

The audit committee's role in major transactions

Introduction

The European Audit Committee Leadership Network (EACLN) held its eighth meeting in Amsterdam on 8 June 2007. Members discussed two topics: private equity and public companies¹ and the audit committee's role in major transactions. For further information about the network, see *About this document* on page 7.

The discussion on the audit committee's role in major transactions covered the following topics:

- **The governance issue**
- **The pre-transaction phase**
- **The post-transaction phase**

The members of the network participating in the meeting sit on the boards of about 20 large, mid and small cap public companies. They were:

- Mr Tom de Swaan, Audit Committee Chair, GlaxoSmithKline and Royal Ahold
- Mr Per-Olof Eriksson, Audit Committee Chair, Volvo
- Prof Guido Ferrarini, Audit Committee Member, Atlantia
- Mr Phil Hodgkinson, Audit Committee Chair, BT
- Dr DeAnne Julius, Audit Committee Chair, Roche Holding
- Mr Daniel Lebègue, Audit Committee Chair, SCOR and Technip
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Dr Bernd Voss, Audit Committee Chair, ABB and Continental

Members from Ernst & Young participating in the meeting were:

- Mr Tom McGrath, Managing Partner, Northern Europe, Middle East, India and Africa Client Service, Ernst & Young
- Mr Christian Mouillon, Global Vice Chair, Assurance and Advisory Business Services, Ernst & Young

Members who participated in individual discussions before the meeting were:

- Mr Jan Hommen, Audit Committee Chair, Royal Ahold
- Mr Gerhard Schulmeyer, Audit Committee Chair, Zurich Financial Services

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 before and during meetings are not attributed to individuals or corporations. Comments described as being provided before the meeting were drawn from discussions with all the members listed above.

¹ European Audit Committee Leadership Network, *Private equity and public companies: a dialogue with Martin Halusa*, *ViewPoints*, 13 July 2007. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_Jul07_View12.pdf

Executive summary

In 2006, European mergers and acquisitions achieved their “strongest performance in recent history with over one trillion euros in announced deals: 5,216 transactions worth €1,056.1bn to be precise. This was a 31% increase on 2005 deal value, and only slightly down from 5,272 deals in that year”.²

Many of these transactions may end up destroying shareholder value. In 2002, *BusinessWeek* conducted an exclusive survey of the last transaction wave: “The results? Fully 61% of corporate buyers destroyed their own shareholders’ wealth. Companies that paid for mergers solely in stock had the worst results. They overpaid much more readily than buyers using cash”.³

Given the size and complexity of today’s deals and the track record of previous transaction waves, audit committee chairs and other board directors have been moved to evaluate their roles in major transactions. The specific issues that network members found to be most important are highlighted below, with more detailed discussion on the following pages:

- **The governance issue** (*page 3*)

The regulatory environment provides little or no formal guidance on the role of an audit committee in major transactions. Members agreed that responsibility for decisions about transactions lies primarily with management and the full board. In contrast to North American audit chairs, European network members are uncertain whether there is a useful role for the audit committee to play in transactions. However, there are special situations in which an audit committee may be asked to play a larger role, including a merger of equals, the disposal of a major part of the business, related-party transactions or a conflict of interest between shareholders.

- **The pre-transaction phase** (*page 3*)

Members tend to defer pre-transaction and due diligence activity to the full board. However, some reported that their audit committees are now more involved in overseeing transactions because of their companies’ ambitious M&A programmes. These members described several activities involving the audit committee, including preparing the board for affordability discussions, commissioning independent fairness opinions, assessing the company’s acquisition readiness and providing balance to board discussions about potential transitions. Other members said that in the future, audit committees may spend more time assessing the quality of the transaction process in the company, much as they often have responsibility for overseeing the risk management process.

- **The post-transaction phase** (*page 5*)

Members are more confident that there is a role for the audit committee in the post-transaction phase, particularly in overseeing the reporting of the transaction on the balance sheet and ensuring that synergies are adequately represented. Management can often be counted upon for short-term monitoring of transactions to measure how much value they have added, but to look after shareholders’ interests it may make sense for audit committees to monitor long-term progress to ensure the company learns from both successful and less successful transactions.

² Mergermarket, *Deal drivers Europe – FY 2006*, 2007. Available for purchase or through subscription at: http://www.mergermarket.com/public/default.asp?pagename=remark_detail&docid=989.

³ BusinessWeek, *There’s no magic in mergers*, 14 October 2002. Available at: http://www.businessweek.com/magazine/content/02_41/b3803160.htm.

The governance issue

The EU's 8th Directive and the Sarbanes-Oxley Act (for SEC registrants), require public company boards to assess disclosure controls and procedures, internal controls, the composition of the target company's audit committee and off-balance-sheet transactions. Many European countries have also defined the role of the full board and the audit committee in their national corporate governance codes. However, there are fewer examples of the audit committee being assigned specific duties associated with transactions.

Despite this, Ernst & Young's recent audit committee survey of 176 global public companies noted that 84% identify one of their primary tasks as "understanding the implications of significant transactions with respect to financial controls".⁴ For additional information on the audit committee's role in transactions as specified in selected national corporate governance codes, see the appendix on pages 8-9.

Members reported that for the companies whose boards on which they sit, there are few examples of audit committees playing a large role in transactions. One member expressed concern "about the audit committee taking [responsibility] for [company] performance and managing it. That's the full board's job". Another member suggested: "It is up to the full board to decide if the audit committee has a specific role to play". However, there were a number of scenarios in which members felt the audit committee would need to play a fuller role (see box below).

Circumstances in which the audit committee may be asked to play a fuller role

- A merger of equals.
- A disposal of a major part of the business.
- A related-party transaction. (In some European countries – Italy, for instance – the audit committee is the only entity with a majority of independent directors who can oversee negotiations).
- A significant conflict of interest between majority and minority shareholders.

The European perspective contrasts with the views of North American audit chairs reported in *ViewPoints*: "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".⁵

The pre-transaction phase

Members agreed the role of the audit committee remains limited in the pre-transaction phase. One member observed: "Before the deal [a transaction] has to be a full-board issue". This is especially true of the more strategic transaction-related tasks of setting objectives, selecting targets and giving final

⁴ Ernst & Young, *Audit committee perspectives*, 2006, page 3. Available at: [http://www.ey.com/Global/download.nsf/International/AABS_Audit_Committee_Perspectives_Executive_Summary/\\$file/2006AuditCommitteeSurveyIndustryInsightsExecSummary.pdf](http://www.ey.com/Global/download.nsf/International/AABS_Audit_Committee_Perspectives_Executive_Summary/$file/2006AuditCommitteeSurveyIndustryInsightsExecSummary.pdf).

⁵ Audit Committee Leadership Network, *Transaction risk*, *ViewPoints*, 5 March 2004, page 2. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar04_View4.pdf.

approval for specific deals. Several members remarked that they were less likely to get involved if management had *“an excellent track record”*.

However, even when their trust in management has been strong, some members’ audit committees have undertaken more oversight of transactions because of their companies’ ambitious M&A programmes. These members described several activities involving the audit committee, including:

- **Affordability discussions.** It is the audit committee’s responsibility to answer questions regarding value and the impact of accounting choices. Some audit committees also discuss in advance how the acquired entity will be assessed after the transaction, in order to determine whether it has created value. Several members felt that the role of the audit committee was to prepare and present the financial discussion about the deal price to the board. One member specified it was important for the audit committee to become part of the discussion *“when there is too clever an economic argument”*. Another audit committee commissioned and analysed an independent fairness opinion on behalf of the board and made a recommendation about whether to proceed with the transaction.
- **Readiness audit.** One audit committee provides assurance to the board that the company’s management will be able to successfully integrate any potential acquisition. The member concerned said: *“More frequently there is the question of whether the organisation is able to take on [another transaction]... to advise the board and balance the risk”*. The audit committee sets out to *“understand the status quo in the part of the business doing the transaction, including how they are absorbing their last transaction; [establishes] metrics which would tell the board if it is easier or harder for the transaction to be absorbed and [oversees] the reporting process associated with that”*. The audit committee also considers the infrastructure, including the resources available in the specific business area, and reports on its recommendations concerning readiness to the board.
- **Assessment of the risks of a transaction.** The audit committee is often mandated by national codes and its own charter and agenda⁶ to oversee a company-wide risk management programme. Members agree that there may be a role for the audit committee in looking at what one member described before the meeting as *“the risk element, not the transaction [itself]”*. Another member said that management would come to the audit committee for advice before a transaction *“because of the financial risk [associated] with each transaction”*. Other members said that in the future, the audit committee may play more of a role in assessing the quality of the company’s transaction process – in much the same way that it currently oversees the company’s risk management process.
- **Providing balance in transaction discussions.** There is often an overwhelming drive within management to move quickly and positively towards the completion of a transaction, especially if there are competitive parties involved. One member said that it was often up to the audit chair to *“play devil’s advocate”* and ensure the board *“discussion covers what could go wrong [with the transaction]”*. The committee may find it valuable to *“inject a sense of realism”* at the beginning of the process than to have to evaluate a failed transaction
- **Due diligence and planning activity.** Members expect to be informed of due diligence activity, rather than being involved in it. One member noted: *“The audit committee is informed first, then the full board”*. Another member said the audit committee receives formal updates from

⁶ European Audit Committee Leadership Network, *Audit committee charters and agendas, ViewPoints*, 14 November 2006. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_Nov06_View10.pdf.

the disclosure committee: *“We receive the disclosure committee report each quarter, which covers off major due diligence [issues]”*. However, members agreed that there is a time when the audit committee may need to take a more active role with regard to due diligence, including approving use of the company’s external auditors. Speaking before the meeting, one member said: *“There are cases where the audit committee gets involved because of accounting issues, as there is a question of how to account for the transaction”*.

- **Related-party and conflict-of-interest transactions.** In certain special cases, depending on the ownership structure of the company and the country’s industrial structure, related-party transactions can occur. The International Accounting Standards Board (IASB) has launched an effort to write a standard specifically for these transactions – IAS 24 – to be issued in the fourth quarter of 2007.⁷ Related-party transactions may require the audit committee to play a unique role from the very first steps of a transaction. One member explained before the meeting: *“We appointed independent advisers; we tried to negotiate the terms of the deal with the other side ... and then of course we reported to the full board”*.

On average, 56% of corporate transactions are completed within six months, with a further 20% reporting that completion takes place within ten months.⁸ In contrast, 74% of private equity transactions are completed within six months.⁹ Despite the increased length of time for corporate transaction completions, members were concerned that the audit committee is sometimes hindered in carrying out many of the activities referred to above because it is *“usually too late to the party”*.

Members were concerned about management teams that use media leaks to pressure the board and audit committee to approve acquisitions. One member recalled a situation in which block shareholders decided to pursue a transaction, and by the time the board was notified *“it was too late because it was already in the press”*. Another member responded: *“If you have that problem, then you have the wrong management”*. However, a third member added: *“A clever management knows how to prepare the board”*.

One member specifically mentioned that SEC registrants face significant risks with regard to market notification of a transaction. This member noted that *“[in some cases] the SEC considers that as soon as the board is informed of a potential transaction, they have to make it public”*. Another member warned that the longer board-level negotiations take, the more the board needs to *“watch it, because of insiders and leaks”*.

The post-transaction phase

Members were generally more positive about the possibility of useful audit committee involvement after a deal is completed. This perspective was shared by North American audit chairs. *ViewPoints* previously reported: *“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*

⁷ For more information on IAS 24, see the discussion on the IASB website:
<http://www.iasb.org/Current+Projects/IASB+Projects/Related+Party+Disclosures+%28IAS+24%29/Related+Party+Transactions.htm>.

⁸ DLA Piper, *European M&A activity survey 2007*. Available at: http://www.dlapiper.com/files/Publication/fb0cc41-b558-4829-bc40-c6e1b5c875a2/Presentation/PublicationAttachment/7f805d1e-7176-49bd-a039-bc6ee3552794/DLAPiper_EuropeanMASurvey2007.pdf

⁹ Ibid.

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”.¹⁰

While the audit committee and the board in Europe do not necessarily have full oversight of the integration of acquired companies, audit committees may insist that companies establish the same IT platforms and accounting systems, usually within the first 6–12 months of the integration.

Members also suggested that the audit committee may be involved in the following:

- **Financial results.** Perhaps the most obvious role of the audit committee is to monitor anything involving *“the numbers”*. One member noted that there is a role for the audit committee *“if there has been a public commitment to make sure that the disclosures are okay”*. However, members also cautioned that the role of the audit committee *“isn’t to track [company] performance”*. One member said it was the *“duty of the audit committee to ensure that the transaction is accurately reported on the balance sheet”*.
- **Internal controls.** One member explained before the meeting: *“Once it goes to the next step, then the audit committee is involved in making sure that you get the right kind of controls in place quickly”*. This member believes that it is probably never too early to start implementing the proper control environment – and that the audit committee’s role is to ensure that this is happening. Internal controls are also necessary for assuring proper data flow on the financial and operating success of a transaction. Before the meeting, in the context of how important IT systems are for ensuring strong internal controls and accurate financial data, one member specifically mentioned the importance of checking on the IT integration *“to see if those systems migrated one way or another”*.¹¹
- **Working with the other board of directors and committees.** A merger of equals also requires dialogue between both companies’ boards of directors and committees. Recalling a merger experienced by one audit chair, the member noted: *“[The audit committee] gave advice to the board ... in terms of setting the governance equilibrium, such as the connection between the two boards, composition of the new board, composition of the committees of the board, [appointment of the] external auditor, the CFO and [the] internal auditor”*. The member noted that although the two audit committees began to work together on a joint agenda as soon as they could, they wished that they had started even earlier.
- **Long-term monitoring.** Management can often be counted upon for short-term monitoring of transactions to measure any value added to the company. But, in shareholders’ interests, it may make sense for audit committees to monitor long-term progress to improve corporate decision-making capabilities. Before the meeting, one member described a situation in which there was *“an issue where the transaction itself had various bits of money that would be turned over during five or six years”*. In such a case, it may make sense for the audit committee to monitor the details *“just to make sure that someone is paying attention to them”*.

¹⁰ Audit Committee Leadership Network in North America, *Transaction risk*, ViewPoints, 5 March 2004. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar04_View4.pdf

¹¹ For more information on the role of the audit committee in IT governance, see European Audit Committee Leadership Network, *IT governance*, ViewPoints, 30 May 2006. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_May06_View8.pdf.

- **Learning from negative outcomes.** When an acquisition fails, the audit committee may want to take the lead in evaluating what went wrong and develop “*an institutional learning of what has gone wrong [with other deals]*”. One member said in reference to a failed acquisition: “*Internal audit did a retrospective to see if there was something we could learn from it*”. The audit committee may also want to examine “*the system of how [the company] does deals*”.

Conclusion

It is a common assertion that two-thirds of acquisitions fail to deliver shareholder value. Today, many European audit committees play no role in overseeing major transactions before or after a deal is done, in contrast with North American audit chairs. However, in the future, European audit committees may feel compelled to increase their role, especially given the potential impact of large, complex transactions on shareholder value and the balance sheet, as well as the increasing activism of the investment community.

About this document

The European Audit Committee Leadership Network is a select group of audit committee chairs from leading European 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 endeavour to fulfil their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, members of management and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The views expressed in this document represent those of the European Audit Committee Leadership Network, a group of audit committee chairs drawn from Europe's leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organisation.

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Appendix: Board and audit committee roles in transactions according to the corporate governance codes of network members' countries

Country	Board and audit committee roles
France	<p>The French corporate governance code¹² for listed companies suggests the full board should "monitor the management and secure the quality of information provided to shareholders and to the market, through the accounts or in connection with major transactions". The full board (or appropriate ad hoc committee) also evaluates transactions with an eye towards their strategic importance.</p> <p>The audit committee is tasked with reporting to the board the methodology and reliability of how the accounts "are drawn up, rather than going into the details of the accounts". Audit committees are also tasked with making sure the transaction does not involve any conflicts of interest.</p>
Germany	<p>The German corporate governance code¹³ notes that the supervisory board (in the dual-board system) should approve transactions "include decisions or measures which fundamentally change the asset, financial or earnings situations of the enterprise".</p> <p>The audit committee is responsible for overseeing risk management in general, but the code contains nothing specific concerning the role of the audit committee in transactions.</p>
Italy	<p>The Italian corporate governance code¹⁴ assigns the full board the task of examining transactions that have an impact on the company's assets, liabilities and profitability, as well as any transaction that may present a conflict of interest. The board is directed to consult with the independent auditor and the internal controls committee to determine if the full board should approve a transaction that presents a conflict of interest.</p> <p>The internal controls committee (the Italian equivalent of the audit committee) works with the board to ensure that an adequate internal controls system is in place, including internal controls that impact the efficiency and effectiveness of business transactions.</p>
The Netherlands	<p>The Dutch corporate governance code¹⁵ requires the supervisory board to approve transactions. There is special emphasis on the board's role in ensuring the independence of both management and the supervisory board in any transaction.</p>
Sweden	<p>As noted in the October network meeting on audit committee charters and agendas,¹⁶ the Swedish corporate governance code¹⁷ recommends – but does not formally call for – the creation of an audit committee. The Swedish Shareholders' Association's corporate governance policy¹⁸ for listing on the Stockholm Stock Exchange, which does mention audit committees, sets aside a role for the audit committee in assessing risks, but does not mention transaction risk specifically.</p>

¹² Available at: http://www.ecgi.org/codes/documents/cg_oct03_en.pdf.

¹³ Available at: http://www.ecgi.org/codes/documents/corgov_endfassung_e.pdf.

¹⁴ Available at: http://www.ecgi.org/codes/documents/codiceautodisciplina_en.pdf.

¹⁵ Available at: <http://corpgov.nl/page/downloads/CODE%20DEF%20ENGELS%20COMPLEET%20III.pdf>.

¹⁶ See European Audit Committee Leadership Network, *Audit committee charters and agendas*, ViewPoints, 14 November 2007. Available at http://www.tapestrynets.com/documents/Tapestry_EY_Euro_ACLN_Nov06_View10.pdf.

¹⁷ Available at: http://www.ecgi.org/codes/documents/swe_codes_group_en_mar2005.pdf.

¹⁸ Available at: http://www.ecgi.org/codes/documents/corporate_governance_policy0201.pdf.

Country	Board and audit committee roles continued
Switzerland	The Swiss Exchange's corporate governance directive ¹⁹ makes no mention of an audit committee. The Swiss Business Federation's <i>Swiss Code of Best Practice for Corporate Governance</i> ²⁰ suggests that the full board maintains the right to approve certain business transactions. The audit committee is not tasked with any specific responsibility for transactions.
United Kingdom	The UK's corporate governance combined code ²¹ directs the audit committee to monitor and review any formal announcements relating to the company's financial performance. Since a major transaction would impact financial performance, it is likely that the audit committee would monitor and review the supporting materials associated with any announcement regarding the transaction. Also, if there is not a specific risk committee, the code suggests that the audit committee reviews the company's internal controls and risk management programme.

¹⁹ Available at: http://www.swx.com/download/admission/regulation/guidelines/swx_guideline_20020701-1_en.pdf.

²⁰ Available at: http://www.ecgi.org/codes/documents/swisscodeofbestpractice_english.pdf.

²¹ Available at: http://www.ecgi.org/codes/documents/frc_combined_code_june2006.pdf.