CHAPTER 2
THEORETICAL ASPECTS OF THE STUDY

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2.1 INTRODUCTION OF FINANCIAL PERFORMANCE

The word ‘Performance is derived from the word ‘parfourmen’, which means ‘to do’, ‘to carry out’ or ‘to render’. It refers the act of performing; execution, accomplishment, fulfilment, etc. In border sense, performance refers to the accomplishment of a given task measured against preset standards of accuracy, completeness, cost, and speed. In other words, it refers to the degree to which an achievement is being or has been accomplished. In the words of Frich Kohlar “The performance is a general term applied to a part or to all the conducts of activities of an organization over a period of time often with reference to past or projected cost efficiency, management responsibility or accountability or the like. Thus, not just the presentation, but the quality of results achieved refers to the performance. Performance is used to indicate firm’s success, conditions, and compliance.

Financial performance refers to the act of performing financial activity. In broader sense, financial performance refers to the degree to which financial objectives being or has been accomplished. It is the process of measuring the results of a firm's policies and operations in monetary terms. It is used to measure firm's overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries or sectors in aggregation.

There are many different ways to measure financial performance, but all measures should be taken in aggregation. Line items such as revenue from operations, operating income or cash flow from operations can be used, as well as total unit sales. Furthermore, the analyst or investor may wish to look deeper into financial statement and seek out margin growth rates or any declining debt, measuring the results of a firm’s policies and operations in monetary terms. These results are reflected in the firm’s return on investment, return on assets, value added etc.
2.2 CONCEPT OF FINANCIAL ANALYSIS

Meaning
Management, creditors, investors and others to form judgement about the operating performance and financial position of the firm use the information contained in the financial statements. Users of financial statements can get further insight about financial strengths and weaknesses of the firm if they properly analyse information reported in these statements. Management should be particularly interested in knowing financial strengths of the firm to make their best use and to be able to spot out financial weaknesses of the firm to take suitable corrective actions. The future plans of the firm should be laid down in view of the firm’s financial strengths and weaknesses. Thus, financial analysis is the starting point for making plans, before using any sophisticated forecasting and planning procedures. Understanding the past is a prerequisite for anticipating the future.

Financial analysis is the process of identifying the financial strengths and weaknesses of the firm by properly establishing relationships between the items of the balance sheet and profit and loss account.

Users
Financial analysis can be undertaken by management of the firm, or by parties outside the firm, i.e. owners, creditors, investors and others. The nature of analysis will differ depending on the purpose of the analyst.

1. Trade Creditors: The trade creditors are interested in firm’s ability to meet their claims over a very short period of time. Their analysis will, therefore, confine to the firm’s liquidity position.

2. Suppliers of Long-term Loan: The supplier or long-term loans are concerned with the firm’s long-term solvency and survival. They analyse the firm’s profitability over time, its ability to generate cash to be able to pay interest and repay principal and the relationship between various sources of funds. Long-term creditors do analyse the historical financial statements, but they place more emphasis on the
firm’s projected, or proforma, financial statements to make analysis about its future solvency and profitability.

3. Investors: The investors are most concerned about the firm’s earnings. They restore more confidence in those firms that show steady growth in earnings. As such, they concentrate on the analysis of the firm’s present and future profitability. They are also interested in the firm’s financial structure to the extent it influences the firm’s earning ability and risk.

4. Management: The management or the firm would be interested in every respect of the financial analysis. It is their overall responsibility to see that the resources of the firm are used most effectively and efficiently, and that the firm’s financial condition is sound.

2.3 MEANING AND TYPES OF FINANCIAL STATEMENTS

Meaning
The basis for financial planning, analysis and decision-making is the financial information. Financial information is needed to predict, compare and evaluate the firm’s earning ability. It is also required to aid in economic decision-making, investment and financing decision-making. The financial information of an enterprise is contained in the financial statements or accounting reports.

A financial statement is an organized collection of data according to logical and consistent accounting procedures. Its purpose is to convey an understanding of some financial aspects of a balance sheet, or may reveal a series of activities over a given period of time, as in the case of an Income Statement.

Types
The term ‘Financial Statements’ generally refers to two basic statements:
1. The Income Statement
2. The Balance Sheet
3. Cash Flow Statement
1. **Profit and Loss Account**

The Profit and Loss Account (also known as Income Statement) summarizes the activities of an enterprise in a period by disclosing the revenues earned and the expenses incurred. By measuring the net profit earned by a business, it indicates its degree of operating success.

2. **Balance Sheet**

It is a statement of financial position of a business at a specified moment of time. It represents all assets owned by the business at a particular moment of time and the claims (or equities) of the owners and outsiders against those assets at that time. It is in a way a snapshot of the financial condition of the business at that time.

The important distinction between an Income Statement and a Balance Sheet is that the Income Statement is for a period while Balance Sheet is on a particular date. Income statement is, therefore, a flow report, as contrasted with the Balance Sheet which is a static report. However, both are complementary to each other.
3. Cash Flow Statement
The profit and loss account reports only the effects of the current operations of the enterprise on its financial position. The balance sheet shows the financial position of the enterprise at the end of a period. Neither of these statements describes the investments in assets during the period and how those investments are financed. The cash flow statement sums up the major sources of cash receipts and cash payments of an enterprise in a period. It reports the cash effects of not only the enterprise’s operations but also its investing and financing activities.

2.4 MEANING OF FINANCIAL STATEMENT ANALYSIS
The financial performance of the company can be measure by analysing financial statements because the financial statements provide a summarized view of the financial position and operation of a firm.

The focus of financial analysis is on key figures in the financial statements and significant relationship that exists between them. The analysis of financial statement is a process of evaluating relationship between the component parts of financial statements to obtain a better understanding of the firm’s position and performance. The first task of the financial analyst is to select the information relevant to the decision involved in financial to arrange the information in a way to highlight significant relationships. The final step is interpretation and drawing of inferences and conclusions. In brief financial analysis is the process of selection, relation and evaluation.

Financial Statement Analysis is an analysis which highlights important relationships in the financial statements. It focuses on evaluation of past operations as revealed by the analysis of basic statements. Financial Statement Analysis embraces the methods used in assessing and interpreting the results of past performance and current financial position as they relate to particular factors of interest in investment decisions. It is an important means of assessing past performance and in forecasting and planning future performance.

According to Lev, “Financial Statement Analysis is an information processing system designed to provide data for decision making models, such as the portfolio
selection model, bank lending decision models, and corporate financial management models.”

According to Myers, “Financial statement analysis is largely a study of the relationship among the various financial factors in a disclosed by a single set of statements and a study of the trend of these factors as shown in a series of statements.”

2.5 OBJECTIVES OF FINANCIAL STATEMENT ANALYSIS
Financial statement analysis can be used by the different users and decision makers to achieve the following objectives:

1. **Assessment of Past Performance and Current Position**
   Past performance is often a good indicator of future performance. Therefore, an investor or creditor is interested in the trend of past sales, expenses, net income cash flow and return on investment. These trends offer a means for judging management’s past performance and are possible indicator of future performance. Similarly, the analysis of current position indicated where the business stands today. For instance, the current position analysis will show the types of assets owned by a business enterprise and the different liabilities due against the enterprise. It will tell what the cash position is, how much debt the company has in relation to equity and how reasonable the inventories and receivables are.

2. **Prediction of Net Income and Growth Prospects**
The financial statement analysis helps in predicting the earning prospects and growth rates in the earnings which are used by investors while comparing investment alternative and other users interested in judging the earning potential of business enterprise. Investors also consider the risk and uncertainty associated with the expected return. The decision makers are futuristic and are always concerned with the future. Financial statements which contain information on past performances are analysed and interpreted as basis for forecasting future rates of return and for assessing risk. The prediction of future earnings tends to improve the financial made by the investors and financial analyst.
3. Prediction of Bankruptcy and Failure

Financial statement analysis is a significant tool in predicting the bankruptcy and failure probability of a business enterprise. Financial statement analysis accomplishes this through the evolution of the solvency position. After being aware about probable failure, managers and investors both can take preventive measures to avoid/minimize losses. Corporate arrangements can effect changes in the operating policy, reorganize financial structure or even go for voluntary liquidation to shorten the length of time losses.

4. Loan Decision by Financial Institutions and Banks

Financial Statement Analysis is used by financial institutions, loaning agencies, banks and others to make sound loan or credit decision. In this way, they can make proper allocation of credit among the different borrowers. All lenders are primarily concerned with repayment of loan and payment of interest on the due dates. This requires comprehensive investigation and analysis of the financial statements submitted by the borrowers. Financial statement analysis helps in determining credit risk, deciding terms and condition of loan if sanctioned, interest rate, maturity date etc.

2.6 TYPES OF FINANCIAL STATEMENT ANALYSIS

Financial statement analysis can be classified into following:

1. On the Basis of Material Used

According to this basis, financial analysis can be of two types:

A. External Analysis

This analysis is done by those who are outsiders for the business. The term outsiders include investors, credit agencies, government agencies and other creditors who have no access to the internal records of the company. They mainly depend upon the published financial statements. Their analysis serves only a limited purpose. The position of these analysis has improved in recent times on account of increased governmental control over companies and governmental regulations requiring more detailed disclosure of information by the companies in their financial statements.
B. Internal Analysis
This analysis is done by persons who have access to the books of account and other information related to the business. Such an analysis can, therefore, be done by executives and employees of the organization or by officers appointed for this purpose by the Government or the Court under powers vested in them. This analysis is done depending upon the objective to be achieved through this analysis.

2. On the Basis of modus operandi
According to this, financial analysis can be of two types:

A. Horizontal Analysis
In this case, financial statements for a number of years are reviewed and analysed. The current year’s figures are compared with the standard or base year. The analysis statement usually contains figures for two or more years and the changes are shown regarding each item from the base year usually in the form of percentage. Such an analysis gives the management considerable insight into levels and areas of strength and weakness. Since this type of analysis is based on the data from year to year rather than on one date, it is also termed as ‘Dynamic Analysis’.

B. Vertical Analysis
In this case, a study is made of the quantitative relationship of the various items in the financial statements on a particular date. For example, the ratios of different items of costs for a particular period may be calculated with the sales for that period. Such an analysis is useful in comparing the performance of several companies in the same group, or divisions or departments in the same company. It is also called ‘Static Analysis’ as it is frequently used for referring to ratios developed on one date or for one accounting period.

2.7 LIMITATIONS OF FINANCIAL STATEMENT ANALYSIS
Financial analysis is a powerful mechanism which helps in ascertaining the strengths and weaknesses in the operations and financial position of an enterprise. However, this analysis is subject to certain limitations. Most of these limitations are because of the limitations of the financial statements themselves. These limitations are as follows:
1. **Financial Analysis is only a Means**
   
   Financial analysis is a means to an end and not the end itself. The analysis should be used as a starting point and the conclusion should be drawn not in isolation, but keeping in view the overall picture and the prevailing economic and political situation.

2. **Ignores Price Level Changes**
   
   Financial statements are normally prepared on the concept of historical costs. They do not reflect values in terms of current costs. Thus, the financial analysis based on such financial statements or accounting figures would not portray the effects of the price level changes over the period.

3. **Financial Statements are Essentially Interim Reports**
   
   The profit shown by Profit and Loss Account and the financial position depicted by the Balance Sheet are not exact. The exact position can be known only when the business is closed down. Again, the existence of contingent liabilities and deferred revenue expenditure make them more imprecise.

4. **Accounting Concepts and Conventions**
   
   Financial Statements are prepared on the basis of certain accounting concepts and conventions. On account of this reason the financial position as disclosed by these statements may not be realistic. For example, fixed assets in the balance sheet are shown on the basis of going concern concept. This means that value placed on fixed assets may not be the same which may be realized on their sale. On account of convention of conservatism the income statement may not disclose true income of the business since probable losses are considered while probable incomes are ignored.

5. **Influence of Personal Judgement**
   
   Many items are left to the personal judgement of the accountant. For example, the method of depreciation, mode of amortization of fixed assets, treatment of deferred revenue expenditure, all depend on the personal judgement of the accountant. The soundness of such judgement will necessarily depend upon his competence and
integrity. However, the convention of consistence acts as a controlling factor on making indiscreet personal judgements.

6. Disclose only Monetary Facts
Financial statements do not depict those facts which cannot be expressed in terms of money. For example, development of a team of loyal and efficient workers, enlightened management, the reputation and prestige of management with the public, are matters which are of considerable importance for the business, but they are nowhere depicted by financial statements.

2.7 TECHNIQUES OF FINANCIAL STATEMENT ANALYSIS

Chart 2.2: Techniques of Financial Statement Analysis
1. **Comparative Financial Statements**
Comparative financial statements are those statements which have been designed in a way so as to provide time perspective to the consideration of various elements of financial position embodied in such statements. In these statements figures for two or more periods are placed side by side to facilitate comparison.

Both the Income Statement and Balance Sheet can be prepared in the form of Comparative Financial Statements.

i. **Comparative Income Statements**
The Income Statement discloses Net Profit or Net Loss – on account of operations. A Comparative Income Statement will show the absolute figures for two or more periods, the absolute change from one period to another and, if desired, the change in terms of percentages.

ii. **Comparative Balance Sheet**
Comparative Balance Sheet as on two or more different dates can be used for comparing assets and liabilities and finding out any increase or decrease in those items.

2. **Common-size Financial Statements**
Common-size Financial Statements are those in which figures reported are converted into percentages to some common base. In the Income Statement thesis figure is assumed to be 100 and all figures are expressed as a percentage of this total.

3. **Trend Percentages**
Trend percentages are immensely helpful in making a comparative study of the financial statements for several years. The method of calculating trend percentages involves the calculation of percentage relationship that each item bears to the same item in the base year. Any year may be taken as the base year. It is usually the earliest year. Any intervening year may also be taken us the base year. Each item of base year is taken as 100 and on that basis the percentages for each of the items of each of the years are calculated. These percentages can also be taken as Index
Numbers showing relative changes in the financial data resulting with the passage of time.

The method of trend percentages is a useful analytical device for the management since by substituting percentages for large amounts; the brevity and readability are achieved. However, trend percentages are not calculated for all of the items in the financial statements. They are usually calculated only for major items since the purpose is to highlight important changes.

4. Funds Flow Analysis
Funds flow analysis has become an important tool in the analytical lit of financial analysts, credit granting institutions and financial managers. This is because the Balance Sheet of a business reveals its financial status at a particular point of time. It does not sharply focus those major financial transactions which have been behind the Balance Sheet changes. For example, if a loan of ₹ 2,00,000 was raised and paid during the accounting year, the balance sheet will not depict this transaction. However, a financial analyst must know the purpose for which the loan was utilized and the source from which it was obtained. This will help him in making a better estimate about the company’s financial position and policies.

Funds flow analysis reveals the changes in working capital position. It tells about the sources from which the working capital was obtained and the purposes for which it was used. It brings out in open the changes which have taken place behind the Balance Sheet. Working capital being the life-blood of the business, such an analysis is extremely useful.

5. Cash Flow Analysis
Cash flow analysis is another important technique of financial analysis. It involves preparation Cash Flow Statement for identifying sources and applications of cash. It is a statement depicting change in cash position from one period to another. It helps management in making plans for the immediate future. A projected Cash Flow Statement or Cash Budget will help the management in ascertaining how much cash will be available to meet obligations to trade creditors, to pay bank loans and to pay divided to the shareholders.
6. **Cost – Volume – Profit Analysis**

Cost – Volume – Profit Analysis is an important tool of profit planning. It studies the relationship between cost, volume of production, sales and profit. Of course it is not strictly a technique used for analysis of financial statements. However, it is an important tool for the management for decision-making since the data is provided by both cost and financial records. It tells the volume of sales at which the firms will break-even, the effect on profit on account of variation in output, selling price and cost, and finally, the quantity to be produced and sold to reach the target profit level.

7. **Ratio Analysis**

This is the most important tool available to financial analysis for their work. An accounting ratio shows the relationship in mathematical terms between two interrelated accounting figures. The figures have to be interrelated (e.g., Gross Profit and Sales, Current Assets and Current Liabilities), because no useful purpose will be served if ratios are calculated between two figures which are not at all related to each other, e.g., sales and discount on issue of debentures.

shiney MERGERS AND ACQUISITIONS

2.8 **INTRODUCTION OF MERGERS AND ACQUISITIONS**

An entrepreneur may grow its business either by internal expansion or by external expansion. In the case of internal expansion, a firm grows gradually over time in the normal course of the business, through acquisition of new assets, replacement of the technologically obsolete equipment and the establishment of new lines of products. But in external expansion, a firm acquires a running business and grows overnight through corporate combinations. These combinations are in the form of mergers, acquisitions, amalgamations and takeovers and have now become important features of corporate restructuring. They have been playing an important role in the external growth of a number of leading companies the world over. They have become popular because of the enhanced competition, breaking of trade barriers, free flow of capital across countries and globalization of businesses. In the wake of economic reforms, Indian industries have also started restructuring their operations around their core business activities through mergers, acquisitions and takeovers because of their increasing exposure to competition both domestically and internationally.
Mergers and acquisitions (M & As) have been a very important market entry strategy as well as expansion strategy. This present era is known as competition era. In this era companies, to avoid the competition, go for merger, and enjoy sometimes monopoly. Corporate India is waking up to the new millennium imperative of mergers and acquisitions in a desperate search for a panacea for facing the global competition. This is hardly surprising as stiff competition is, in a sense, implicit in any bid to integrate the national economy with the global economy. The ongoing process of liberalization has exposed the unproductive use of capital by the Indian corporate both in public and private sectors. Consolidation through mergers and acquisitions (M & As) is considered one of the best ways of restructuring structure of corporate units.

The concept of mergers and acquisitions is very much popular in the current scenario, so it is significantly popular concept, after 1990s, where India entered in to the Liberalization, Privatization and Globalization (LPG) era. The winds of LPG are blowing over all the sectors of the Indian economy but its maximum impact is seen in the industrial sector. It caused the market to become hyper-competitive. As competition increased in the economy, so to avoid unhealthy competition and to face international and multinational companies, Indian companies are going for mergers and acquisitions.

Basically, a merger involves a marriage of two or more entities. Merger is defined as blending of two or more entity into a single entity. The shareholders of each blending entity will become the substantially the shareholders in the entity which is to carry on the blended entity.

**2.9 CONCEPT AND DEFINITION OF MERGERS AND ACQUISITIONS**

Merger is defined as combination of two or more companies into a single company where one survives and the other lose their corporate existence. The survivor acquires the assets as well as liabilities of the merged company or companies.

A merger is a combination of two companies where one corporation is completely absorbed by another corporation. The less important company losses its identity and becomes part of the more important corporation, which retains its identity. A merger extinguishes the merged corporation and the surviving corporation assumes all the
right, privileges, and liabilities of the merged corporation. A merger is not the same as a consolidation in which two corporations lose their separate identities and unite to form a completely new corporation.

A merger is a combination of two or more businesses into one business. Laws in India use the term 'amalgamation' for merger. The Income Tax Act, 1961 [Section 2(1A)] defines amalgamation as the merger of one or more companies with another or the merger of two or more companies to form a new company, in such a way that all assets and liabilities of the amalgamating companies become assets and liabilities of the amalgamated company and shareholders not less than nine-tenths in value of the shares in the amalgamating company or companies become shareholders of the amalgamated company.

According to the Oxford Dictionary the expression merger or amalgamation means “Combining of two commercial companies into one” and “Merging of two or more business concerns into one” respectively. A merger is just one type of acquisition. One company can acquire another in several other ways including purchasing some or all of the company’s assets or buying up its outstanding share of stock.

To end up the word “MERGER” may be taken as an abbreviation which means:

- M → Mixing
- E → Entities
- R → Recourses for
- G → Growth
- E → Enrichment and
- R → Renovation

**Acquisition**

Acquisition in general sense is acquiring the ownership in the property. Acquisition is the purchase by one company of controlling interest in the share capital of another existing company. This means that even after the takeover although there is change in the management of both the firms retain their separate legal identity.
The Five Rules of Successful Acquisition

By: Peter F. Drucker is as under

1. Think what you can contribute to the business it is buying not what the acquirer company will contribute to the acquirer.
2. Common core of unity: The two business must have a common either markets or technology.
3. Temperamental fit: No acquisition works unless people in the acquiring company respect the product, the markets and the customers of the company they acquire.
4. Within a year or so the acquiring company must be able to provide top management for the company it acquires.
5. Within the first year of a merger, it is important that a large number of people in management groups of both companies receive substantial promotion across the line that is from one of the former companies to the other.

2.10 HISTORY OF MERGERS AND ACQUISITIONS

Merger and acquisition activity in the United States has typically run in cycles, with peaks coinciding with periods of strong business growth. U. S. merger activity has been marked by five prominent waves: One around the turn of the twentieth century, the second peaking in 1929 the third in the latter half of the 1960s the fourth in the first half of 1980s and the fifth in the latter half of the 1990s. This last peak, in the final years of the twentieth century, brought very high levels of merger activity.

2.11 TYPES OF MERGERS

There are mainly four types of mergers based on the competitive relationships between the merging parties:

1. Horizontal Mergers
2. Vertical Mergers
3. Conglomerate Mergers
4. Reverse Mergers
1. Horizontal Mergers
Horizontal Merger is a combination of two or more firms in the same area of business. Horizontal merger is a merger of two companies which are essentially operating in the same business. The main purpose of this merger is to obtain economy of scale in production by eliminating duplication of facilities, reducing of competition, reduction of cost, increase in share price and market segments e.g.; the merger of ICICI Bank and Bank of Madura is a horizontal merger. But the merger of ICICI bank and Mahindra Tractor it is not a horizontal merger.

Horizontal mergers raise three basic competitive issues. The first is the elimination of competition between the merging firms, which, depending on their size, may be significant. The second is that the unification of the merging firm’s operations may create substantial market power and could enable the merged entity to raise prices by reducing output unilaterally. The third problem is that by increasing concentration in the relevant market, the transaction may strengthen the ability of the markets remaining participants to co-ordinate their pricing and output decisions. The fear is not that the entities will engage in secret collaboration but that the reduction in the number of industry members will enhance co-ordination of behaviour.

2. Vertical Mergers
Vertical merger is a combination of two or more firms involved in different stages of production or distribution of the same product. It is a merger of one company with another having different stages of production / distribution process of the same product / service. In short the merging companies are engaged in different stages of production or distribution. The main objective is to increase profitability by the previous distributors e.g.; ICICI Ltd. With ICICI Bank is an example of vertical merger with backward linkage as far as ICICI Bank is concerned.

Vertical merger may take the form of forward or backward merger. When a company combines with the supplier of material, it is called backward merger and when it combines with the customer, it is known as forward merger, and their two benefits: first, the vertical merger internalizes all transactions between manufacturer and its supplier or dealer thus converting a potentially adversarial relationship into something more like a partnership. Second, internalization can give the management
more effective ways to monitor and improve performance. Vertical mergers may also be anticompetitive because their entrenched market power may impede new business from entering the market.

Vertical integration by merger does not reduce the total number of economic entities operating at one level of the market, but it may change patterns of industrial behaviour. Whether a forward or backward integration, the newly acquired firm may decide to deal only with the acquiring firm, thereby altering competition among the acquiring firm's suppliers, customers, or competitors. Suppliers may lose a market for their goods, retail outlets may be deprived of supplies, or competitors may find that both supplies and outlets are blocked. This raises the concern that vertical integration will foreclose competitors by limiting their access to sources of supply or to customers. Vertical mergers may also be anticompetitive because their entrenched market power may impede new businesses from entering the market.

3. Conglomerate Mergers

Conglomerate merger is an amalgamation of two companies engaged in different line of business, in other words, the merging companies are engaged in diverse business activities e.g.; ICICI Ltd. merger with Mahindra tractor and Reliance Industries Ltd. merged with Reliance Petroleum Ltd. Conglomerate transactions take many forms, ranging from short term joint ventures to complete mergers. Whether a conglomerate merger is pure, geographical or a product line extension it involves firms that operate in separate market. Conglomerate transactions ordinarily have no direct effect on competition. Conglomerate merger can supply a market or demand for firms thus giving entrepreneurs liquidity at an open market price and with a key inducement to form new enterprises. Conglomerate merger also provide opportunity for firms to reduce capital cost and overhead and achieve other efficiencies.

This type of merger may also reduce the number of smaller firms and increase the merged firm’s political power, thereby impairing the social and political goal of retaining independent decision making centre guaranteeing small business opportunities and preserving democratic processes.
4. **Reverse Mergers**  
Reverse merger is a merger of an ordinary merger, achieved the same general industry but in the same line of business. In case of a reverse merger a healthy company merges into a financially weak company and the former company is dissolved e.g.; the merger of machine tool manufacturer with the manufacturer of industrial conveyor system.

The principal change the name of the company to the name of their company and elect their nominees to the board of directors. A private company merged with an existing public company or a subsidiary of a public company. In a reverse merger an operating private company merges with a public company which has no assets or known liabilities.

**2.12 DIFFERENCE BETWEEN MERGERS AND ACQUISITIONS**

**What is a Merger?**  
The word Merger has a strictly legal meaning and has nothing to do with how the combined companies operate in the future. A merger occurs when one corporation is combined with and disappears into another corporation. All mergers are statutory mergers, since all mergers occur as specific formal transactions in accordance with the laws, or statutes, of the states where the companies are incorporated. The post-transaction operations or control of a company has no relevance on whether a merger has occurred or not.

**What is an Acquisition?**  
An Acquisition is the process by which the stock or assets of a corporation are owned by a purchaser. The transaction may take the form of a purchase of stock or a purchase of assets.

**Difference between Mergers and Acquisitions**  
Difference between Mergers and Acquisitions is subtle. It is true that the terms Mergers and Acquisitions are used in a way that it seems, both are synonymous. But, the fact is that, there is a slight difference in the two concepts.
In case of a Merger, two firms, together, form a new company. After merger, the separately owned companies become jointly owned and get a new single identity. When two firms get merged, stocks of both the concerns are surrendered and new stocks in the name of new merged company are issued. Generally, Mergers take place between two companies of more or less of same size. In these cases, the process is called Merger of Equals.

But, in case of Acquisition, one firm takes over another and establishes its power as the single owner. Here, generally, the firm which takes over is the bigger and stronger one. The relatively less powerful smaller firm loses its existence after Acquisition and the firm which takes over, runs the whole business by its' own identity. Unlike Merger, in case of Acquisition, the stocks of the acquired firm are not surrendered. The stocks of the firm that are bought by the public earlier continue to be traded in the stock market. But, often Mergers and Acquisitions become synonymous, because in many cases, the big firm may buy out a relatively less powerful one and thus compels the acquired firm to announce the process as a Merger. Although, in reality an Acquisition takes place, the firms declare it as a Merger to avoid any negative impression.

Another difference between Mergers and Acquisitions is that, when a deal is made between two companies in friendly terms, it is proclaimed as Merger, even in case of a buyout. But, if it is an unfriendly deal, where the stronger firm swallows the target firm, even when the target company is not willing to be purchased, then it is called an Acquisition.

### 2.13 MERGERS AND ACQUISITIONS PROCESS

Mergers and Acquisitions Process is a great concern for all the companies who intend to go for a merger or an acquisition. This is so because, the process of mergers and acquisitions can heavily affect the benefits derived out of the mergers or acquisitions. So, the Mergers and Acquisitions Process should be such that it would maximize the benefits of a mergers or acquisitions deal.

The Mergers and Acquisitions Process can be divided in to some steps. The stepwise implementation of any merger process ensures its profitability.
1. **Preliminary Assessment or Business Valuation**

In this first step of Mergers and Acquisitions Process, the market value of the target company is assessed. In this process of assessment not only the current financial performance of the company is examined but also the estimated future market value is considered. The company which intends to acquire the target firm engages itself in a thorough analysis of the target firm's business history. The products of the firm, its' capital requirement, organizational structure, brand value everything are reviewed strictly.

2. **Phase of Proposal**

After complete analysis and review of the target firm's market performance, in the second step, the proposal for mergers or acquisitions is given. Generally, this proposal is given through issuing a non-binding offer document.

3. **Exit Plan**

When a company decides to buy out the target firm and the target firm agrees, then the latter involves in Exit Planning. The target firm plans the right time for exit. It considers all the alternatives like Full Sale, Partial Sale and others. The firm also does the tax planning and evaluates the options of reinvestment.

4. **Structured Marketing**

After finalizing the Exit Plan, the target firm involves in the marketing process and tries to achieve highest selling price. In this step, the target firm concentrates on structuring the business deal.

5. **Origination of Purchase Agreement or Merger Agreement**

In this step, the purchase agreement is made in case of an acquisition deal. In case of Merger also, the final agreement papers are generated in this stage.

6. **Stage of Integration**

In this final stage, the two firms are integrated through Mergers or Acquisitions. In this stage, it is ensured that the new joint company carries the same rules and regulations throughout the organization.
2.14 SIGNIFICANCE OF MERGERS AND ACQUISITIONS

Requirement of Mergers and Acquisitions

2+2=5: This equation is the special alchemy of a mergers or acquisitions. The key principle behind buying a company is to create shareholder value over and above that of the sum of the two companies. Two companies together are more valuable than two separate companies this is the main reason behind mergers and acquisitions.

Sometimes organization can produce goods or services more efficiency if they combine their efforts and facilities. These efficiency gains may come simply of the size of the combined company. Collaborating or sharing expertise may be achieve gains in efficiency or a company might have underutilized assets, the other company can better use. Also a change in management may take the company more profitable. The management of an acquiring company may be motivated more by the desire to manage large companies than by any possible gains in efficiency.

Motives behind Mergers and Acquisitions

Accelerating a company's growth particularly when its internal growth is constrained due to paucity of resources, internal growth requires that a company should develop its operating facilities- manufacturing, research, marketing, etc. But, lack or inadequacy of resources and time needed for internal development may constrain a company's pace of growth. Hence, a company can acquire production facilities as well as other resources from outside through mergers and acquisitions. Specially, for entering in new products/ markets, the company may lack technical skills and may require special marketing skills and a wide distribution network to access different segments of markets. The company can acquire existing company or companies with requisite infrastructure and skills and grow quickly.

This may happen because of:-

1. **Economies of Scale**

Arise when increase in the volume of production leads to a reduction in the cost of production per unit. This is because, with merger, fixed costs are distributed over a large volume of production causing the unit cost of production to decline. Economies
of scale may also arise from other indivisibilities such as production facilities, management functions and management resources and systems. This is because a given function, facility or resource is utilized for a large scale of operations by the combined firm.

2. **Operating Economies**

Arise because, a combination of two or more firms may result in cost reduction due to operating economies. In other words, a combined firm may avoid or reduce overlapping functions and consolidate its management functions such as manufacturing, marketing, R & D and thus reduce operating costs. For example, a combined firm may eliminate duplicate channels of distribution, or create a centralized training centre, or introduce an integrated planning and control system.

3. **Synergy**

Implies a situation where the combined firm is more valuable than the sum of the individual combining firms. It refers to benefits other than those related to economies of scale. Operating economies are one form of synergy benefits. But apart from operating economies, synergy may also arise from enhanced managerial capabilities, creativity, innovativeness, R & D and market coverage capacity due to the complementarily of resources and skills and a widened horizon of opportunities.

4. **Cross Selling**

For example, a bank buying a stockbroker could than sell its banking products to the stock broker’s customers, while the broker can sign up the bank’s customers for broker’s accounts.

5. **Taxes Savings**

A profitable company can buy a loss making unit to use the targets tax write offs. In the U.S. and many countries, rules are in place to limit the ability of profitable companies to shop for loss making companies limiting the tax motive of an acquiring company.
6. **Greater Value Generation**
Companies go for Mergers and Acquisitions from the idea that, the joint company will be able to generate more value than the separate firms. When a company buys out another, it expects that the newly generated shareholder value will be higher than the value of the sum of the shares of the two separate companies.

7. **Gain in Market Share**
Mergers and Acquisitions can prove to be really beneficial to the companies when they are weathering through the tough times. If the company which is suffering from various problems in the market and is not able to overcome the difficulties, it can go for an acquisition deal. If a company, which has a strong market presence, buys out the weak firm, then a more competitive and cost efficient company can be generated.

Here, the target company benefits as it gets out of the difficult situation and after being acquired by the large firm, the joint company accumulates larger market share. This is because of these benefits that the small and less powerful firms agree to be acquired by the large firms.

8. **Resource Transfer**
Resource are unevenly distributed across firms and the interaction of target and acquiring firm resources can create value through either overcoming information or combining scarce resources.

2.15 **LIMITATIONS OF MERGERS**
Mergers involves the following limitations
- Elimination of healthy competition
- Striving for bigness
- Concentration of economic power
- Monopoly affecting the customer and suppliers
- Adverse effects on national economy.
2.16 IMPACT OF MERGERS AND ACQUISITIONS

1. Impact of Mergers & Acquisitions on Shareholders
We can further categorize the shareholders into two parts:
• The Shareholders of the acquiring firm
• The shareholders of the target firm.

A. Shareholders of the Acquired Firm
The shareholders of the acquired company benefit the most. The reason being, it is seen in majority of the cases that the acquiring company usually pays a little excess than it what should. Unless a man lives in a house he has recently bought, he will not be able to know its drawbacks. So that the shareholders forgo their shares, the company has to offer an amount more than the actual price, which is prevailing in the market. Buying a company at a higher price can actually prove to be beneficial for the local economy.

B. Shareholders of the Acquiring Firm
They are most affected. If we measure the benefits enjoyed by the shareholders of the acquired company in degrees, the degree to which they were benefited, by the same degree, these shareholders are harmed. This can be attributed to debt load, which accompanies an acquisition.

i. Impact of Mergers & Acquisitions in Human Development Employees
In the process of consolidation of corporate sector human resource is also considered to be vital and sensitive issue. The UNI Europe estimated that around 13000 jobs have been lost in 10 years as a result of mergers and acquisitions process. It is a well-known fact that whenever there is a merger or an acquisition, there are bound to be layoffs. In the event when a new resulting company is efficient business wise, it would require less number of people to perform the same task. Under such circumstances, the company would attempt to downsize the labour force. If the employees who have been laid off possess sufficient skills, they may in fact benefit from the lay off and move on for greener pastures. But it is usually seen that the employees, those who are laid off, would not have played a significant role under the new organizational set up. This accounts for their removal from the new organization
set up. These workers in turn would look for re-employment and may have to be satisfied with a much lesser pay package than the previous one. Even though this may not lead to drastic unemployment levels, nevertheless, the workers will have to compromise for the same. If not drastically, the mild undulations created in the local economy cannot be ignored fully.

ii. Impact of M & A on Customers
The impact of mergers and acquisitions has brought a win situation for the customers; this is because the customers are left with a high range of products with a low range of price. This has become possible because the cost of the production which has been reduced due to the cost reduction process adopted by the banks. Thus, offering a wide range of services at a lower rate. All this has become possible due to the advent of information and technology, which allows them to save cost by operating with fewer branches or without a traditional branches network.

iii. The Impact of the Mergers or Acquisitions on the New Organization
Mergers and acquisitions immediately impact organizations with changes in ownership, in ideology, and eventually, in practice. Of the three root strategic assets noted above, cultural cohesion is most often the critical asset in the eventual success or failure of the overall deal and the one that impacts the extent to which qualitative talent retention can be attained.

Despite the fact that it is increasingly common these days for companies to publish their cultural traits or values, what is listed does not always reflect the actual culture of the place. Anthropologists have long known that the task of learning about a specific group’s culture does not start by asking members themselves to identify the specific traits. In fact, cultural traits are not readily identified by the members of a social group. Understanding the depth of cultural influences that are practiced over time within a specific group or organization requires long periods of reflective observation and the formation of key questions about beliefs, disciplines and innovative problem solving strategies.
iv. Impact of Mergers and Acquisitions on Top Level Management

Impact of mergers and acquisitions on top level management may actually involve a "clash of the egos". There might be variations in the cultures of the two organizations. Under the new set up the manager may be asked to implement such policies or strategies, which may not be quite approved by him. When such a situation arises, the main focus of the organization gets diverted and executives become busy either settling matters among themselves or moving on. If however, the manager is well equipped with a degree or has sufficient qualification, the migration to another company may not be troublesome at all.

2.17 FINANCIAL ACCOUNTING FOR MERGERS AND ACQUISITIONS

Mergers and Acquisitions Accounting is done either by Purchase Method or by Pooling of Interests Method as per Accounting Standard – 14.

1. Pooling of Interest Method

This method assumes that the transaction is simply an exchange of equity securities. Therefore the capital stock account of the target firm is eliminated, and the acquirer issues new stock to replace it. The two firm’s assets and liabilities are combined at their book values as of the acquisition date. The end result of a pooling of interests transaction is that the total assets of the combined firm are equal to the sum of the assets of the individual firms. No goodwill is generated, and there are no charges against earnings. A tax free acquisition would normally be reported as a pooling of interests.

But, there are some drawbacks of this Purchase Method. When Mergers and Acquisitions Accounting is done through this Purchase Method, then there is a chance of over rating the Depreciation Charges. This is because, in Purchase Method, book value of assets are used in accounting, but the book value of assets is generally lower than the fair value if there is inflation in the economy.

2. Purchase Method

Under the purchase method assets and liabilities are shown on the merged firm’s at book value or their market values as of the acquisition date. This method is based on the idea that the resulting values should reflect the market value established during
the bargaining process. The total liabilities of the combined firm equal the sum of the two firm’s individual liabilities. The equity of the acquiring firm is increased by the amount of the purchase price.

Purchase accounting usually results in increased depreciation charges because the book value of most assets is usually less than fair value because of inflation. For tax purpose depreciation does not increase because the tax base of the assets remains the same. Since depreciation under pooling accounting method is based on the old book values of the assets accounting income is usually higher under the pooling method. Some firms may dislike the purchase method because of the goodwill created. The reason for this is that goodwill is amortized over a period of years.

2.18 VALUATION RELATED TO Mergers AND ACQUISITIONS

A. Valuation related to mergers and acquisitions employ several procedures, namely, the income based procedure, the asset based procedure and the market based procedure. There are many factors, which determine whether a particular company ought to be bought or not. The financial soundness of the subject company is very important to determine. Along with these the financial trends over the past couple of years and the trends manifested in the macroeconomic indicators also need to be judged.

B. Valuation related to mergers and acquisitions usually follow these three methods. They are market based method, asset based method and income based method. It may be felt that the market based method is more relevant but all the three methods are significant depending on the situation prevailing during the course of the mergers as well as acquisitions.

1. Market Based Method: Valuation related to mergers and acquisitions estimated by the market based method, compares various aspects of the target company with the same aspects of the other companies in the market. These companies (not the target company) usually possess a market value, which has been established previously. There are few things to be kept in mind prior to comparing the various aspects. Firstly, which factors need to be compared and secondly, which are the
companies, which will serve as comparable. Public companies, belonging to similar industries (of the target company) may be opted for as comparable. However, if the target company is not listed on the stock exchange or is comparatively smaller in size than the public companies, comparison with the public companies may not be of much help. In such cases, private as well as public databases are available, which are commercial in nature.

The other aspects that need to be compared include book value and earnings or total revenue. Once all the data are collected, an extensive comparison is made to find the value of the target/subject company.

2. Asset based method: Valuation related to mergers and acquisitions employ this method when the subject or the target company is a loss making company. Under such circumstances, the assets of the loss making company are calculated. Along with this method, the market based method as well as the income based method may also be employed. Valuations obtained from this method may generate very less value. However, it is more likely to generate the actual picture of the assets of the target company.

3. Income based method: Valuation related to mergers and acquisitions employing the income based method take the net present value into consideration. The net present value of income, which is likely to be in the future, is taken into account by the application of a mathematical formula.

The phrase mergers and acquisitions (abbreviated M & A) refers to the aspect of corporate strategy, corporate finance and management dealing with the buying, selling and combining of different companies that can aid, finance, or help a growing company in a given industry grow rapidly without having to create another business entity.

Merger is a tool used by companies for the purpose of expanding their operations often aiming at an increase of their long term profitability. There are 15 different types of actions that a company can take when deciding to move forward using M & A. Usually mergers occur in a consensual (occurring by mutual consent) setting.
where executives from the target company help those from the purchaser in a due diligence process to ensure that the deal is beneficial to both parties. Acquisitions can also happen through a hostile takeover by purchasing the majority of outstanding shares of a company in the open market against the wishes of the target's board. In the United States, business laws vary from state to state whereby some companies have limited protection against hostile takeovers. One form of protection against a hostile takeover is the shareholder rights plan, otherwise known as the "poison pill".

Historically, mergers have often failed to add significantly to the value of the acquiring firm's shares. Corporate mergers may be aimed at reducing market competition, cutting costs (for example, laying off employees, operating at a more technologically efficient scale, etc.), reducing taxes, removing management, "empire building" by the acquiring managers, or other purposes which may or may not be consistent with public policy or public welfare. Thus they can be heavily regulated, for example, in the U.S. requiring approval by both the Federal Trade Commission and the Department of Justice.

2.19 MERGERS AND ACQUISITIONS STRATEGIES

Mergers and Acquisitions Strategies are significant in order to bring success to a mergers or acquisitions deal. A sound strategic planning can protect any merger from failure. The important issues that should be kept in mind at the time of developing Mergers and Acquisitions Strategy are discussed as follow:

Mergers and Acquisitions Strategies are extremely important in order to derive the maximum benefit out of a mergers or acquisitions deal. It is quite difficult to decide on the strategies of mergers and acquisitions, especially for those companies who are going to make a mergers or acquisitions deal for the first time. In this case, they take lessons from the past mergers and acquisitions that took place in the market among other companies and proved to be successful.

Through market survey and market analysis of different mergers and acquisitions, it has been found that there are some golden rules which can be treated as the Strategies for Successful Mergers or Acquisitions Deal.
These rules or strategies are discussed below:

1. Before entering into any mergers or acquisitions deal, the target company's market performance and market position is required to be examined thoroughly so that the optimal target company can be chosen and the deal can be finalized at a right price.

2. Identification of future market opportunities, recent market trends and customer's reaction to the company's products are also very important in order to assess the growth potential of the company.

3. After finalizing the mergers or acquisitions deal, the integration process of the companies should be started in time. Before the closing of the deal, when the negotiation process is on, from that time, the management of both the companies require to work on a proper integration strategy. This is to ensure that no potential problem crop up after the closing of the deal.

4. If the company which intends to acquire the target firm plans restructuring of the target company, then this plan should be declared and implemented within the period of acquisition to avoid uncertainties.

5. It is also very important to consider the working environment and culture of the workforce of the target company, at the time of drawing up Mergers and Acquisitions Strategies, so that the labourers of the target company do not feel left out and become demoralized.

### 2.20 MERGERS AND ACQUISITIONS IN WORLD

The opening up of the European countries to international mergers and acquisitions and the economic reforms in developing countries provided major boost to international mergers and acquisitions since the 1990s. Foreign investment gets major impetus from international mergers and acquisitions. While there are various advantages of international mergers and acquisitions, certain impediments in the form of regulatory restrictions also exist.

The adoption of economic reforms in many countries in the last two decades of the 20th century opened up opportunities of international mergers and acquisitions. With different countries opening up their economies to foreign investors, international mergers and acquisitions has received. The European economy also opened up to
foreign mergers and acquisitions in the 1990s, which resulted in M & As (mergers and acquisitions) activities of large volumes taking place across Europe.

While USA has always been the pioneer in mergers and acquisitions activities, UK too has registered high levels of mergers and acquisitions. With the European countries gaining momentum in mergers and acquisitions, international mergers and acquisitions also received a major boost.

There are various benefits that accrue to firms that undertake international mergers and acquisitions. Cross border mergers and acquisitions are effective in boosting Foreign Direct Investment (FDI). For international investors, it is easier to invest through a merger or an acquisition. International mergers and acquisitions provide access to infrastructure and customer base in a country which is quite difficult to build from the scratch. Moreover an existing brand name in a country provides strong business edge. Access to local markets of different countries is possible through international mergers and acquisitions.

With the developing countries adopting liberal economic policies, the incentives of firms in the developed nations to indulge in mergers and acquisitions in these countries are huge. International mergers and acquisitions provide a way to tap the markets of these countries. On the other hand, for these developing countries international mergers and acquisitions provide them access to improved technologies and more productive operative mechanisms.

However there are certain impediments to international mergers and acquisitions. Regulations of different countries play an important role. In some countries certain sectors are prohibited from international mergers and acquisitions, while for some other sectors certain conditions need to be fulfilled.

In China, for instance, laws regarding international mergers and acquisitions are quite stringent.
Reasons for Mergers and Acquisitions

The acquiring company should be prepared to indicate the reasons why it has decided to take the mergers/ acquisitions route as a means of achieving its objectives and implementing its long – range plans. While this statement should touch on the advantages which the acquiring company hopes to realize, it should carefully avoid creating an impression or making statements which might give the prospective acquisition a bargaining advantage.

Special emphasis should be placed on the advantages which would accrue to any company by virtue of association with the acquiring company.

Mergers and acquisitions take place for many strategic business reasons, but the most common reasons for any business combination are economic at their core. Following are some of the various economic reasons:

1. Increasing capabilities: Increased capabilities may come from expanded research and development opportunities or more robust manufacturing operations (or any range of core competencies a company wants to increase). Similarly, companies may want to combine to leverage costly manufacturing operations (as was the hoped for case in the acquisition of Volvo by Ford).

2. Gaining a competitive advantage or larger market share: Companies may decide to merge into order to gain a better distribution or marketing network. A company may want to expand into different markets where a similar company is already operating rather than start from ground zero, and so the company may just merge with the other company.

3. Diversifying products or services: Another reason for merging companies is to complement a current product or service. Two firms may be able to combine their products or services to gain a competitive edge over others in the marketplace. For example, in 2008, HP bought EDS to strengthen the services side of their technology offerings (this deal was valued at about US $ 13.9 billion).
4. **Replacing leadership:** In a private company, the company may need to merge or be acquired if the current owners can’t identify someone within the company to succeed them. The owners may also wish to cash out to invest their money in something else, such as retirement!

5. **Cutting costs:** When two companies have similar products or services, combining can create a large opportunity to reduce costs. When companies merge, frequently they have an opportunity to combine locations or reduce operating costs by integrating and streamlining support functions.

   This economic strategy has to do with economies of scale: When the total cost of production of services or products is lowered as the volume increases, the company therefore maximizes total profits.

6. **Surviving:** It’s never easy for a company to willingly give up its identity to another company, but sometimes it is the only option in order for the company to survive. A number of companies used mergers and acquisitions to grow and survive during the global financial crisis from 2008 to 2012.

   Mergers and acquisitions occur for other reasons, too, but these are some of the most common. Frequently, companies have multiple reasons for combining.

   Combining companies has some potential downsides for employees, who have to deal with immediate fears about employment or business lines, but more positive sides of merging may include more opportunities for advancement, or having access to more resources to do one’s job.