Corporate acquisitions and the integration of control systems

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In this article the various approaches adopted by large acquisition-intensive corporations in integrating control systems upon the acquisition of a small company are being investigated. Five matched pairs of acquiring and acquired companies meeting specific predetermined criteria were created, and detailed interviews conducted with key managers involved in the acquisition and subsequent integration process. A set of standard proceedings for integrating control systems are recommended following the analysis of the findings.

In hierdie artikel word die verskillende benaderings tot geïntegreerde beheerstelsels wat deur groot oorma- gerigte organisasies gebruik word, wanneer kleiner maatskappye oorgeneem word, onderzoek. Vyf pare organisasies, wat bestaan uit die oormemende en die oorgeome organisasie, is gekies volgens spesifieke voorafbepaalde kriteria. Uitgebreide onderhoude is met die sleutelbestuurders gevoer wat betrokke was by die oornamme en die gevolglike integrasieprosesse. ’n Stel aanbevelings vir prosedures by die integrasie van beheerstelsels word voorgestel op grond van die bevindinge van die onderhoude.

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It is generally accepted that if a business entity is to survive in an economic environment, it must grow. There are only two ways that growth can be achieved; the first is through internal expansion, and the second is through the process of merger or acquisition. A strategy of growth through merger or acquisition is becoming an increasingly popular alternative to internally generated growth. In Britain alone, during the period 1965 to 1980 an estimated 12000 mergers among publicly quoted companies were transacted (Wallum, 1980), while in the USA, the rate of corporate linkings is estimated to be increasing at approximately 10.05% per annum (Business Week, 1978). This phenomenon has not escaped South Africa and has resulted in the amalgamation of many industrial, commercial, and financial concerns. Oberholzer (1985) reveals that between 1980 and 1984, there were 115 mergers or acquisitions involving listed companies. Supporting this trend, the Financial Mail (1985) commenced their 1985 ‘Top Companies Special Survey’ with the following statement:

‘Even more economic power is concentrated in fewer hands. And many more companies, stretched by the recession, are ripe for acquisition.’

Research on mergers and acquisitions (Rockwell, 1968; Wallum, 1980; Jacobs, 1984; Swain, 1985; Farrant, 1970; Ketching, 1967; Rawlinson, 1983) has shown that despite sound economic, financial, marketing and strategic motivation for the acquisition, many fail to meet the expectations of the acquirers. Numerous reasons have been suggested for the failure of corporate marriages to achieve expectations. Lipworth (1975) in an unpublished report, mentions that some of the reasons are the failure to release synergy, inadequate financial returns because of excessive purchase consideration, size mismatch, different cultures, different stages of growth, lack of knowledge of the acquired company’s business and industry, inadequate pre and/or post acquisition planning, a change in the economic environment or market, lack of strategic fit, mis-evaluation of the company’s management, etc. The imposition of sophisticated control systems on the small acquired company is considered by some researchers to be one of the major reasons for the failure of acquisitions of this nature (Jones, 1980 and 1986b; Rawlinson, 1983; Kitching, 1967).

Jones (1980) indicates that an important factor, which tends to be ignored by most writers, is the ability and willingness of management and staff on both sides to modify their planning and control systems. This enables them to co-ordinate the differentiation of functions and to provide appropriate data for making decisions and for operational control. He goes on to suggest that the extent of the modification of planning and control systems may contribute to the success or failure of some acquisitions.

Changes in control systems are likely to extend throughout the enterprise because the systems themselves are woven into the fabric and philosophy of the concern and their effects may not be neutral. The importance of control systems is confirmed by Kitching’s (1967) study in which a major finding is that the nature of reporting relationships set up between parent and acquired companies, along with the responsibilities and control systems established, is a dominant influence on their success or failure.

As companies grow in size and complexity, so the problems of integration increase. Lawrence and Lorsch (1976) believe that sophisticated controls are powerful integrative devices, i.e. they furnish norms of performance and by enforcing standards, make coordination easier between interdependent functions such as manufacturing and marketing. During the acquisition process, the more functions that change or need to become integrated, the more complex the acquisition becomes. Jones (1986b) uses the model shown in Figure 1 to illustrate the progressive complexity which occurs as more functions (and thus more control systems) need to be integrated.

The least complex acquisition is the one undertaken for financial reasons with no intention to change the
pattern of manufacturing, distribution or marketing. Here, conformity with the financial controls should be restricted to centralised cash management and the allocation of financial resources. The acquired company should be encouraged to continue to use its own operational practices and management style. This is appropriate for conglomerate acquisitions.

Complexity increases when bringing together overlapping product ranges and markets. Some of the products or markets may be sufficiently different to merit two sales forces, whilst others require rationalisation of resources. If manufacturing, marketing, distribution and financial changes have to be made simultaneously, the complexity of integration intensifies greatly. This is one area where easy assumptions about the release of synergy through the acquisition route should be carefully avoided. The control systems, which act as co-ordinating mechanisms for the different functions, will have to change. This presents problems as to the degree of change and how the change is managed.

Integrating the control systems

Lowe (1971) describes a control system as a system of organisational information seeking and gathering, accountability and feedback, designed to ensure that the enterprise adapts to changes in its substantial environment. Also, the work behaviour of its employees is measured by reference to a set of operational sub-goals (which conform with overall objectives) so that the discrepancy between the two can be reconciled and corrected. From an organisational perspective, the Budgetary Planning and Control System probably forms the most common financial planning and control system. The budgeting process, once completed, becomes a plan of action for the entire organisation and must therefore reflect the co-ordinated efforts of all components of the organisation. Handled wisely, budgets act as a powerful controlling and co-ordinating device; handled badly, they can destroy motivation and cause apathy and alienation.

Although little has been written on budgetary control systems in small companies, Viscione (1984); Churchill (1984); Edmunds (1979); Churchill and Lewis (1983) contend that the small company owner/manager sees less need for formalised systems which are perceived to detract from flexibility and creativity and to consume limited resources.

Approaches to integration

The question of how companies should best integrate and handle management control systems after a merger or acquisition has led to two distinct views. One view, supported by Wallum (1980); Caulkin (1975); Harvey and Newgarden (1969); Searby (1969); Leighton and Todd (1969) suggests the immediate imposition of the acquiring company’s budgetary planning and control system in order to ensure that the parent company does not lose control of the key operational variables, especially in the period of rapid growth which usually follows a transference of capital and management assistance.

In contrast, other authors, notably, Pearson (1978); Jones (1980) and (1986b); Levinson (1970); Mullins (1983); Odley (1987); Campbell (1985); Caplan (1971), contend that a more cautious and participatory approach should be investigated. The immediate or hasty imposition of a system, particularly an inappropriate system, could lead to strong negative reaction on the part of the management and employees of the acquired company. The negative effects on morale and motivation could far outweigh the benefits that might be gained from improved operational control. They generally argue that if the change is to be successfully effected, there must be recognition of the different cultures and structures and the development of control and reporting systems appropriate to each. These should also be introduced in such a way as to minimise resistance to the change. Lawler (1976) supports these findings and generally concludes that the imposition of control systems often produces behaviour that is dysfunctional, resulting in rigid bureaucratic behaviour, resistance and production of invalid information.

The effective integration of the management control systems of acquired companies then becomes a critical issue to balance the need for gaining adequate control on the one hand, and sustaining motivation and momentum on the other. Jones (1986b) suggests that once the legal and administrative formalities of the acquisition have been followed, a possible sequence to achieve integration may be:

1. Decide upon and communicate initial reporting relationships.
2. Achieve control of critical factors.
3. Review the resources of the acquired company.
4. Define corporate objectives and develop strategic plans. Howell (1970) supports this step by suggesting that the strategic plans should focus on corporate objectives relative to the acquisition process. In other words, clarifying what the company wants to
accomplish.
5. Develop a revised organisational structure.

Howell (1970) adds to this approach by further suggesting a periodic formal report and face-to-face evaluation process to determine progress against plan and to determine the need for corrective action or a change to the reporting procedure.

Current research questions
With the above information providing a theoretical framework, it was decided to investigate how large South African corporations integrated their budgetary control systems into smaller companies acquired by them. Specifically, the research was designed to answer the following questions:
1. Do local acquiring companies have a formal acquisition policy?
2. Are the budgetary control systems in smaller acquired companies unsophisticated in comparison to those in larger acquiring companies?
3. Do acquiring companies have a formal policy with respect to the integration of budgetary control systems?
4. If a formal policy of integration exists, what were the specific goals of this policy.
5. What specific criteria do acquiring companies consider in the implementation of their acquisition policy?
6. What problems arise in the acquiring and acquired companies as a result of the integration and how are these overcome?
7. Do acquiring companies have a standardised approach with regard to the integration of the budgetary control system?
8. Can a standardised approach concerning the integration be applied to acquisitions in general?

Methodology adopted
Five large acquisition-intensive South African corporations listed on the Johannesburg Stock Exchange were selected for the study, and a recent horizontal or vertical integration acquisition by a large company within each of the five corporations was chosen for intensive analysis. For ease of reference, the five matched pairs of acquiring and acquired companies were designated 'A' through 'E'. Two of the corporations are listed in the industrial sector and one each in the electronics, building and construction, and paper and packaging sectors.

In addition, the previous owner/chief executive officer or financial director of each of the five acquired companies was also interviewed. This was done to obtain a balanced viewpoint on how they thought the acquiring company should go about integrating the different budgetary control systems, and to highlight any problems or frustrations they encountered during the integration process.

The acquiring and the acquired companies are all involved in manufacturing activities. Manufacturing companies were chosen as control systems, and especially the budgetary control systems, are an essential controlling and co-ordinating mechanism in these companies. They are needed to monitor the value added to production costs and to co-ordinate planning between the sales and production functions.

The criteria that the small acquired manufacturing company had to meet before being selected were:
- turnover at the date of the acquisition must have been less than eight million rand;
- the acquired company must have continued to operate from its existing premises;
- the acquired company's sales must have been less than 10% of the parent company's sales before the acquisition;
- the acquisition must have taken place within the previous four years.

The criteria that the respondents in the acquiring companies had to meet before being interviewed were:
- they must have had previous experience with acquisitions;
- they must have been actively involved in the evaluation, negotiations and implementation of the acquisition studied in the research.

While respondents in the acquired companies must have:
- been involved in the negotiations;
- continued managing the company after the acquisition.

A semi-structured questionnaire based on the findings of previous research in the area, as outlined in the introduction to this article, served as an agenda during the one and a half to two hour interviews.

Analysis of the findings
Given the small number of horizontal and vertical integration acquisitions surveyed, caution must be expressed in terms of the generalisation of the findings. They do however provide some useful insights and guidelines that can be applied in acquisitions of a similar nature.

An analysis of the responses to the eight pre-established research questions revealed the following:
1. Do acquiring companies have a formal acquisition policy?

All five acquiring companies surveyed had an acquisition policy, although only one company's policy (Company A) was formally documented. The acquisition team in the remaining four companies all tended to follow the same procedures which had been modified through experience.

Four of the five acquiring companies initially identified the need for an acquisition. Once the need had been identified, they searched for an appropriate acquisition. Only one of these four companies (Company A) had set parameters prior to the search and potential acquisition had to meet these parameters before the company proceeded. The fifth company (Company D) did not necessarily plan for, or seek out, an acquisition. If an opportunity arose, this company would then determine whether it was worthwhile proceeding.
All five companies then did an evaluation before the negotiations started. Once the negotiations were concluded, the acquisition was then implemented in accordance with the five companies’ policies. Four companies monitored the performance thereafter, but only one company (Company A) compared the actual results against the forecasted results.

2. Are the budgetary control systems in small companies unsophisticated in comparison with those in larger companies?

In order to assess this question a simple point system was devised. By definition of the researchers, the budgetary control systems were classified as follows:

<table>
<thead>
<tr>
<th>Points</th>
<th>Sophistication</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 5</td>
<td>unsophisticated</td>
</tr>
<tr>
<td>6 - 10</td>
<td>medium level of sophistication</td>
</tr>
<tr>
<td>11 - 14</td>
<td>sophisticated</td>
</tr>
</tbody>
</table>

The outcome of the analysis to this question are outlined in Table 1. Table 1 also contains some additional useful information on turnover and age of the acquired companies.

Where the acquired company is small and has been in existence for a relatively short period (less than five years), the control system, and especially the budgetary control systems are not well developed. The company is usually small enough for the owner to control all the activities and emphasis is placed on monitoring the bank balance.

In three out of the five acquired companies surveyed, budgeting was done with the assistance of the external auditors. Budgeting tended to be basic and was used mainly for planning purposes. Where the budgetary control system was more sophisticated (Acquired Company B), it was found that the original owner had an accounting background and had ensured the introduction of sophisticated systems.

As was expected in the case of all five acquiring companies, their budgetary control systems are classified as sophisticated, where budgeting is used for coordination, control and performance evaluation purposes.

3. Do acquiring companies have a policy with respect to the integration of budgetary control systems?

In Table 2 a summarised outcome of the findings relating to this question is represented.

The response to questions relating to this area of the research indicated that all the selected acquiring companies did have a policy with respect to the integration of the budgetary control systems. In four out of the five acquiring companies selected, the policy was not documented, but the same approach was normally applied to all acquisitions. Generally, the policy depended on whether the acquiring corporations had a decentralised or centralised management philosophy. In the case where a decentralised corporate philosophy was pursued, the acquiring company (Company A in Table 2) evaluated the existing control systems during the negotiation stage. If these systems were found to meet the acquiring company’s requirements, they were generally left alone. Minor modifications were made only to ensure that essential information was produced in the required format. Compliance with the reporting time-table established by the acquiring company was required. If the control systems were found to be inadequate, resources were immediately made available to assist in the implementation of systems which would meet the needs of both the acquiring and the acquired companies.

In the latter case, where a centralised corporate policy was adopted, the acquiring companies (Companies C, D and E in Table 2) immediately imposed their own budgetary control system onto the acquired company. The previous owners and the staff had no participation in this decision and had to accept the policy. In some cases the previous owners of the acquired company were informed about this policy during the negotiations; in other cases they were not told that the acquiring company’s control system would be imposed upon them.

The control systems were imposed even if the acquired company’s control system may have been appropriate and adequate. In all three acquired companies (Companies C, D and E) a new position of Financial Manager was created and filled immediately after the acquisition took place.

Generally, assistance was given to implement the new control systems and staff from the acquiring company could spend up to six months in the acquired company. Training was given and the financial person from the acquiring company continued to monitor the control systems and the performance of the small company.

From the analysis of information relating to this question, it was found that acquiring Company B did not impose its budgetary system on acquired Company B as the control systems were considered to be adequate.

4. What were the specific goals of the acquiring companies’ integration policy?

The findings on the research relating to this question revealed three consistent goals, namely, (a) to gain financial control over the acquired company; (b) to be able to rely on the information coming from the acquired company; and (c) to ensure compliance with the group’s reporting format. (Not applicable in the case of Company B, as the systems were not imposed.)

This was done to enable the management of the acquiring company to manage the acquired company from their own offices. They also believed it enabled them to make better decisions regarding the future
With respect to matched Companies 'A', the non-availability of resources to second to acquired Company A, created problems of not being able to understand the business and to control it effectively. Integration only occurred during the third year after acquisition when acceptable accounting and budgetary control systems were implemented which assisted in eliminating unprofitable lines and allowed the business to concentrate on those products with the greatest margins.

Following is a summary of the additional problems that were experienced by the acquired companies:
- The changes to the control systems were aimed at meeting the needs of the acquiring company and were normally financial and not operational in nature.
- No consideration was taken of the large adjustments that were needed to be made by the previous owners and staff of the acquired companies. Three previous owners indicated that the control systems should be phased in over a number of years and should not be immediately imposed.
- Additional paperwork was created and the previous owners did not have the necessary time to properly manage the acquired company.
- The acquired company normally had to employ additional staff to implement and monitor the new systems. These systems were not really beneficial because of the small company's size.
- The staff suddenly had to do all the budgeting and accounting, whereas this was normally done by the external auditors.
- The flexibility and the entrepreneurial ability of the previous owners were curtailed by the imposition of the new control systems. This caused frustration.

The five acquiring companies included in this study indicated that they did have a standardised approach to the integration of the budgetary control process. Acquiring Company A, after the particular acquisition in question, indicated that a change in policy was called for which resulted in the upfront evaluation of the control systems of any potential acquisition. It also now ensured that there were adequate human resources available to assist in the implementation of control systems, if applicable.

The approach of the remaining four acquiring companies has not changed and is perceived by them as still being appropriate.

Whether a standardised approach concerning the integration of control systems be applied to acquisitions in general?

Of the companies included in the research one gave an unqualified 'yes' (Company A); one a 'no' answer (Company C); and the remaining three companies (Companies B, D & E) a qualified 'yes' answer to this question.

From the detailed answers gained to this and other questions posed during the exercise, the researchers are
of the opinion that a standardised approach to the integration of the budgetary control systems upon the acquisition of a small company can be employed.

The recommended approach which considers the needs and potential problems of both the acquiring and acquired companies, is outlined below. The approach recommended attempts to balance the need for immediate control on the one hand and the maintenance of motivation on the other and includes the following vital steps:

a) evaluate the control systems and the budgetary control systems before the acquisition is finalised;
b) discuss any changes to the control systems during the negotiations and obtain the previous owner’s acceptance of the decision made;
c) if the control systems in the acquired company are considered inadequate by the acquiring company, then:
   - ensure that the changes made meet the needs of both the acquired company and the acquiring company;
   - involve the owner in determining the period of time during which the changes will be made;
   - do not implement all the changes immediately as the owner and staff of the small company need time to adjust to the new ‘culture’;
   - ensure that there are adequate human resources in both the acquiring and the acquired companies to implement the new control systems;
   - training must be given and courses, explaining the background to and the philosophy of the need for proper budgeting, should be attended by key personnel from the acquired company;
   - initially, ensure that key information is budgeted and reported upon so that the management of the acquiring company know what is happening;
   - on an annual basis, usually before the budgeting exercise starts, allow the previous owner of the acquired company to discuss any problems, recommended changes etc.
   - take heed of these suggestions as they are important to the previous owner and may be a cause of negative motivation or frustration; implement these recommendations if applicable;
   - try and minimise the monthly reporting back (against budget) so that the previous owner spends less time on paperwork. This will also enable him to spend more time productively managing the acquired company; and

d) if the existing control systems are considered to be adequate in terms of the acquiring company’s requirements, then:
   - do not tamper with the existing control systems;
   - however, ensure that key information is provided monthly in the format required by the acquiring company (this will allow for easier consolidation);
   - ensure that the smaller acquired company has the resources (both human and computer) to provide the key information within the deadlines imposed;
   - if applicable, assist the previous owner in adapting to the ‘culture’ of monthly or quarterly Board reviews and the presentation of the budget to senior management;
   - consider any recommendations that the previous owner makes; his recommendations may contain insights that could be of great value because of his intimate knowledge of the business.

References

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