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Understanding the Strategic Role of Financial Statements through a Case Study on Corporate Mergers

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Abstract: ***This article examines the critical role of financial statements in strategic decision-making, particularly within the context of mergers and acquisitions. Through the lens of a case study involving the all-stock merger of Washington H. Soul Pattinson and Milton Corporation, the paper highlights how an understanding of balance sheets, income statements, and cash flow reports can inform value-based decisions. It presents evidence of shareholder value creation by leveraging overvalued stock, and improved liquidity post-merger. The study underscores the necessity of financial literacy and accurate valuation to drive informed business strategy.***

Keywords: financial statements, strategic decision making, balance sheet, shareholder value, mergers and acquisitions

1. Introduction

The primary purpose of business strategy is to maximise value for shareholders by selecting appropriate initiatives and allocating resources to them (Boyles, 2022). Corporations create value through the provision of goods and services and considerable managerial attention is paid to efficient operations. However, it is surprisingly difficult to determine reliable valuations for companies. The impact from poor valuation is often multiplied across multiple valuation related actions companies take namely: issuance of new stock, buybacks, equity carve outs, mergers and acquisitions which have often destroyed not enhanced shareholder value (Rappaport & Mauboussin, 2002). Appropriate allocation of capital, whether it be by individual investors or companies is essential for investment success and this wealth creation is beneficial to individual shareholders and society as a whole.

The capital budgeting process involves the comparison of several investment opportunities to determine the optimum projects to invest in. The predominant manner to compare opportunities remains financial metrics that measure return on investment (ROI), such as Net Present Value (NPV), Internal rate of return (IRR), and Payback Period. These tools should be used to objectively assess an investment, instead of being used retrospectively to justify decisions already taken prior to the financials being computed (Knight, 2015). The assumptions built into these tools should be based on the best available evidence. Managers should endeavour to eliminate bias and research the best body of knowledge available both from experienced practitioners and available validated literature (Pfeffer & Sutton, 2006). This article aims to examine how financial statements influence strategic decisions, using a corporate merger as a practical case study.

Significance of financial statements in strategic decision making

Valuation requires a good understanding of cashflows as these represent the future economic benefits referenced in the definition of asset. In order to correctly identify cashflows, knowledge of how to read a company's balance sheet, income and cashflow statement is required. A thorough understanding and application of financial statement concepts along with business model understanding will result in an evidence based valuation.

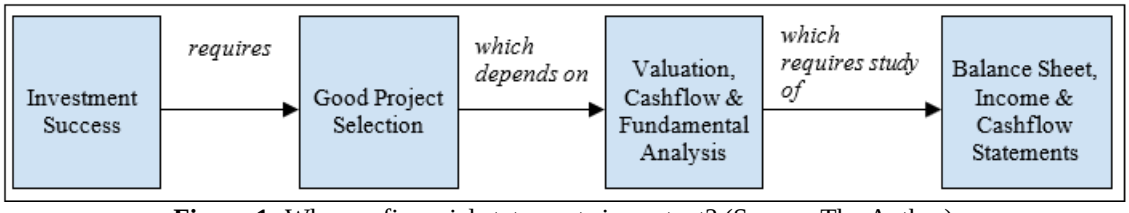

Figure 1: Why are financial statements important? (Source: The Author)

The Australian Bureau of Statistics (ABS, 2015) defines an asset as:
"*as instruments or entities over which ownership rights must be able to be enforced, and from which economic benefits may be derived by holding them, or using them, over a period of time*"

In his book, Financial Shenanigans, Schilt (1993) outlines various semi-fraudulent activities a company might undertake to inflate its earnings. Whilst in some cases these are done deliberately, they could also occur innocently from not having a good understanding of the theory and result in improper decision making. Some of the issues or possible mistakes highlighted are:

- Recognising future revenues in the current period and corresponding expenses in a later period
- Incorrect depreciation rates
- Incorrectly capitalising what should be expensed

- Treating operating expenses as abnormal or one-time writeoffs
- Incorrectly inflating operating cashflow by mis-classifying investing and capital inflows as operating

Plakalovic (2015) concluded that financial literacy among SME managers is surprisingly low. In another study, Hussain et al (2018) argue that financial literacy reduces business failure, facilitates more employment and reduces the need for social support. When recommending a project for approval, it is essential to express the viability of the project in terms of metrics and in language that is universally understood, especially by the finance team in the company (Knight, 2015) and investors. As a manager or an entrepreneur it is beneficial to understand finance for effective strategic decision making.

Purpose and Interrelationships between Financial Statements

Most developed nations follow the accrual based approach to accounting as opposed to cash basis. What this means is revenue is recognised, when a product or service is delivered as opposed to when cash is actually received in the bank account. Consequently then, all liabilities and expenses incurred in the same period are recognised when they happen, rather than when payment is actually made (Bean et al, 2006).

Schilt (1993) outlines that the primary goal of financial reporting is to disseminate information that reflects the true financial health of a company. The three parts of financial reporting are:

- The Balance sheet which reflects assets and liabilities at a particular point in time
- The Income Statement which reflects net profit expressed taking all revenues and expenses into account including tax and depreciation
- The Cash Flow Statement which is critical to valuation and explains the movement of money between the balance sheet and income statement

Balance Sheet

The Balance Sheet is meant to reflect the financial position of a company at a point in time (Stobierski, 2020) and comprises of the following sections:

a) Assets
- Short term Assets
- Long term Assets

b) Liabilities
- Short term liabilities
- Long term liabilities

c) Equity
- Share Capital
- Reserves and Surpluses

The Balance sheet is understood via the accounting equation: Equity = Assets - Liabilities (Stobierski, 2020). True to the double accounting system, Liabilities and Equity are shown on the same side of the Balance sheet, offset by the Assets. The balance sheet offers the following key insights (Bigel, 2022):

- Debt/Equity ratio, which is a measure of leverage
- Quick ratio which compares current assets (minus inventory) to current liabilities and is a measure of liquidity
- Book value which measures the liquidation value of the company

Income Statement

The income statement, also known as the Profit and Loss statement reflects all the income, expenses that occurred in a period and in a sense describes the operating activities of a company from a financial perspective (Stobierski, 2020). It consists of the following sections:

Income as
- Gross Revenue

Expenses as
- Cost of Goods Sold (COGS)
- Operating Expenses which includes items like office administration
- Depreciation and Amortisation
- Interest
- Tax

The following types of profit can be derived from this information (Bigel, 2022):

- Gross Profit = [Gross Revenue] - [COGS]
- Operating Profit, as called Earnings before Interest and Tax (EBIT) = [Gross Profit] - [Operating Expenses] + [(Depreciation & Amortisation)]
- [Net Profit] = [Operating Profit] - [Interest] - [Tax]

It is interesting to note that depreciation is a non-cash expense and hence does not impact cashflow. Hence it is common for companies to use earnings before interest, tax, depreciation and amortisation, acronym EBITDA as a proxy for operating cashflow (Bigel, 2022).

Cash Flow Statement

The cash flow statement reflects the actual movement of cash into and out of the business (Miller, 2021). There are three types, cashflows from:

- Operating activities relating to the cash disbursements and receipts from operations
- Financing activities relating to payment of dividends, repayment and receipt of debts and equity financing
- Investment activities relating to long term purchases of plant, machine, equipment etc using cash not debt

By summing up these three cashflows to the opening balance at the start of the year, we will obtain the cash balance at the end of the year.

The statement of cashflow is extremely important to gauge the viability of a business. A company can generate a lot of revenue or even be very profitable but if it is not generating cash or sinking cash into large capital expenses, it could get into serious trouble (Fulmer et al, 2002). The important insights that can be gleaned from the cashflow statement are:

Free cashflow, which is the cash remaining after the company accounts for its capital and operational expenses (Bigel,

2022). This cash can be used to pay dividends and repay debt obligations.

Retained Earnings

Retained earnings are funds remaining after dividend payments have been paid to shareholders. These retained earnings are part of shareholder equity and must be realised profits not paper profits for which cash has not yet been received (Troy, 2011). Inspecting retained earnings can indicate how long a company can sustain a dividend without making a profit or if cash needs to be diverted towards a capital works program.

As can be seen, these three statements are integral to developing an understanding of a company's financials and also how a new project would impact or complement its financial health.

Interrelationships among Financial Statements

These three financial statements are inherently related:

- The equity and debt capital of the firm on the balance sheet is used to generate income, which shows up in the income statement.
- Tangible and intangible assets on the balance sheet are subject to a depreciation-amortisation schedule which shows up as an operating expense in the income statement.
- The balance sheet reflects retained earnings which are profits retained after dividends have been paid. This transaction is explained in the cash flow statement
- Dividends are shown in the statement of retained earnings.
- Assets and liabilities acquired as a result of transactions on the cashflow statement are reflected in the balance sheet
- Liabilities on the balance sheet require payments to be made to creditors which are shown in the cashflow statement

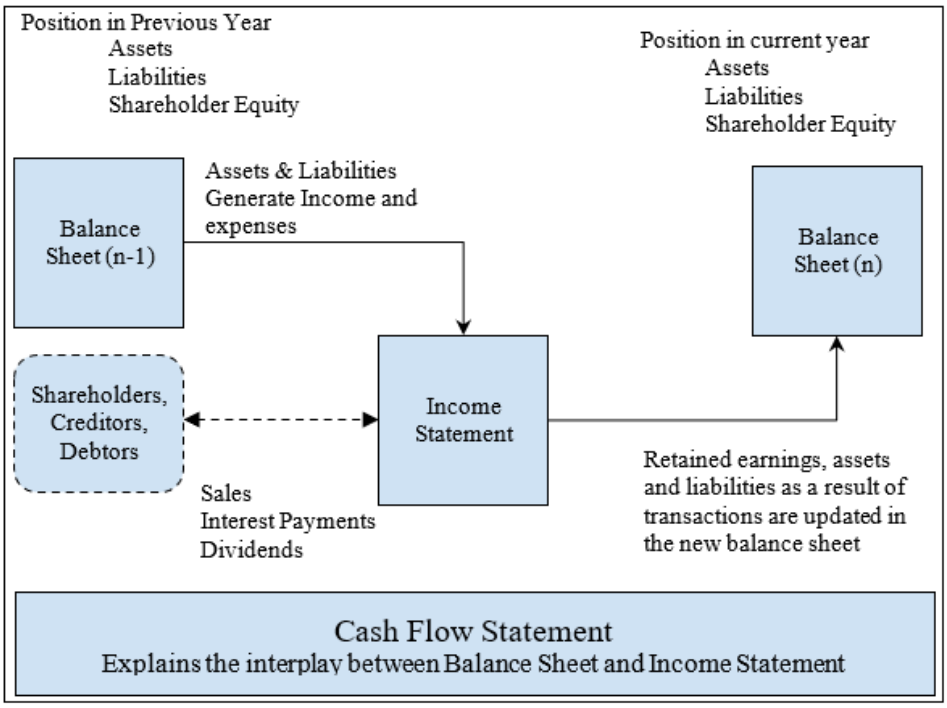

Figure 2: Interrelationships in Financial Reporting (Source: The Author)

Strategic Decision-Making and Financial Statements

Strategic decision making can be impacted by financial position. This is because a weak financial position (high liabilities, falling revenue, negative cashflow etc) limits the ability of a company to obtain debt or equity funding. Higher hurdle rates to make projects viable will require a firm to curtail investment or expansionary activities till balance sheet repair is undertaken. According to Price (2023), the gradual withdrawal of banks from providing leveraged lending, increased regulation, quantitative tightening and recessionary signals in the economy will impact the ability of firms to secure debt funds at competitive prices. As per the Pecking Order Theory (Myers & Majluf, 1984), the preferred precedence is retained earnings, debt and equity is only a final resort. So, funds with insufficient retained earnings, might struggle to raise debt in this environment and be forced into alternate means of financing. Price (2023) suggests reining in spending, implementing process efficiency and approaching the private debt market or a tech-enabled marketplace where several commercial and non-commercial lenders have the opportunity to assess and fund loan applications.

All capital structuring decisions should be made to maximise the value of the company. Hence risky firms, where risk is defined by volatility should borrow less or firms with intangible assets should borrow less to minimise the bankruptcy impact (Myers, 1984). Hence for such firms, convertible debt, internal savings or even equity might be better options. Such firms would want to consider keeping dividend payout ratios as low as possible.

A final consideration is that the choice to issue debt or equity might signal to the market whether the company believes it is overpriced or underpriced. An overpriced firm will issue equity and an underpriced one will issue debt (Myers, 1984). To avoid sending an incorrect signal to the market (Myers et al, 1984), a firm should report and communicate transparently to its stakeholders and follow a process to manage its capital

structuring that is consistent with shareholder expectations as per Agency Theory (Jensen & Meckling, 1976).

2. Case Study Analysis

The case study discussed below illustrates that a strong balance sheet offers superior strategic decision making options. A strong balance sheet is considered to have sufficient liquidity, solvency and good debt to asset ratio. The presence of retained earnings, cash and cash equivalents is considered advantageous.

Background Information

In the area of mergers and acquisitions, there are broadly three approaches that can be taken: all cash, stock for stock or a blend of cash and stock. In an all cash acquisition, the acquiring company runs the risk of ensuring that the synergies of the merger are realised. In a stock for stock scenario, it is sometimes hard to tell which company is the acquirer especially if the two companies are equally sized. However, in a scenario where the acquired company will only have a small holding in the combined entity, the acquired company carries the risk that the valuation of the combined entity will remain at a level to justify the stakeholder (Rappaport & Sirower, 1999).

Details of the case

The case discussed involves two Australian companies:

1) Washington H Soul Pattinson (WHSP): An investment conglomerate which first listed on the Australian Stock Exchange (ASX) in 1903. For 118 years, it has always paid a dividend to shareholders and has interests in construction, telecommunications, coal, private equity, credit and direct property. At the time of the merger in 2021, WHSP had a market cap of $7.2 Billion AUD.
2) Milton Corporation (MLT): A listed investment company first listed on the ASX in 1956 with assets of $3.3 Billion AUD at the time of the merger. A listed investment company, invests in the shares, trusts and property with the aim of building an investment portfolio that will generate capital growth and dividends which can be passed on to its own shareholders.

In 2021, WHSP completed an all stock acquisition-merger with MLT creating a 10.5 Billion conglomerate. The case study analyses the deal with a focus on:

a) The financial position of WHSP at the time, which includes the balance sheet, income statement and cash flow statement
b) How this merger created value for both WHSP and MLT shareholders. Shareholder value added (SVA) is the estimated value of the merger synergies and the premium paid for the acquisition (Rappaport & Sirower, 1999).

Details & Balance Sheet Synergies of the deal

MLT shareholders received (Gluyas, 2021) the following consideration:

- A 10% premium of the net tangible asset (NTA) value of their shares less any declared dividends on the announcement date of 21 June 2021.
- Three special dividends amounting to 52 cents per share

The deal was announced on 21 June 2021 and completed in October of the same year. On the face of it, the merger which was initiated by WHSP does not make much sense. This is because MLT is a listed investment company, almost all of its assets are the listed securities of other companies. Theoretically, this portfolio could be replicated, so why pay a premium for these assets?

The answer to why the merger makes sense lies in the balance sheet of WHSP. For the purposes of this analysis, the financials for WHSP for the years leading up to Financial Year 21 (FY21), and beyond will be analysed.

This paper makes the following propositions:

- P0 - Shares of WHSP were overvalued at the time of the merger.
- P1 - WHSP improved its balance sheet via the merger
- P2 - By funding the merger via its overvalued shares, WHSP created tangible shareholder value for its shareholders.

P0: Overvaluation of WHSP shares by the market

Paying for the merger with overvalued shares would be an intelligent way for WHSP shareholders to realise value. In June 2021, the cash rate in Australia was 0.1%. WHSP shares ticker SOL closed at $30.25 (The Wall Street Journal, 2024) on the announcement date, 21 June 2021.The Book Value per share taking an average of 10 years is $18.01. This is a conservative approach with a large margin of safety as the book value in 2021 is nearly $26.

Calculate Book Value Per share										
	31 Jul,2021	31 Jul,2020	31 Jul,2019	31 Jul,2018	31 Jul,2017	31 Jul,2016	31 Jul,2015	31 Jul,2014	31 Jul,2013	31 Jul,2012
Total Assets	7,636,455,000	7,336,719,000	5,877,219,000	5,295,537,000	4,748,394,000	4,343,867,000	4,253,015,000	4,366,381,000	4,209,327,000	4,157,484,000
Total Liabilities	2,482,874,000	2,224,732,000	1,365,750,000	953,932,000	710,084,000	597,216,000	478,580,000	526,256,000	459,306,000	383,608,000
Book Value	5,153,581,000	5,111,987,000	4,511,469,000	4,341,605,000	4,038,310,000	3,746,651,000	3,774,435,000	3,840,125,000	3,750,021,000	3,773,876,000
Book Value/Share	25.96	21.35	18.85	18.14	16.87	15.65	15.77	16.04	15.66	15.79
Avg Book Value /Share	18.01									

Figure 3: Book Value per share of WHSP (Data Source: The Wall Street Journal)

This implies the cashflows from WSHP must be worth at least $12.24 approximately to justify the market price using Discounted Cash Flow (Damodaran, 2013). Rather than forecasting the cash flows on an arbitrary multiple, we will use historical cashflows to calculate free cash flow (FCF) per share. This is a conservative approach.

Calcuate Free Cashflow										
	31 Jul,2021	31 Jul,2020	31 Jul,2019	31 Jul,2018	31 Jul,2017	31 Jul,2016	31 Jul,2015	31 Jul,2014	31 Jul,2013	31 Jul,2012
Operations Cashflow	514,715,000	341,769,000	366,002,000	507,560,000	399,392,000	119,827,000	222,690,000	175,589,000	208,922,000	199,690,000
Capital Expenses	(181,552,000)	(223,066,000)	(194,834,000)	(149,157,000)	(96,168,000)	(90,920,000)	(137,780,000)	(164,576,000)	(207,782,000)	(81,241,000)
FCF	333,163,000	341,769,000	366,002,000	507,560,000	399,392,000	119,827,000	222,690,000	175,589,000	208,922,000	199,690,000
Shares on issue	198,557,000	239,395,320	239,395,320	239,395,320	239,395,320	239,395,320	239,395,320	239,395,320	239,395,320	239,073,628
FCF/share	1.68	1.43	1.53	2.12	1.67	0.50	0.93	0.73	0.87	0.84

Figure 4: Free cashflow per share of WHSP (Data Source: The Wall Street Journal)

Using the FCF per share, the implied discount rate can be calculated using Excel's NPV formula.

Table 5: Implied discount rate (Source: Using Excel NPV formula)

NPV of FCF at different discount rates		
0%	$12.30	*A discount rate of 0 values FCF at $12.30*
1%	$11.74	
2%	$11.22	
3%	$10.74	
4%	$10.29	
5%	$9.87	

However, although this aligns with the cash rate in Australia at the time, a discount rate of 0% does not reflect the risk premium associated with equities. The cash rate is risk free, whilst WHSP shares are higher up the risk curve.
Hence, the numbers indicate that the market price of WHSP was inflated at the time of the merger.

An appropriate valuation for WHSP could be:
- FCF discounted to 5% : $9.87
- Plus Book Value : $18.01
- For a total valuation of $27.88.

Hence the market price of $30.25 represents an 8.5% overvaluation to assumed fair value.

P0 Conclusion
From the above discussion we can conclude that WHSP shares were overvalued at the time of the merger. The valuation presented relies on historical cash flows, a 5% equity premium, and a cautious book value assessment.

P1 - WHSP improved its balance sheet via the merger

Benefits of the deal to MLT shareholders
As a result of the deal, MLT shareholders received a 20% premium to the closing share price of $5 on announcement date at an implied valuation of $6 per share (The ASX, 2021). It is non unusual for a listed investment company to trade at a discount to its net tangible assets. In the case of MLT, the closing share price reflected an 8% discount to the NAV. In summary, the WHSP deal provided an exit point with significant upside. Moreover, under Australian Tax law, capital gains tax is deferred for a script for script merger. In addition, MLT shareholders received exposure to a broader set of opportunities such as private equity, direct credit, emerging companies and property.

Table 6: MLT shareholder benefits (Data Source(s):The Wall Street Journal, The ASX)

MLT Shareholder Benefits	
MLT closing share price	$5.00
MLT NAV	$5.46
Discount to NAV	8.42%
MLT Shareholder Premium	
MLT NAV	$5.46
(Less Announced Dividends)	-$0.45
Adjusted NAV	**$5.01**
Plus 10 percent	$5.51
Plus special divdends	$0.52
Notional MLT Valuation	**$6.03**
Premium to MLT Share Price	**20.62%**

Benefits to WHSP Shareholders
WHSP market capitalisation increased from $7bn pre-merger to about $11bn post-merger, and that brought inclusion to the ASX top 50 where previously WHSP was in the ASX top 100. This created greater liquidity via passive ETF inflows. Also WHSP obtained control of MLT's listed share investments which is also a source of liquidity and can be sold off to raise capital rather than a traditional equity or debt capital raising.

Quick Ratio
We will analyse this position from the perspective of Quick Ratio which measures liquidity, by comparing current assets minus inventory to current liabilities.
Quick Ratio = ([Current Assets] - [Inventory]) / [Current Liabilities]

Analysis of the balance sheet reveals that indeed the Quick Ratio has improved post merger. The merger was announced in June 2021, but only completed in October 2021. Hence the figures from FY22 onwards depict the improvement in Quick Ratio, however the bulk of improvement is driven from inventory reduction.

Debt to Equity Ratio
The debt to equity simply measures leverage by comparing total debt to shareholder equity.
Debt-Equity Ratio = [Total Debt]/ ([Total Assets] - [Total Debt])

In this case, the jump in assets and reduction in debt between the years FY21 and FY22 which coincides with the merger can be clearly observed.

Table 7: WHSP Quick Ratio & Debt to Equity Ratio

	2023-07-31	2022-07-31	2021-07-31	2020-07-31	2019-07-31
Current Assets	1,717,298,000.00	1,416,461,000.(	1,335,986,000.0	966,207,000.00	486,845,000.00
Minus Inventory	75,605,000.00	56,810,000.00	131,624,000.00	116,164,000.00	120,471,000.00
Current Liabilities	375,241,000.00	402,320,000.00	547,119,000.00	466,491,000.00	305,039,000.00
Long term Assets	8,079,889,000.00	8,289,158,000.(	6,300,469,000.0	6,370,512,000.00	5,188,646,000.0
Long term Liabilities	686,933,000.00	844,400,000.00	1,935,754,999.0	1,758,241,000.00	364,948,000.00
Quick Ratio	4.37503631	3.379526248	2.201279795	1.822206645	1.20107265
Debt to Equity Ratio	0.1215995901	0.1473856113	0.4817764577	0.4351990723	0.1338500579

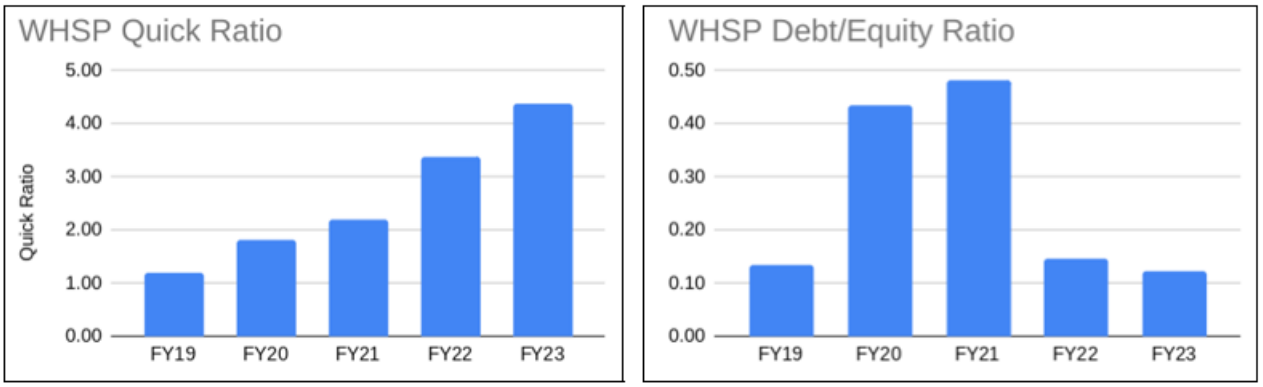

Figure 3: WHSP Liquidity and Leverage Ratios (Source: The Author)

P1 Conclusion

From looking at the improved Quick Ratio and Debt to Equity Ratio, we can see the improved balance sheet position of WHSP in terms of better liquidity and leverage.

P2 - By funding the merger via its overvalued shares, WHSP created tangible shareholder value for its shareholders

Cost Avoidance of Debt Raising

As per the Pecking Order Theory (Myers & Majluf, 1984), the preferred precedence for capital raising and investment is retained earnings, debt and equity is only a final resort. Milton held assets of $3.7 Billion on the announcement dates consisting of shares, property and cash (The ASX, 2021). Disposing of such a large volume of shares to cash on-market might result in discounting, so assuming a 15% markdown, liquidity of $3.1 Billion AUD has been achieved.

Table 8: MLT Liquid Assets

Million Assets (Billions)	3.7	
Shares		3.6001
Property		0.0481
Cash		0.0518
Immediately Liquid (Billions)		3.6519
Discounting at Liquidation	15%	3.104115

The Australian corporate bond yield to maturity in June 2021 was 1.55% (Standard & Poors, 2024). Using this yield as a proxy for the cost of debt to WHSP, the monthly cost of servicing a debt of $3.1 Billion can be calculated. Assuming the debt is raised as fixed rate bonds with equal annual coupon payments and return of capital at maturity, the annual debt is $48 Million.

Table 9: Implied saving, figures in Billions

Value of Debt	$3.10
Interest Rate	1.55%
Annual Payments	$0.048

Hence, WHSP received control of a 3.6 Billion portfolio of shares which they are able to liquidate to fund other projects without needing to raise debt. Had they needed to raise debt, the cost to service would have been $48 Million annually.

According to Rappaport & Sirower (1999), Shareholder value added (SVA) is the estimated value of the merger synergies and the premium paid for the acquisition.
SVA = [Merger Synergies] - [Premium Paid]

The parameters used in this modelling are:

- MLT annual dividend yield - 4.1 % (Annual Reports, n.d)
- Annual Debt payments on an implied debt of 3.1 Billion USD - 48 Million
- Premium Paid for merger, 20% of MLT share price - 753 Million

Table 10: Shareholder Value Created

			Payback Period						
Premium Paid for Acquisitior	20.62%	per share	Year	0	1	2	3	4	5
Asset Value	3.65	Billion	Initial Outlay	-753.02					
Total Premium Paid	0.75	Billion	Dividend Income		149.7279	149.7279	149.7279	149.7279	149.7279
	753.02	Million	Debt Cost Avoidance		48	48	48	48	48
			Cashflow, no discount rat	-753.02	197.7279	197.7279	197.7279	197.7279	197.7279
MLT assets dividend yield	4.10%	Per share	Discount Factor	1	0.9523809524	0.9070294785	0.8638375985	0.8227024748	0.7835261665
Asset Value	3.65	Billion	Discounted CashFlow	-753.02178	188.3122857	179.345034	170.8047943	162.6712327	154.9249835
Dividend Income	0.1497279	Billion	**Cumulative CashFlow**	**-753.02**	**-564.71**	**-385.36**	**-214.56**	**-51.89**	**103.04**
	149.7279	Million per year	Assumed Discount Rate	5%					
Debt Payments Avoided	48	Million per year	**Payback Period**	**4.33**	**years**				

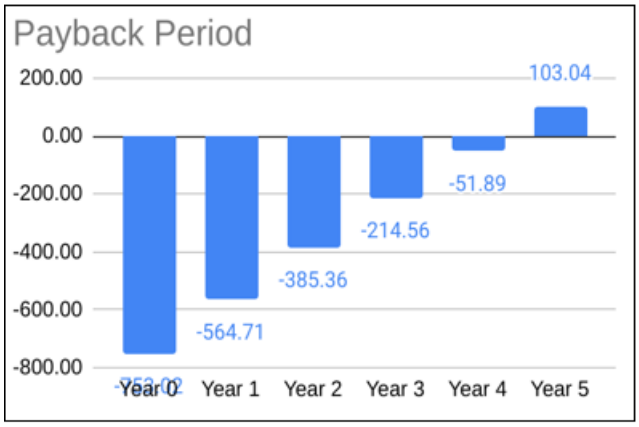

Figure 4: Payback Period (Source: The Author)

P2 Conclusion

Modelling this scenario and discounting the cashflows at 5%, WHSP can recover the premium paid of $753 Million in 4.33 years from a combination of dividend payments and the cost saving from debt avoidance. This represents the Shareholder Value created.

3. Conclusion

This paper analyzed the role of financial statements in guiding strategic decisions and illustrated their practical application through a detailed case of a corporate merger. It demonstrated that financial health directly affects a firm's strategic flexibility, particularly in capital structuring and value realization. The interplay between these statements was discussed and a diagram provided to illustrate how capital deployed is converted to revenue and cashflows to pay for expenses, investment activities and capital purchases. The financial position of the firm does impact strategic choices available to it and to illustrate this, a case study concerning the merger of 2 Australian companies was explored. Whilst operationally, the case for the merger was not compelling, the answer to why it was undertaken lay deeply hidden in the balance sheet.

The paper advanced three propositions:

a) The acquiring company WHSP executed the merger in an all stock manner using its over-valued shares which provided an efficient way to realise value for its share holders;
b) The liquidity and leverage of WHSP improved post merger
c) WHSP was able to create tangible Shareholder value as defined by Rappaport & Sirower (1999) via this merger

These propositions were explored using financial statements analysis and assumptions and calculations provided. The case study illustrates the position that financial statements can influence the strategic direction taken by a company.

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