Y Company – Holding Company Banking & Acquisition Issues Revisions

Y Company Limited is a TSX public Company operating as a holding company for corporations in various industries including apparel manufacturing and distribution, small appliance manufacturing, travel industry accessories, and imported housewares products. Its acquisition targets are Canadian controlled public and private companies that wish to remain Canadian but want or need new ownership.

Y Company arranges its financing through a major Canadian Bank on an exclusive basis because of a commonality of Board of Directors' members and traditional long-term business relationships. The banking for the group is controlled and managed by Y Company, the parent company. All conditions of the banking are on a consolidated basis. The Bank provides operating financing as well as traditional long-term financing for acquisitions. Y Company in turn finances directly or indirectly all of its subsidiaries and their acquisitions. The Bank, which deals directly with the President of Y Company, requires Y Company to comply with normal borrowing arrangements including a consolidated working capital ratios which had been established two years earlier. Y Company's President was the key negotiator of the banking terms and conditions with some assistance from the new CFO who had just joined Y Company as the transactions outlined below were about to be concluded.

Y Company has targeted a client (C Co.) of the Bank that is public and is currently in the business of processing pulp and paper. However, C Co. is exiting that pulp and paper business for environmental reasons and is looking to expand into the consumer products field. The controlling shareholder wants to exit the business and have it taken private. He is willing to do a share for share exchange (on a tax deferred basis) for a portion of his shares as long as he gets a sufficient amount of cash from the transactions and all of the other shareholders are given the same options. It was agreed that the controlling shareholder would get a minimum of 60% cash and the of the balance of the purchase price in shares of Y company at a fixed issue price while the other shareholders would have the same option but could take all cash.

The target company will have $15 million in cash on its balance sheet and long-term debt of $20 Million in the form of a long-term 15-year debenture. It has minimal short-term liabilities not exceeding $ 1.0 million and the remaining balance of the assets will be disposed at their book value for cash of $31 million. C Co. is committed to the divestiture which will be completed prior to the take-over but is also committed to a $36 Million asset acquisition in a new venture in the office furniture line of products, believing that the new business has a promising future. This latter transaction will also close before the acquisition by Y Company. Included in the $36 million purchase price is $12 million of net working capital assets. All assets in the acquisition are believed to be tangible assets carried at their fair market value.

The target company has a net equity of about $30 million and is trading at a discount to net book value of $5.0 million. Note: Distributing the cash in C Co. to shareholders would be costly to them in the form of dividends for tax purposes. Payments of dividends are restricted by the debenture and would trigger the repayment of the debenture, as it would violate the restrictive covenant which governs the amount of the dividends permitted.

Because of the nature of the business, the agreed price was to be a premium of 20% over the trading value of $25.0 million, or $30.0 million. At the last minute the price was adjusted up to a premium of 30% to $32.51 million. The Board of Directors of Y Company objected to the increase in the deal size but was persuaded by the then President of Y Company that it was necessary to complete the transaction.

It became obvious that the majority shareholder (50.1%) of the target company benefited most from the increase in cash compensation, but all shareholders of the target were better compensated. The excess of the purchase price of the shares over the fair market value of the net equity acquired could easily be assigned to the net assets purchased without creating "goodwill" as long as the intangible assets were recognized for the new office furniture venture.

The audit committee of Y Company met to recommend the approval of the final consolidated financial statements. After all of the transactions were completed, the review presentation by the company officials, which was concurred with by the auditors, indicated that all financial affairs were in order and that all covenants of the debenture financing and the bank financings were in order and confirmed as compliant.

It was also announced by the Y Company's Chairman, that the President of Y Company was being replaced by the new CFO of Y Company going forward. The announcement of this change would be made official at the annual general meeting coming up in 4 weeks.

Question:

1. Should the auditors have raised any concerns with the Audit Committee?
2. If so, what might those concerns have been?
3. Should the new CFO, in his capacity as CFO, or his new upcoming capacity of President raised any concerns?

Source: Professional Skepticism Case Collection for Professional Accountants, University of Toronto Professional Accounting Centre, 2023, PAC website https://www.utm.utoronto.ca/pac/case-collections/enhancing-professional-skepticism-case-collection.