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Case Studies in Finance & Accounting

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Case Studies in Finance and Accounting

Preface

This book contains seventeen case studies on various topics in Finance & Accounting, published in International Research Journal of Applied Finance (IRJAF) during the year 2012. Faculty members can use these cases for class room discussions. However, we request you to send an acknowledgement mail to case authors as a curtsey. Teaching Notes are available to faculty members on request. Please send your requests to editor@irjaf.com. The copy rights of all these cases are with Kaizen Publications, Hyderabad, India.

The cases in this book touch several dimension in Finance and Accounting like, **International Finance** (The Case of the Drifting Exchange Rate), **Financial Processes and Procedures** (Integrating a New Business into the Financial Planning Process at Unilever), **Corporate Valuation** (Manufacturas Lizard), **Corporate Valuation** (BCE Inc. Privatization: Fact or Fiction?), **Financial Ethics** (Pacific Health Care: What should the Controller do?), **Complex Projects - Network Analysis** (The Dolphin Bay Development: Optimum Strategy using Network Analysis), **Internal Audit - Code of Ethics** (Mercy Hospital: A Case Analysis), **Project Valuation and Evaluation** (Privatization: Chicago Parking Meters, LLC), **Financial and Social Responsibility** (Blue Mountain State University – A Case Study - Selecting Socially Responsible Contractors for a New Building), **Preparation of Financial Statements** (Omega Tech Case: Putting it all together), **Inventory Valuation** (Antiock Hardware: An Inventory Case Study), **Asset Misappropriations** (Big Training Corporation), **Cash Flows and Ethical Dilemmas** (Sunset Medical: A Statement of Cash Flow Case), **Audit Tasks - Ethical Dimensions** (Brad's Time for a Decision), **Business Analysis** (Micro-District Coal Heating Case Study), **Environmental Management Accounting** (Should you buy an energy efficient refrigerator? An Environmental Accounting Case), and **Organizing a Case Competition** (A Model for Running an Undergraduate Business-focused Case Competition).

The Editor of the Journal invites papers / cases with theoretical research/conceptual work or applied research/applications on topics related to research, practice, and teaching in all subject areas of Finance, Accounting, Investments, Money, Banking and Economics. The original research papers, articles, and cases (not currently under review or published in other publications) will be considered for publication in International Research Journal of Applied Finance.

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The Case of the Drifting Exchange Rate

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Randy Bozarth loosened his grip on the tiller of his sail boat and let the bow turn slowly into the breeze. Soon the craft nosed into the wind and was virtually dead in the water giving Randy time to think about what had been troubling him for days now. If only he had taken an international finance course rather than wasting his time on “fun” electives when in college. But that was in the past and if he had learned anything so far in life it was you cannot change the past.

Randy had relocated from the Chesapeake Bay area to the west coast of Mexico a couple of years earlier to be able to sail more and also to experience a different culture. So far he was quite happy with his decision although life ‘south of the border’ did present some unique challenges. Most of the challenges came from his housing arrangements. Upon moving south he decided he would forgo living in a single family dwelling and instead opt for a condominium. There were several condo complexes to choose from and most were owned predominately by Canadians, U.S. citizens, and Europeans. Randy chose Bahia Mar Condominiums as his home and in general was very satisfied with his choice.

Given Randy’s educational background (B.S. in accounting) and years spent as a hospital controller it was no surprise that he was called upon by his neighbors to assist in the governance of the homeowners association (HOA). With some reluctance he had allowed himself to be elected treasurer of the Bahia Mar HOA’s Board of Directors last year. This means that he is obligated to review the quarterly financial statements prepared by the management of the HOA. Additionally he is responsible for presenting the proposed budget for the upcoming year to the annual meeting of all 150 condo owners. It is the budget that is troubling him.

The HOA is responsible for building and grounds maintenance, security, maid service (if desired), as well as general administration of the HOA which includes paying taxes, utilities, billing owners, etc. Virtually all costs incurred are denominated in pesos. The current year’s budgeted expenditures are 5,250,000 pesos. Approximately two-thirds of the budget is comprised of salaries for various HOA employees.

The budgeting process is largely driven by the expenditures requested by management. Once those have been justified and agreed upon by the Board of Directors of the HOA, management converts the budget into U.S. dollars. The budgeted expenditures amount is then divided by 150, the number of condominiums, to determine the annual condominium fees. The resulting annual fee is then divided by four as homeowner fees are paid quarterly on the first day of each quarter. Since most condo owners’ primary residences are in the U.S. it was decided that condo fees would be denominated in U.S. dollars rather than the local currency.

During the last few years management used an exchange rate of 10.5 pesos to the U.S. dollar to convert the peso denominated budget into dollars. Actual exchange rates fluctuated between 9.9 and 13.9 pesos per U.S. dollar during that period. The manager of the HOA is insisting on utilizing the same conversion factor as in the past years. His arguments range from “consistency” to “no one can predict the future”. Randy is uncomfortable with this approach. He takes his fiduciary responsibilities seriously and while on his watch as treasurer he wants the budgeting process accomplished in a professional manner.

As the budgeting process moves forward Randy knows he must decide how he wants the currency translation to be handled. He will also need to provide a coherent argument for his position and draft a memo for the HOA’s Board and manager. As Randy contemplates these exchange rate issues he notices a squall building rapidly a few miles to the west and moving his way. Apparently it’s time to make some decisions both financial and navigational.

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Appendix A

Depending on the extent of guidance the faculty member desires to provide to students, the following information regarding the current situation (as of Sept. 20X0) may be provided:

The expected interest rate in the US for 20X1 is approximately 0.25%

The expected interest rate in Mexico for 20X1 is approximately 4.50%

The current spot rate is 13.03 pesos/US\$.

A chart of the forward prices offered by a local bank is:

Date	Futures Price: \$/peso
Sept. 20X0	0.076925
Oct. 20X0	0.076400
Nov. 20X0	0.076100
Dec. 20X0	0.076275
Jan. 20X1	0.075775
Feb. 20X1	0.075475
Mar. 20X1	0.075125
Apr. 20X1	0.074975
May 20X1	0.074625
June 20X1	0.074400
July 20X1	0.074225
Aug. 20X1	0.074025
Sept. 20X1	0.073600
Dec. 20X1	0.072800

Questions

1. Assuming Mr. Bozarth would prefer to use external sources for an exchange rate, how would you suggest a rate for converting next year's budget from pesos to U.S. dollars be determined?
2. What alternate methods might Mr. Bozarth propose to the Board for dealing with foreign currency fluctuations?
3. How might Mr. Bozarth go about formulating an estimate of the exchange rate for the upcoming year rather than relying on external quotes?
4. What are the implications for the owners and the HOA manager of using the actual foreign exchange rate as compared to the 10.5 pesos per U.S. dollar rate used in prior years' budgeting process? How might this influence the owners' and managers preferences regarding the choice of exchange rate for next year's budget?

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Integrating a New Business into the Financial Planning Process at Unilever

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Abstract

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A new Controller in this case was recently hired by Unilever, a global 200 consumer products organization, to integrate a newly acquired business into Unilever's financial planning process. The newly acquired organization was a publically held company and had its own existing financial processes and procedures. Financial planning and reporting are major company activities and finance and accounting professionals are expected to "get it right." The purpose of this case study is to get students to think about the difficulties and challenges of revamping existing financial processes and procedures and alert them to areas where other financial professionals have encountered difficulties so they can benefit from their experience.

Keywords: Acquisitions, Capital Planning, Financial Planning, Inventory Valuation, Key Performance Measures

Background Information about Unilever

Unilever is well known around the world for its brands. On any given day, two billion people use Unilever products to look good, feel good and get more out of life. The company manufactures more than 400 brands focused on health and wellbeing. Many Unilever Brands, Dove, Axe, Ben and Jerry's, Lipton, are respected around the world and have become household names. The finance team developed a financial planning process to support their role in driving the success of these brands and others.

Unilever achieved a strong set of financial results in 2011. Underlying sales growth in 2011 was 6.5%, up from 3.5% in 2009, while 60% of Unilever categories are growing share despite challenging market conditions and a difficult economic climate. Its strategy is to focus on volume growth and strengthening the competitive position of the company's brands. Commenting on the company's performance, CEO Paul Polman said: "In 2011 we have made significant progress in the transformation of Unilever to a sustainable growth company despite difficult markets and an unusual number of significant external challenges. Our overall performance was driven by our growth in emerging markets and the Home Care and Personal Care categories. We invested heavily in our brands and exit the year with positive momentum. In Foods, whilst price increases have impacted volumes, we have grown in line with our markets and gained share in many of our key businesses."

In the past several years Unilever also enhanced their position in attractive, high-growth categories and purchased a portfolio of desirable brands through company acquisitions, joint ventures or Greenfield investments.

Case Context

You have been recently appointed to a start up project as a result of one of the activities mentioned above. You are facing demands on your time from your colleagues, boss and subordinates. At the same time you are receiving requests from headquarters and specialized support functions including Tax, Treasury, and Insurance. You constantly have to prioritize and there is danger that important tasks get delayed, or worse, never get done. Since Financial Planning and Reporting are one of the major activities you are responsible for you must quickly familiarize yourself with these Unilever financial processes. You are given nine areas of importance to focus your activities. The areas are:

1. Global Standard Chart of Accounts (SCOA)
2. Local Company Chart of Accounts
3. Financial Reporting Routine
4. Key Performance Measurements
5. Financial Budgeting System

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6. Capital Planning Process
7. Inventory Valuation and Cost of Goods Sold
8. Sarbanes Oxley Considerations

For each of the activities above you are given the objectives and the rules. You must identify the list of actions required and identify any potential obstacles or challenges you may face.

Global Standard Chart of Accounts (SCOA)

Objective

Unilever's global chart of accounts is a general ledger accounting system that allows for the accumulation globally and regionally of financial information. This global chart of accounts is a global mandate. Migration to this global chart of accounts is only recommended once you have a fully understanding of your current systems.

Rules

- You must implement and follow Unilever's Standards Chart of Accounts (SCOA)
- You must ensure implementation and accommodate local, legal, and fiscal requirements

Questions for Discussion

1. What reference documents should you obtain?
2. What are the key elements of your plan to implement the SCOA?
3. What are some obstacles or challenges you may face in trying to impose a global SCOA?
4. How do you identify if additional resources are needed?

1. Local Chart of Accounts – (LCOA)

Objective

In some countries, there are rules and regulations that dictate the local chart of accounts must be maintained. If the accounting professionals do not maintain the original set of accounting records, the company may be subject to criminal proceedings and/or significant fines or penalties. The accounting professional must become familiar with the local chart of accounts in order to properly prepare financial planning and reporting results. The accountant must also map the existing chart of accounts with Unilever's SCOA.

Rules

- Realize that, in some countries the LCOA must be maintained
- You must comply with both Unilever and local regulations and standards
- You must contact local auditors to determine local reporting laws and regulations and their impact

Questions for Discussion

1. How do you ensure accounting treatment is in accordance with Unilever standards and local regulations?
2. What is the best way to obtain an understanding of local standards or regulations and the adjustments required to convert the results to Unilever's reporting and accounting principles
3. How should you validate the existing trial balance?

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4. How do you identify the key personnel who are familiar with the political aspects of local regulations? Why is this individual crucial?
5. How do you know that the local statutory results reconcile to Unilever reported results?

2. Financial and Management Reporting Routine

Objective

One of the responsibilities of a financial manager is to report accurate financial results within predetermined deadlines while minimizing the disruption to the company and your staff.

Rules

- You must ensure all Management and Financial reports are submitted accurate and in a timely manner. This includes the Balance Sheet, Income Statement and Cash Flow Statement.
- You must ensure all reported financial results reconcile with local financial records

Questions for Discussion

1. What are the important issues in determining financial and management reporting requirements?
 2. How do you plan to ensure the deadlines are met?
 3. Who are the important groups to liaise with if there are any reporting issues?
- ### 3. Key Performance Measures

Objective

For each of the businesses' critical processes identify a Key Performance Measure or Indicator. You must establish a reporting routine and definition for each Key Performance Measure.

Rules

- You must ensure that all critical processes are identified and that each has a key performance metric
- You must be able to identify how you will collect and report each key performance metric

Questions for Discussion

1. How do you identify what is an important business process?
2. How do you know the information you are reporting is helpful and who you should distribute the key performance measure to?

4. Financial Budgeting System

Objective

One of your responsibilities is to establish budgets that are an accurate but challenging goal for the business to achieve. You must ensure that the budgets are a reflection of managements' goals and that everyone on the organization feels that they have participated in the budget process and own the budget.

Rules

- Assumptions must be realistic
- Local management must participate in and own the budget

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Questions for Discussion

1. Identify several approaches to budgeting and recommend what are best practices in setting an initial budget
2. Identify best practice in establishing budget variances
3. What is the best way to ensure the budget is kept up to date?

5. Capital Planning Process

Objective

You must ensure that the capital planning process operates effectively and that capital purchases are properly included in the budget

Rules

- You must prepare an accurate capital expenditure and disposal proposal in order to execute a capital purchase
- You must ensure that capital purchases are properly reflected in the budget

Questions for Discussion

1. What are the key steps in ensuring you have the information to properly prepare a capital budget and who should be consulted?
2. What are some guidelines you should develop to determine if capital expenditures are reasonable?

6. Inventory Valuation and Cost of Goods Sold

Objective

You must establish an inventory valuation system and methodology for estimating cost of goods sold.

Rules

You will not be expected to develop a sophisticated method for estimating cost of goods sold but there must be a method for developing a cost of goods sold estimate as quickly as possible

Questions for Discussion

1. What are some ways to obtain an understanding of the existing inventory valuation methodology?
2. Why is an accurate an inventory valuation methodology critical?

7. Sarbanes Oxley Considerations

Objective

You must ensure there are adequate internal controls in the business and Sarbanes Oxley rules are established

Rules

The CEO must sign a confirmation that Sarbanes Oxley rules are followed and a system of internal controls is in place and controls are adequate

Questions for Discussion

1. What do you do if controls are not adequate?
2. How should you prioritize the issues to be addressed?

Manufacturas Lizard

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In early June 2011, Julio Hernández, general manager of the company Plásticos Reales S.A. (PERESA), decided that he had better devote most of his time over the next few days to preparing for an upcoming meeting. This was due to take place on the 15th and would be an opportunity for PERESA to make a counter-offer for the purchase of Manufacturas Lizard S.A. by proposing a revised price for the company.

As the leader of PERESA's negotiating team, Mr Hernández was aware that buying Lizard potentially represented a unique opportunity for the company's growth strategy, and that the next meeting could be decisive to completing the transaction.

However, one of the vendor company's negotiating team had made a comment that summed up the state of the negotiations at that point:

"The negotiations we began four months ago are at a critical point right now. Everything went as smooth as silk, until we broached the minor detail of the price."

Some Background Information About Manufacturas Lizard, S.A.

Manufacturas Lizard S.A. (MALISA) was a family firm founded in 1975 by Mr José Castro and was devoted to the production of plaster and gypsum for use as building materials. Plaster and gypsum are composite materials mainly consisting of semihydrate and anhydrate calcium sulphate. They are obtained by processing chalk and have the property that after mixing with water they harden on contact with air as a result of crystallisation of the hydrated calcium sulphate.

MALISA had its headquarters in Sabanagrande, a town near Barranquilla, in the north of Colombia. Although ownership of the company was spread among various members of the Castro family, the control and management of the company was in the hands of Santiago Castro, the founder's son, who held the position of general manager.

The company sold its production through general (non-specialist) building materials distributors. In 2011, the gypsum and plaster sector for the construction industry in Colombia was highly fragmented, with very few exclusive distribution agreements.

MALISA's market was primarily centred on the north of Colombia, where it had a market share of close to 50%. The company did not have a nationwide presence. Its main competitor was another local producer, Materiales de Construcción y Cementos (MCC), which was present throughout the country and accounted for the remaining 50% of the market in the north.

Prices in the north-Colombian plaster market were significantly higher than in the rest of the country, due to the strength of demand and the fact that production and marketing were very concentrated.

In late 2010, Santiago Castro felt that MALISA's position was untenable in the medium to long term. In his opinion, the company lacked the financial resources necessary to compete with MCC over the long term as the competitive advantages it currently enjoyed would not last forever. One possible solution would be for a financial partner to put up the resources necessary to develop the company, which had reserves of calcium sulphate that were excellent on account of their purity, size and location.

Moreover, Mr Castro was aware that multinational firms interested in expanding in Latin America might have the company in their sights.

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Starting the Negotiations

One of these multinational firms was Plásticos Reales, S.A. (PERESA), a Spanish firm with a strategy of growth in new Latin American countries. Its general manager was Julio Hernández. Annex 1 gives audited accounting information about the company.

In 2010, PERESA's corporate development team studied the state of the market in Colombia, and suggested that the possible acquisition of Lizard was a perfect match for PERESA's strategic goals. In early 2011, Mr Hernández was entrusted with the task of starting conversations with MALISA's management with a view to negotiating a possible acquisition. The initial contacts took place in February and March, and the negotiations between the companies proceeded in an atmosphere of mutual interest and cooperation. In early March 2011 the two companies agreed to start the due diligence process.¹

By the end of March 2011 the negotiations had reached a point at which there was a general agreement about the terms of the acquisition, as regards the operational aspects and future plans. The confidentiality agreements and a first letter of intent were therefore signed.² However, the always-delicate issues of the price and form of payment remained to be discussed.

A valuation of Manufacturas lizard (MALISA)

In order to focus discussion towards a possible agreement on the price, both parties decided to make their own valuation of MALISA. To enable the purchaser (PERESA) to make its valuation, MALISA provided the accounting information listed in Annex 2.

¹ The process of due diligence is embarked upon when the parties have agreed the general terms of the merger and it is a preliminary step before signing and exchanging contracts. It involves an investigation which may be defined as a search for information by the purchasing company so as to analyse the risks affecting the company it wishes to buy. It starts at the same time as the formal negotiations. This process does not normally begin until the more general principles and at least the foundations of the transaction have been agreed by the parties, or in some cases, when a serious offer is made. See: "Fusiones y Adquisiciones en la práctica" García Estévez, P. and López Lubián, F. Delta Publicaciones. Madrid 2011.

² After the initial contact between the parties, and before the due diligence is undertaken, the parties agree the more general terms and the foundations of the transaction. When a candidate is identified, a Memorandum of Understanding is signed. The Memorandum of Understanding is a type of non-binding agreement which sets out the undertakings which may later form the basis of the contractual agreement. In it, an undertaking is declared, or an intention stated to start or continue negotiations which may lead to a final agreement on the purchase. Memoranda of Understanding share some features with written contracts but in general, are not entirely binding on the parties. Many, however, contain binding clauses, such as the non-disclosure of the agreements, a good-faith clause, or a willingness to promise exclusive negotiating rights. The importance of this document lies in the fact that it establishes the pacts that may have been reached so far and delimits the set of points on which a satisfactory agreement has to be reached. It may propose an approximate sum to be paid for the shares or assets of the company being sold. See: "Fusiones y Adquisiciones en la práctica" García Estévez, P. and López Lubián, F. Delta Publicaciones. Madrid, 2011

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Based on this information, the CEO of the vendor company, Mr Castro, proposed a value for MALISA based on its book value plus a premium. For the vendor's part, the upper and lower limits for the negotiations were in the range of 1.20 and 1.46 US dollars per share, as shown in Table 1.

Refer Table 1

In Mr Castro's opinion, as the representative of the vendor, this valuation for MALISA was entirely reasonable as the market was paying an average of 3 times EBITDA in similar operations (see Annexure 1).

Although Mr Hernández understood the reasoning behind the way the vendor had set the offered price, he was not convinced by the method. On his view, it would make more sense to try to negotiate the maximum and minimum prices thresholds based on the company's expectations and risks, and not just on the book value of its assets.

The Audit Results

As part of the due diligence process, PERESA ordered an audit on the unaudited financial statements supplied by MALISA. In late May the international audit firm in charge of the audit delivered a report in which it suggested a series of adjustments should be made to the information initially submitted by MALISA.

Table 2 shows the proposed adjustments related to the Accumulated Profit and Loss Account for the period 2008-10.

If all these adjustments were included in P&L, the accumulated result of MALISA for the period 2008-10 would be substantially different (see Annexure 2). Moreover, these new earnings did not include possible tax contingencies that might arise from these adjustments. Obviously, changes were also made to the Balance Sheet as at 31 December 2010 (Annexure 3).

Table 3 summarises the possible tax contingencies not included in the proposed adjustments.

Refer Table 2 & 3

A New valuation of MALISA

In the light of the information provided by the auditors, Mr Hernández felt that a correct valuation of MALISA should be based on these audited financial statements, as in his opinion, they gave a better picture of the operational situation of the company.

In order to negotiate the maximum and minimum price thresholds, Mr Hernández thought that both parts should reach an agreement on the value of the company in a continuity scenario (minimum price), and the value of the company in a scenario including the main synergies that would derive from the acquisition process (maximum price).

After his management team analysed MALISA's earnings after adjustments, Mr Hernández considered that the maximum and minimum prices could be summarised in the assumptions given in Annexure 4.

Counter Offer and Negotiations with MALISA

As mentioned, the date for the meeting with MALISA to discuss and negotiate PERESA's counter offer was set for 15 June 2011. Mr Hernández was aware of the importance of this meeting in order to reach an agreement on the acquisition of MALISA. In his experience, to achieve a good outcome from this sort of meetings it was important to go well prepared (with homework done in advance) and pursue a clear negotiating strategy.

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To this end, he drew up a list of the key points that needed to be addressed in order to conclude the transaction successfully:

Independently on the final price, both PERESA and MALISA (Lizard) are extremely interested in the operation. Over the course of the negotiations the level of mutual understanding has been high, and everything points to a promising future for this acquisition.

The seller (MALISA, and more specifically Mr Castro) has in mind a minimum price of around seven million dollars, based on a multiple of EBITDA and a premium on the net book value. The offer should be made in these terms.

The results of the audit have already been implicitly accepted by the seller, as mentioned in the memorandum of understanding signed in March.

In order to facilitate negotiations, it will be a good idea to differentiate the proposed adjustments from the estimated tax contingencies. Including the former is crucial to obtaining a clear idea of the operational situation of the company. The tax contingencies can be discussed and dealt with separately.

If the maximum and minimum values are analysed based on the expected future cash flows provided by PERESA, what might seller's (Lizard) response be? What reasonable arguments can it provide to increase the value?

Annexure 1: Accounting information about PERESA

Audited figures (In thousands of US dollars)

1. Profit and Loss Account. Fiscal Year 2010

Net sales	50.125
Cost of Sales	-28.520
Gross Margin	21.605
Operating Expenses	-18.547
Operating Earnings	3.058
Other Income/Expenses	-200
EBIT	2.858
Taxes	-857
Net Earnings	2.001

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