

Transaction risk: a role for the audit committee?

About this document

The Audit Committee Leadership Network is a select group of audit committee chairs from leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. *ViewPoints* is a synthesis of key issues arising from a facilitated discussion among members of the Audit Committee Leadership Network. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues.

Initially, *ViewPoints* will be distributed to network members who, in turn, will share it with colleagues on audit committees and boards, and their advisers. It will also be distributed by Ernst & Young to its partners. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The Audit Committee Leadership Network held its fourth meeting on February 20, 2004. The discussion focused on the role of the audit committee in major transactions:

- **The governance issue.** Should the audit committee play any part in transactions?
- **Due diligence phase.** What role can the audit committee play before transaction execution?
- **Post-transaction phase.** What role can the audit committee play after the transaction is complete?

The members of the network present at the meeting, representing in all more than 25 large and small public company boards, were:

- Mr. Jim Adams, Audit Committee Chair, Texas Instruments
- Mr. John Clendenin, Audit Committee Chair, The Home Depot
- Dr. Scott Cowen, Audit Committee Chair, Newell Rubbermaid
- Mr. John Edwardson, Audit Committee Chair, FedEx
- Mr. John Ferraro, Vice Chairman, Ernst & Young
- Mr. Tom Flannery, Americas Director, AABS Quality, Ernst & Young
- Hon. Barbara Hackman Franklin, Audit Committee Chair, Aetna
- Mr. Tom Kierans, Audit Committee Chair, Manulife Financial

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations.

Executive summary

As we reported in the previous issue of *ViewPoints*,¹ significant transactions, including acquisitions, divestitures, and alliances, may present key risk events that do not follow the audit committee's calendar. The discussion at the fourth meeting of the Audit Committee Leadership Network held on February 20, 2004, focused on the role of the audit committee in major transactions. Many members of the Audit Committee Leadership Network are currently involved in such transactions, and others are still dealing with the effects of acquisitions that occurred several years ago.

The issues found to be most important to members are highlighted below, with more detailed discussion on the following pages.

- **The governance issue** (*Pages 3-4*)

While transaction strategy is a matter for the whole board, most network members see the audit committee playing a significant role in the oversight of transaction risk. Furthermore, they believe that the audit committee should be involved in discussions with management about the corporation's general approach to transaction before a specific transaction has even been identified. Some members, however, are concerned about potentially crossing the "bright line" into management and doubt whether audit committee members have enough time to get more involved in transactions.

- **Due diligence phase** (*Pages 4-5*)

Members proposed that there ought to be an agreed upon process, supported by a standard checklist, to govern the involvement of the audit committee in due diligence. They find themselves more involved in due diligence for cross-border transactions and for those involving private companies. They also identified 10 other triggers that would cause them to be concerned about the risks associated with a transaction. Members stressed the importance of resolving differences in business culture revealed through the due diligence process.

- **Post-transaction phase** (*Pages 5-6*)

Audit committees tend to widen the scope of their work post-transaction. Members measure how successfully the integration goals are met, and several supplement this effort with data from employee surveys. Several audit chairs reported that they automatically place any acquired company on their key control watch list and then conduct a full audit. Others simply build the new entity into the existing audit plan. Members welcomed the idea of new audit committee members joining the committee through acquisitions, as this provides an inside perspective into the operations of the acquired company.

¹ Audit Committee Leadership Network, *ViewPoints*, "Enterprise Risk Management," December 19, 2003

The governance issue

While the NYSE listing requirements do not require that the audit committee be the sole body responsible for risk assessment and risk management, they do indicate that audit committees must discuss guidelines and policies for governing the process by which the company handles its exposure to risk. By implication, these rules may require the audit committee to discuss transaction risk.

The discussion among network members revealed that they do see the audit committee playing a significant role in the oversight of transaction risk. Members believe the audit committee should be involved in discussions with management about the corporation's general approach to transactions, even before a particular transaction has been identified. One chair stated, *"The audit committee should have an earlier, more proactive involvement than we had in the past. It surprises me that we haven't."*

Involving the audit committee – the earlier the better

This early involvement would help to counteract what one audit chair called the *"deal heat"* that often dominates discussion of particular transactions. Members felt the audit committee needs to ask questions to determine whether the overall strategy makes sense and to determine its likely impact on the balance sheet and debt profile of the corporation. One member commented, *"I am asking more questions that are annoying than I used to, or that I would welcome if I were the CEO."*

Although the strategy behind a particular transaction is often a matter for the whole board, roles certainly become more differentiated once a decision has been made to proceed. One member observed, *"On behalf of the whole board, the audit committee has an early and continuing role to look at the risks associated with a transaction."* He added that practical matters also determine involvement: *"The internal audit function and the external auditors are both reporting to the audit committee, and both are involved in due diligence."*

Earlier involvement of the audit committee was particularly recommended for transactions concerning foreign businesses (due to the different rules and requirements involved) and private companies (because of the lower levels of public transparency required). One chair commented, *"I feel more comfortable as a board director buying a public company because I know that someone is signing the same documents that I have to sign."*

Possible time and speed constraints

Several members were more skeptical about the audit committee's ability to get more involved before or during due diligence, given the preexisting demands on the committee's time. One chair commented, *"We need to keep in mind the time [constraints] of directors. We should define what needs to be done and oversee that rather than do it."*

Another member also wondered whether the audit committee could move fast enough to keep pace with most transactions. During the discussion one chair responded, *"We are often told that speed is of the*

essence. If we don't do the deal quickly, we will regret it for the next 15 years. The few [quick deals] I have done, I have regretted for the next 15 years – not because we didn't do it, but because we did."

Due diligence phase

Once the acquisition process has begun, audit committees must determine the level of their involvement in due diligence and in integration planning. The requirements of Sarbanes-Oxley have challenged the traditional scope of the due diligence process to include items within the domain of the audit committee: disclosure controls and procedures, internal controls, the composition of the target's audit committee, loans to officers and directors, and off-balance-sheet transactions.

One audit chair saw the committee's role in due diligence as *"asking questions that will irritate the recipient of the questions. The audit committee is not managing due diligence, but has an active role in asking questions that force management to do a good job of the due diligence."* The "irritating questions" may concern the target's risk profile, GAAP accounting issues, the value of synergies, financial projections, the critical path and detailed milestones for the integration, and the timeline for the accretion of earnings.

Members suggested that there ought to be an agreed upon process, supported by a standard checklist, to govern the involvement of the audit committee in the due diligence process that can be used for every transaction. Such a process and checklist would help management work well with the audit committee.

Cross-border transactions

With cross-border transactions there may be the additional risk of the target being only minimally, if at all, compliant with Sarbanes-Oxley, and therefore creating a hidden cost for the transaction and increased risk of a "surprise" emerging later. One audit chair said, *"I had no idea of the additional complexity of putting a foreign firm's records into US accounting standards. This revealed a whole host of variations ... management [had] to work their way through."*

Cultural due diligence

Cultural differences also loom large during the due diligence process. One member revealed that his board asked directors to meet informally with directors from target companies, with the objective being to probe discretely into cultural issues and report back to the board. Another member noted that the audit committee could see the cultural issues and philosophical differences in the target's management compensation philosophy, their approach to succession planning, and their development and performance management processes.

Integration planning

Members who had experience of successful acquisitions believe that integration planning is the key to the achievement of the transaction's objectives. Integration plans need to include sharply defined milestones that can be measured by management and monitored by the audit committee, post transaction.

One audit chair commented, *“Up-front planning is so crucial, and the audit committee needs to be conversant with that planning from a risk perspective.”* For corporations that are very active in transactions, one option for the audit committee is to look at the transaction environment, structure, and process as a key control area under Sarbanes-Oxley Section 404.

10 triggers indicating the need for deeper audit committee involvement in due diligence

Members also discussed the triggers that would determine when the audit committee might require a deeper dive into the due diligence process. Excluding the two triggers already mentioned (cross-border transactions and those involving private companies), we provide below ten additional examples:

- Any acquisition outside the core business of the corporation
- A high degree of complexity in the proposed financial arrangements, and if the arrangements favor a particular group or individual
- Any transaction using an unusual financial instrument, or an instrument with nontraditional terms
- Any transaction in which the presentations from external advisers are too quick, too slick, or in which the advisers don't want to answer questions – especially in any auction situation
- Any transaction that brings in new directors with significant ownership positions who have different ideas about running the business
- Unusual compensation arrangements for senior management, particularly concerning “parachutes”
- Any significant cultural differences regarding ethics – for instance, differing views on integrity, or published and unpublished codes of ethics that diverge from the organization's own code
- Any adverse environmental liabilities
- Specific labor issues, such as long-term contracts or past labor difficulties
- Any transaction in which representations and warranties cannot be backed up

Post-transaction phase

As soon as the transaction is complete, audit committees tend to widen the scope of their involvement. This can include measuring how successfully the integration goals are met. One audit chair mentioned that the audit committee had the transaction on its agenda at every meeting until the integration was complete and the synergies had been delivered. The committee reviewed all the integration milestones, not just the financial ones.

Members also discussed reviewing post-integration employee survey data. *“It is always interesting to look at the differences between the two companies.”* One chair commented that there are specific areas that the audit committee should be asking about because they come up in every transaction, including purchasing and procurement policies and the approach to operations and physical plant security.

Approach to risk management and audit plans

Audit chairs with experience of transactions that failed to deliver their expected benefits stressed the lessons learned as the need for flawless execution and a focus on cultural differences and how to resolve them. Several audit chairs reported that they automatically place any acquired company on their key control watch list and then conduct a full audit.

Audit committees approve audit plans for the newly acquired entity and, together with management, review plans for reconciling differences in accounting policies. A number of audit committees are also actively involved in the integration of the internal audit function.

Dealing with two external audit firms

The audit committee must also decide which external auditor to retain if the parties to the transaction use two different audit firms. Some of the audit chairs present at the meeting have a clear rule to avoid conflict: *“The external auditor of the acquiring company is going to take over the function for the acquired company.”* They were also clear that the rule should be communicated early to enable the firms to focus on their roles without the distractions caused by potential new business opportunities.

Handling changes to the composition of the audit committee and the board

With larger transactions, there may also be changes to the composition of the board and the audit committee. Several audit chairs welcomed the idea of new members coming in through acquisitions as long as the new members are there to add value, rather than simply for reasons of optics, or to soothe feelings: *“If they are willing to join the board, they probably haven’t covered up much.”*

One chair was more cautious: *“You need to be careful that the board doesn’t treat new members as the conquered. Otherwise, the first time there is a problem the existing directors didn’t foresee, the new directors will get the blame for it; committee assignments will be limited for new members; and their advice is heard but not listened to. It takes a very mature board to avoid this.”*

There does not appear to be any specific “on-boarding” for new members of the audit committee beyond the board orientation for new directors. This can help to perpetuate an “us and them” feeling among new members. One audit chair pointed out, *“If all the [acquiring company] is doing is looking at what is wrong with the [target company], this can be devastating for the morale of that company.”* The key, according to those who had been through such an integration, is to ask “How did you do this?” rather than stating “This is what we do.”

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