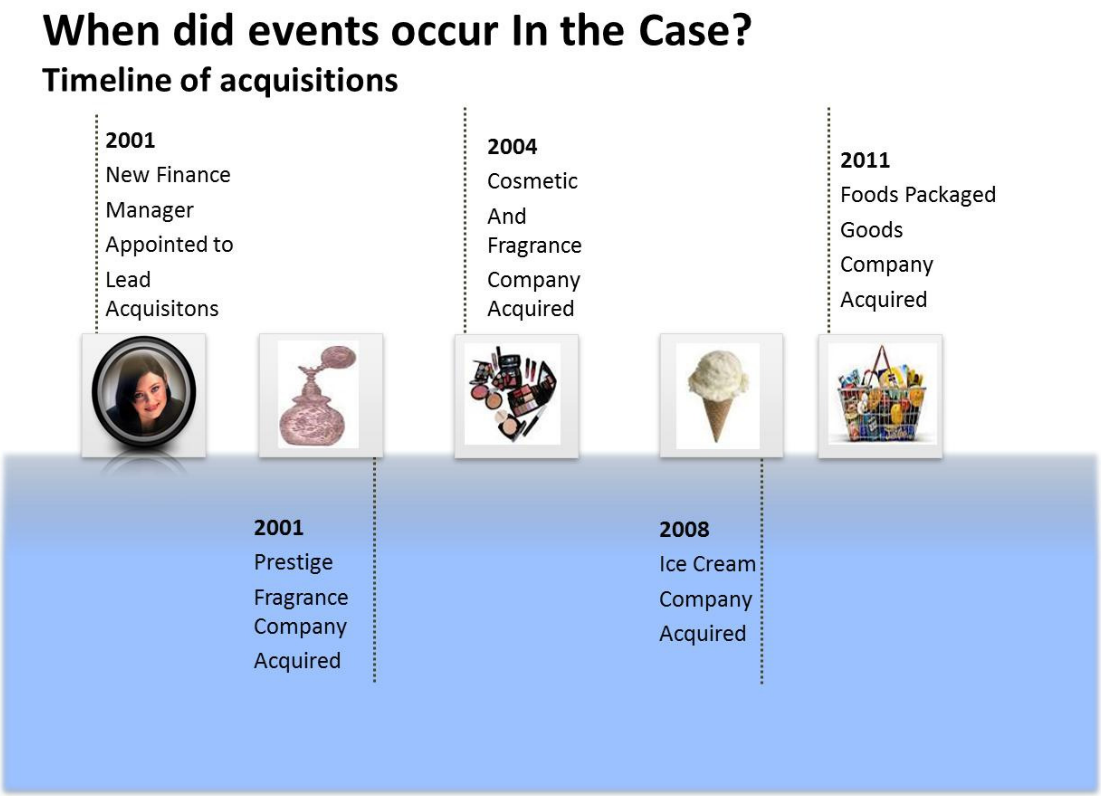
Acquisition IV – Authority Levels – Foods Manufacturer

Q8. What other actions should Bernadette have taken when she realized that inappropriate or unethical actions occurred in the acquired company?

Q9. What other risks to the business exist when a proper table of authorities is not well understood by business leaders?

Q10. Are there any other ethical frameworks that may have helped Bernadette resolved some of the ethical dilemmas in this case?

Exhibit 1



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