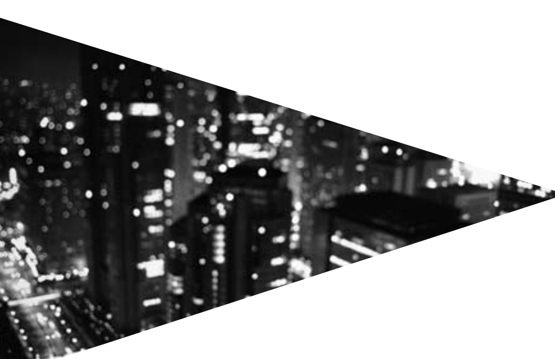
Issue 13: December 2010

InSights for European audit committee members

Increased oversight of M&A: an expanding role for audit committees



Executive summary

"[The] board has an obligation to make sure [target] companies fit into the long-term strategy of the company. I think the audit committee needs to make sure there are processes in place to increase likelihood that an M&A will be successful."
Audit committee chair

Tasked as they are with oversight of financial controls, compliance with regulatory regimes and, in many cases, risk oversight, audit committee chairs are not eager to take on more duties. And yet, in mergers and acquisition (M&A), input from the audit committee offers tremendous benefit with very little extra work. It may be a matter of providing more focused attention.

There is still uncertainty around when M&A activity will return to pre-recession levels, but recent large deals involving cash-rich buyers signal at least a slow return of activity. Ernst & Young commissioned Tapestry Networks to ask over 40 board directors and subject matter experts whether audit committees, or boards as a whole, could contribute to their companies by strengthening their oversight of M&A. The answer was a resounding yes.

Conversations with research participants yielded three key findings:

1. **Shareholders are concerned with high M&A failure rates**
There is no "one-size-fits-all" measure of success in M&A. However, many judge M&A success on whether the transaction achieves the expected increase in shareholder value. Several studies suggest that well over half of M&A deals fail to meet these objectives. Participants agreed with these findings and noted that M&A failure can have dire consequences for CEOs, boards and companies. Failed M&A can destroy a company's market value, destabilize its financial position and credit ratings, impair its strategic position, weaken the organization and damage the company's reputation. As a consequence, shareholders have become increasingly anxious about these high failure rates. One M&A advisor stated, *"The level of shareholder scrutiny has increased exponentially on transactions ... on both the target and acquirer sides."*

Ernst & Young
Quality In Everything We Do

Executive summary *continued*

2. **Most companies' M&A processes are surprisingly inadequate**
   Participants believe that most public companies perform poorly at all stages of the M&A process, from selecting potential acquisition targets, to performing due diligence, to accomplishing integration after the merger. As one audit chair stated, *"No one is holding management accountable for delivering on the key objectives and value drivers that were set out in the beginning."*

3. **Audit committees should use this time to prepare for future M&A**
   Participants noted that M&A activity is currently patchy and inconsistent across regions and industries. Only acquisitions into and from emerging markets are uniformly picking up. Some experts expect large deals and hostile deals to continue over the next six months, but anticipate a slower increase in transactions in general, while confidence in the global economy strengthens.[1] In that context, they urged boards and audit committees to review the company's strategic framework for M&A with management to determine how future transactions will be assessed. Non-executive directors should also ensure that management's M&A process is robust and that they have a strong, independent cadre of advisors to turn to when they need to respond quickly to opportunities.

Participants suggested a significant oversight role for audit committees in M&A. This report outlines their recommendations and identifies key areas of the process that can notoriously destroy value.

[1] "Looking for growth?" *Capital Confidence Barometer*, Ernst & Young, October 2010.

About this document
InSights is produced by Tapestry Networks to provide assessments of key issues of interest to audit committee members. It will be distributed by Ernst & Young and Tapestry Networks. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

The views expressed in this document represent those of the individuals who participated in the research. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks.

Tapestry Networks

Ernst & Young
Quality In Everything We Do

As M&A re-emerges as a growth driver — boards should be prepared

There is no consensus among market experts and board directors on when M&A activity will increase. Some boards are focused on recent bullish activity, while others point to economic concerns that paint a bleak picture; however, research participants stressed that boards should not be complacent about their readiness to respond.

One industry expert suggested there is uncertainty because the global M&A market is nearing an *"inflection point."* As global markets begin to recover and credit markets become more liquid, there has been an increase in M&A deals over the past few months. However, the strength and speed of the M&A rebound depends on the country and industry. Many participants also said reports of an imminent return in M&A activity is *"overhyped."*

- **There is pressure for more activity and signs of growth**
  Many companies have record-high cash balances and are struggling with organic growth. Facing pressure from shareholders who want higher returns from the cash on the balance sheet and spurred by investment bankers with *"a lot of new ideas,"* many companies are looking at M&A as a viable growth option. As companies start *"scooping up scarce assets,"* competitive pressures divide and increase. M&A activity in the third quarter of 2010 was up 21% in terms of value from the previous quarter and represents the third consecutive quarter of growth.[2] Industry experts suggested recent hostile takeover bids (Kraft's for Cadbury, BHP Billiton's for Potash and sanofi-aventis's for Genzyme) indicate confidence levels are rising.

  There is evidence of a two-speed recovery with more robust confidence in emerging markets contrasted with greater caution in many developed markets as companies seek to capitalize on higher growth rates.[3] The economic environment in emerging markets lends itself to increased activity, and multinationals are looking to put foreign capital to use.[4] M&A in emerging markets accounted for 27.5% of the global deal activity in the first nine months of 2010, representing a 72% increase in deal announcements over the equivalent period in 2009.[5]

- **Economic stability is still a concern and confidence is lacking**
  Contributors to this issue of *InSights* said CEO confidence is still not as high as it needs to be, to compel potential buyers to seize opportunities and only market stabilization will restore that confidence. One expert explained, *"We need a less volatile market so boards can get comfortable with where the intrinsic value is."* A recent Ernst & Young survey found there is a reluctance to do deals due to increased taxes, austerity measures and regulatory changes, among other issues.[6] Shareholders also remain cautious, keeping a close eye on cash balances and pressuring companies to return cash through buybacks and dividends.[7] In addition, contributors indicated that financing still poses an issue in the short term: *"Financing markets are not where they were in 2007, but are certainly better than [they were in] 2008."*

Nevertheless, without a double dip in the economy, many participants believe M&A activity will continue to warm up over the next 12 to 18 months. In this context, they reason that the time is right for boards and audit committees to engage their management teams in a discussion about the strategic framework for M&A activity, with the goal of ensuring the processes are sufficiently robust. Companies with significant cash reserves may come upon unexpected opportunities and boards need to be prepared to capitalize on these opportunities quickly.

Questions for audit committees:

- How do you keep abreast of trends in M&A activity in your country or industry?
- How do you get a good view on the state of M&A in emerging markets for your industry?

[2] "M&A Activity in Q3 2010: Dealmakers Continue to Work Overtime," *Business Monitor International*, 27 September 2010.

[3] "Looking for growth?," *Capital Confidence Barometer*, Ernst & Young, October 2010.

[4] Jonathan Lynn, "Global investment flows to recover in 2010–12," 22 July 2010.

[5] Thomson Reuters, *Emerging Markets M&A* (London: Thomson Reuters, 2010).

[6] "Looking for growth?" *Capital Confidence Barometer*, Ernst & Young, October 2010.

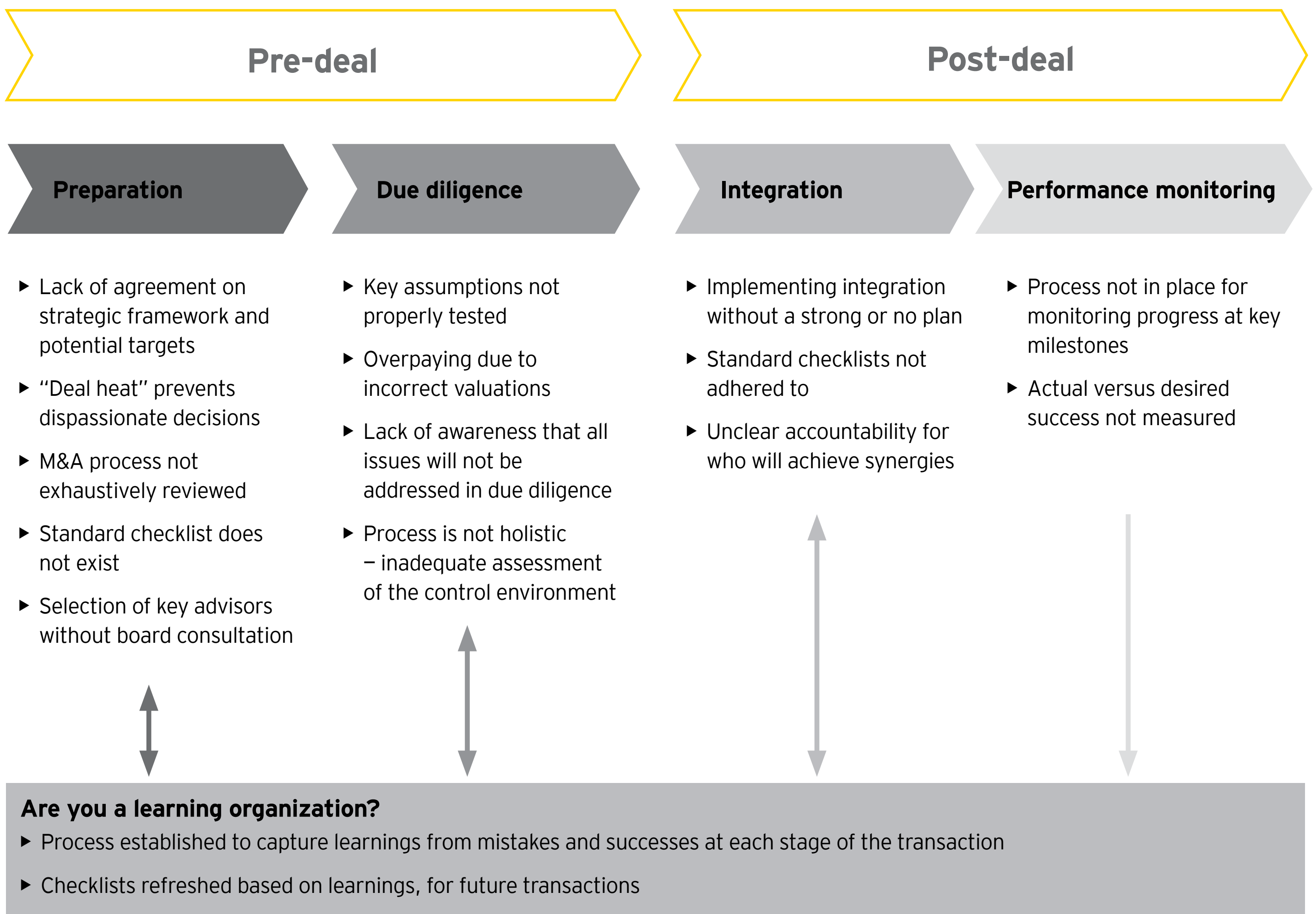
[7] Kate Gibson, "As corporate cash grows, so do dividend calls," *MarketWatch*, 4 October 2010.

Key risks in M&A

"Boards should ensure there is a debate on what risks the acquisition brings to the table." M&A advisor

"When clients are not experienced at M&A, there's no question it's a riskier proposition for them than for companies that are serial acquirers. These companies and boards don't have the organization that serial acquirers do." M&A advisor

This diagram summarises the key risks at each stage during the M&A process



Establishing a strong platform for successful M&A

Many contributors noted the extent of board and audit committee involvement in M&A oversight often depends on the size of the deal and associated risks. One audit chair said, *"If it's a game changer, the whole board is involved."* As for which responsibilities the full board takes and which are delegated to the audit committee, many participants noted that there is significant variation by company. Some audit committees have very little involvement and others essentially serve as an M&A committee. While some boards and audit committees play a role in divestments, in terms of ensuring best value for money, research participants focused on the often more challenging transactions – mergers and acquisitions.

Participants said the most important thing a board can do to ensure its company's success in major transactions is agree on a strategic framework for M&A with senior management. One M&A advisor said, *"Good boards ought to be involved with management and aligned with management every step of the way so they'll never be in a place to have to say no [to a specific deal] – because you would have said no somewhere along the way."*

Most boards appear to fall short of that ideal. One independent director said, *"On the question of whether boards are discharging their oversight responsibilities relative to M&A, I'd say they are either performing dismally or not at all."* He and others recommended several ways boards and audit committees to help their companies prepare for major transactions:

- **The board and CEO must arrive at an effective strategic framework for M&A**
  Boards should establish an open, trusting relationship with management, in which they can discuss the company's strategic rationale for M&A, the list of potential targets and the targets' position in their specific industries and markets. A non-executive director said, *"If you're reactive and opportunistic, you'll have a reactive and opportunistic outcome."* Instead, boards should get regular updates on management's strategy. An M&A advisor said, *"Are we buying because of cost synergies? Will this merger provide growth [through] the combined entity or acquired company?"*

Participants noted two major mistakes that are commonly made in the deal process:

1. **"Deal heat" masks the risks of M&A**
   Management teams are often emotionally invested in growing the company and sometimes *"cannot make dispassionate decisions."* A *Financial Times* article defined this "deal heat" as "the fervour felt by management undertaking a large transaction that often blinds them to the downside of the deal."[8] One advisor explained deal heat is enhanced when the board feels a strong sense of loyalty to the CEO: *"So much of M&A is the human dynamic. The board is in a tough position, because if they say no, the CEO is going to feel that the board doesn't have confidence in his judgment. There is a subtle pressure on the board because of the relationship. At the end of the day, it is hard for them to turn down an energized CEO who is really excited about an idea."* However, one professional countered: *"The board [should be] dispassionate – you need them to be emotionally detached and to focus on the economic case."*
2. **Companies undertake M&A for the wrong reasons**
   Several participants said that companies often engage in transactions for reasons that are not aligned to their core strategy. An advisor said, *"M&A can't be an end in itself. You can't do M&A for M&A's sake."* Participants noted that executives feel pressure from competitors, analysts and shareholders to provide returns, which may lead them to pay more for an acquisition than is warranted: *"In the heat of the moment, you're often not paying what you should."* Participants said growth into non-core business areas to acquire new customers or to diversify the business can be particularly risky and the board should push management to explain whether the company has the resources and capabilities to support this proposed change in strategy: *"If management has a diversification play, that's where the board should challenge the most."*

"Good advisors refine your hypothesis and help you uncover facts that help you disprove your hypothesis. There is a human reluctance to deliver bad news ... Surround yourself with people that will give you bad news." Leading executive

[8] Anthony Goodman, "How directors can help cool 'deal heat,'" *Financial Times*, 2 April 2010.

Establishing a strong platform for successful M&A *continued*

- **The board or audit committee must ensure the M&A process is robust**
  The board or audit committee should challenge management on its transaction processes, from assessment to post-merger integration. This should be done well in advance of considering specific transactions. One M&A advisor outlined several questions the audit committee could ask:

  What is the process before, during and after an acquisition? How do we identify companies so we are not buying the first thing that comes along and we are not just going with the first investment bank that comes up with a cunning idea? How are we organizing our internal team? Who is doing the evaluation? Ensure there is a debate on what risks the acquisition brings to the table. Do you have the capacity to absorb [the acquisition]?

  Some audit committees do manage the process closely. One audit chair described the company's M&A oversight process:

  We asked certain board members to work with the CFO to come up with a template, process [and] checklist that standardized our approach to acquisitions [and] included everything from analysis of the industry landscape to the types of due diligence areas that were needed, all the way through post-acquisition follow-up and our assessment of how the deal model has worked out ... It's a standardized cradle-to-grave process, and ... [it has] helped us assess, execute and review acquisitions much more effectively.[9]

- **The board or audit must have the right external advisors**
  In evaluating whether the company is prepared for future M&A, the board should assess the quality of the external strategic and investment banking advisors and the audit committee should assess financial, accounting and legal advisors who assist in due diligence. Participants said the best support typically comes from advisors that have a long-term relationship with their companies: "*These advisors will know the company better ... [The relationship] is less transactional and more long-term oriented and will result in better advice.*" Participants also noted that companies should be sure their advisors have the necessary technical skills for specialized analysis, when needed. For example, "*If you are in a country where [corruption is] very widespread, you will have to find specific advisory expertise because [corrupt] transactions are not part of the records of the company. Things are buried so deep that you will need full access and power that you don't have as a potential buyer.*"

[9] "The role of the board and audit committee in transaction," Pacific Southwest Audit Committee Network, VantagePoint, 13 March 2008.

Qualities of good due diligence advisors

An M&A advisor noted: "*The audit committee should be concerned about helping the business manage risk and obtaining an independent view – so for material deals (defined by size or strategic importance or risk) they need to know that there is someone independent, objective and with sufficient experience to challenge management.*" In this context, participants identified key characteristics of good advisors:

- They recognize good deals and know how to appropriately assess strategic fit, cultural fit and integration potential.
- They know how to evaluate target businesses, with some granularity, to identify and test key assumptions that underpin the future performance of the business, through accounting, financial and commercial analysis.
- They establish relationships with management where they are comfortable challenging them.
- They are able to question management of target companies, pursuing evidence to support key assumptions and hypothesis.
- They are acute in their judgment of people and character.
- They have international reach and stay close to deals in international markets and bring insights from their network.

Questions for audit committees:

- How does management engage you on M&A strategy and specific M&A deals? How do you ensure alignment between company strategy and M&A activity?
- What processes are in place to ensure there is sufficient oversight of M&A at the board level? What specific responsibilities does the audit committee have in transaction oversight? Where could the board or audit committee add more value?
- How do you get the best support and challenge from M&A advisors?

Enhancing the due diligence process

Participants unanimously agreed that the board and audit committees can greatly improve the due diligence process, particularly on large transactions where risk tends to be the greatest. A participant with broad expertise in transactions said, *"The due diligence phase is the most challenging, because it is the most subjective. The board should really challenge here, because it is not a perfect process."* While management and the board share responsibility for making sure that preparation is adequate for the transaction at hand, the audit committee may have special responsibility to monitor due diligence if it is tasked with risk oversight.

Another advisor said, *"I think the questions are asked today [in the board room], but the answers that are given are more superficial."* This can be remedied by continually pushing management for more specifics by asking targeted follow-up questions. A practitioner said, *"Due diligence should be focused on trying to disprove the [investment] thesis."*

Participants said the audit committee should not be satisfied with the spreadsheets and reports that management provides. An M&A advisor said, *"The strategic glossy reports may be assuring, but if I were a member of an audit committee, I wouldn't be really comfortable with just this material."* Instead, for major transactions, independent directors should meet with the people involved in the deal: *"The audit committee should get more first-hand information to the board rather than just formal reports. There should be more real discussions with the financial people and the business people assessing the business ... Before the deal is inked, [the executives who will lead or oversee the acquired business] should have the chance to give their own opinion on the deal: the top line, the culture, the synergies."*

Participants pointed to two areas in particular that demand robust due diligence: the fundamental financial and business analysis and the latent risks and control environment.

The fundamental financial and business analysis
One independent director said, *"Price is the biggest factor in successful and unsuccessful deals. If you pay too high a price, [then] no matter how good you are at integrating, a transaction may be viewed as unsuccessful."* As noted earlier, sometimes pressure to grow the business can lead the company to pay too much for an acquisition, but participants suggested that, in many cases, overpaying stems from inadequate financial and business analysis and inaccurate valuations. Several participants said earnings quality is the most influential factor in whether a major transaction is successful. One executive said, *"Make sure you're buying something that fits and is not built on a deck of cards. You can be blinded by a set of numbers on an aggregate basis but find out later on that's not what you're buying ... Instead you are buying one-offs. What are the base earnings of a business?"* Participants warned that, when companies are buying into a business they are familiar with, they tend to underplay the financial or business risks: *"Corporates look at the numbers and say, 'Well this looks a bit suspicious, but I can fix this. I know the business; I know how to fix it.'"*

Participants identified two areas that audit committee members or other non-executive directors should focus the most attention on:

- **Evaluate the target's position in the marketplace**
  One advisor asked, *"How strong are the customer relationships? You can look at the P&L, costs of raw materials, personnel costs etc., but if the product is not likeable, that is a deal breaker."* Several participants recommended questions such as, *"Do you really understand the market that the target business is in? You need to start from the market or the competitive environment. You need to talk to the customers, the competitors and try to understand specific markets."*
- **Stress test management's assumptions**
  Participants said the audit committee or the board should take a detailed look at the assumptions behind managements' proposed deals. These may include macroeconomic factors, revenue forecasts and other key indicators. *"If I could only ask one question of management, it would be, 'What are the assumptions that are behind this [proposed] deal, and what would happen if they didn't come to fruition?'"* noted one audit chair. *"What happens if the top line goes down by 25%? What happens if oil prices rise 10%?"* asked another.

  An M&A advisor with experience working with both private equity firms and corporates said, *"In the leveraged market ... you [stress test] as a matter of course because the banking covenants require you to test the 'downside' case and make sure that the business can live within its funding structure and covenants. Corporates do less of this and so don't get visibility of the range of outcomes and the risks attached, and how these risks will be managed, monitored and mitigated ... Boards [and] audit committees should demand to see the outcomes and then probe the extent of historical volatility of key drivers (e.g., raw material prices, key drivers of volumes, impact of competitor strategies) and see what history tells you about the peaks and troughs of the target business' dynamics."*

"Audit committees should play a role in M&A [due diligence]. Dealmakers tend to hold risk management out of the deal because they are afraid that would make the deal more difficult. This is a governance issue. Someone should make sure risk management is part of any equation." M&A advisor

Enhancing the due diligence process *continued*

This analysis is more difficult in the current context. An Ernst & Young report notes, "A transitioning marketplace ... presents a range of challenges. Consider valuation. The same collapse in asset values that may make today's pricing seem so attractive can also frustrate efforts to reliably value any acquisition. Add to this lingering volatility – market indices in Europe, the US and Asia are currently exhibiting wide short-term swings – and valuation becomes a moving target."[10]

The latent risks and control environment

Despite the perception that companies spend a considerable amount of time evaluating the risks and controls in the potential acquisition targets, in reality, *"there isn't much time for such analysis."* The result is that *"companies don't focus enough on the control environment. They focus too much on the strategic fit or the revenue number that might exist."* Participants urged audit committees to ensure that due diligence is holistic: *"There is bribery compliance, antitrust compliance etc., but [at present, overall] there is not a holistic analysis of the company's compliance systems."*

Several participants noted that sometimes it is impossible to do the type of analysis that should be done prior to a deal. As one executive said, *"It is an imperfect world and you never get to see everything you want ... for example, it is difficult to get the true state of the regulatory files of companies in emerging markets and it is also difficult to constantly stay on top of regulatory changes."* Another urged: *"Boards need to ask, 'What trade-offs have been made during the due diligence? There is always going to be something you missed. What might those be?"* Companies must acknowledge that there may be "unknown risks" that have not been addressed during due diligence and be aware that they could crop up later, in the integration phase. In this context, the participants recommended that audit committees focus on three specific and potentially disastrous risks:

- **Environmental liabilities**
  Given the increasing importance of sustainability to shareholders, analysts and regulators, environmental liabilities are emerging as a key risk in M&A.[11] One advisor said, *"Environmental performance is becoming a major red flag. It's a killer if the company has major environmental problems that are not uncovered in the due diligence process."*
- **Corruption risks**
  Ernst & Young's 2010 global fraud survey, which solicited views from over 1,400 CFOs and heads of internal audit, legal and compliance, found that "more than half of respondents will be looking for opportunities for growth in the next 12 months, particularly in Latin America and the Far East, regions that are perceived to pose ethical challenges."[12] However, about 40% of those respondents said they *"rarely perform fraud or corruption due diligence, despite the inherent risk that could lead to enforcement action and potential successor liability."*[13] Given the enhanced enforcement of anti-corruption measures all over the world and the coming implementation of the UK Bribery Act, which creates a more effective legal framework to respond to bribery, the risks associated with acquiring companies that engage in corrupt business practices will only increase.[14]
- **Cultural risks**
  As M&A activity in emerging markets grows, assessment of cultural risks becomes more important. An M&A advisor said, *"Companies usually fail in their attempts to find out how the cultures would fit."* Participants said that analyzing cultural risks is more difficult when the proposed acquisition is a non-domestic company and they urged the board or audit committee to ensure management is sensitive to national differences: *"It is different country by country. For example, in Germany, there is a regime of labor, where employees organized in the form of a work counsel have a large amount of influence. Labor lawyers deal with this every day. So the companies who take labor seriously have done well with integration. Those that ignored labor have not done so well."*

Questions for audit committees:

- How do you sufficiently test management's financial assumptions and due diligence quality? How do you ensure a dispassionate decision on the deal?
- How do you ensure your processes sufficiently assess the risks in new markets (e.g., corruption, environmental and cultural risks)?

[10] Steve Krouskos, "Corporate transactions: opportunities abound, but proceed cautiously," Transaction Advisory Services, June 2010.

[11] "The Sustainability Journey: From compliance, to opportunity, to an integrated business strategy," *InSights*, Ernst & Young and Tapestry Networks, September 2010.

[12] Driving ethical growth - new markets, new challenges: 11th Global Fraud Survey, Ernst & Young, 2010

[13] Ibid.

[14] Ernst & Young, Business briefing: The Bribery Act (Ernst & Young Global Limited, 2010).

Post-merger integration: realizing the value of transactions

Participants pointed out that there are some issues, pertaining to the integration process, that should be addressed during the due diligence phase itself. One M&A advisor said, *"Focus on the way in which these integrations are assessed and the potential value-creation measures. Focus on who in our organization spends time dealing with the business and top-line assessment and the integration aspect. Because these transactions are all very complex, ensure that these people are involved."* Prior to integration, the decision on who will run the company post-merger must be made. If the answer is the existing management, the audit committee or board must be sure these executives are capable and willing to stay.

All the contributors to this research were highly critical of most public companies' records with regard to integrations. An audit committee chair noted, *"People acquire a company because of its strategic fit, but then let them operate on their own. This is a dichotomy."* Subject matter experts agreed. One executive said, *"Acquisition strategies fail because of a lack of integration. Doing the deal is only a quarter of the process. The rest is making it fit."* While the companies may have the *"high-level structure"* (i.e., whether the acquired company will be fully or partially integrated or will stand alone) agreed prior to the deal being signed, rarely is the integration plan complete. These risks related to integration can be substantially mitigated through enhanced board and audit committee oversight.

Participants identified three key areas of focus:

Planning

Many participants agreed with one expert's assertion that in public companies there is *"either no plan or a lack of granularity in the plan."* As one advisor said, *"Corporates are allergic to the need for rigor, process, metrics, tracking and well-articulated [integration] plans."* Moreover, even when a plan exists, no one feels fully accountable for its success, and there is limited oversight.

- **Taking time to get the plan right**
  While all participants advocated for a robust plan, several subject matter experts cautioned against implementing a plan too quickly. One executive said, *"There is this ridiculous urgency to get things done quickly. You pay a lot for a good company, and you have to look at it cold-bloodedly. You can't start implementing until you have the entire plan in place."* One M&A advisor commented that *"on day one, you don't know as much about the business as the people in the business ... [so often you need to] understand and get to know the management."* Another said boards should ensure management is taking time to *"gain trust ... [and ask] where are the value levers? How is [the plan] going to happen? Who's going to do it? Put a key performance indicator dashboard together."* An executive noted it was important to ensure someone (e.g., internal audit, legal or compliance) was tracking the *"punch list"* of items that may not have been adequately covered in the due diligence process.

Execution

Participants suggested a number of ways that boards or audit committees could get involved in oversight of the integration process. One subject matter expert observed, *"Boards cannot treat the post-merger environment as a spectator sport,"* and several audit chairs agreed that *"the audit committee has a role to play here, monitoring consolidation and the integration of operations and people ... [We also] need key metrics [to monitor progress] ... A lot of mergers get done with minimal key metrics to monitor the combination."*

"As long as discipline is in place, there is a great deal of learning that can be applied to other acquisitions." Audit committee chair

Post-merger integration: realizing the value of transactions *continued*

Participants outlined three areas where companies make mistakes in integrations and where the board and audit committee could provide more oversight:

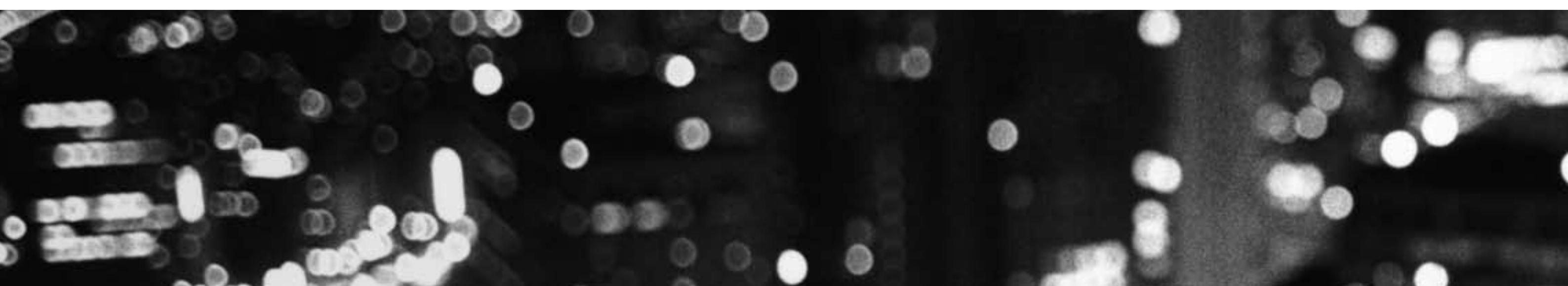
- **No one is accountable for its success**
  Several participants who have been involved in many acquisitions noted that *"if you have a system to track the areas where there are expected synergies … it makes management accountable for what they did."* One executive noted, *"We are crystal clear – preferably in the pre-deal plan – who exactly will be held accountable for the success in achieving the financial and strategic objectives."* In his case, the board requests that this information be included in the deal book presented to them. He noted that this can be as granular as who is responsible for each part of the value that is to be expected: for example, revenue gains and cost savings. He said that companies should try to avoid having the sponsoring executive subsequently change roles: *"In those cases, you either don't change their role or you ensure the person coming into the role inherits and commits to the existing goals."*
- **No integration checklist exists and it is not adhered to**
  Several experts suggested that a *"checklist of things we always need to do"* is invaluable. Corporate development executives are sometimes tasked with working with the business owners to ensure the latter adhere to the corporate integration process. *"No one is allowed to deviate from our checklist,"* noted one participant. Audit committees could ask to review the checklist to ensure that it is being used.
- **Performance against the plan is not monitored**
  Many contributors noted boards typically have very little oversight of the integration process. It seems companies assume that integration will be successful rather than working to make it so. One audit chair recommended that *"management present what the key milestones are for a successful integration and report back to the board on regular basis on those."*

Improvement: learning from successes and failures in M&A
One of the main risks for companies is an unwillingness to assess the assumptions made earlier in the process: one former CEO, now an independent director, noted, *"[Boards of directors] only face [post-acquisition issues] when it's been a disaster … or … do a post-mortem when it's too late."* Another director noted, *"No one really asks, 'Did we get the market share we expected? Did we get the technology transfer that we did [this deal] for?'"* Participants recommended much more discipline in monitoring success against agreed goals
and milestones.

Companies that are not serial acquirers may not have the institutional knowledge or robust processes in place to ensure acquisitions are successful. These companies may also fail to learn from past mistakes. By contrast, serial acquirers recognize that *"the acquisition should be a learning process."* One expert noted that an effective monitoring process captures key learnings on an ongoing basis, so *"the company can leverage best practices and failures."* One professional said that his company reviews its M&A checklist after every transaction to see if improvements can be made. Audit committees could benefit from a similar lessons-learned approach. Regular assessment of where and how boards can improve oversight will help mitigate many of the risks that plague M&A.

Questions for audit committees:

- How could you improve your oversight of the integration process?
- What could be done to ensure accountability among management for realizing M&A synergies?
- How does your company learn from its successes and failures in M&A? How does it incorporate these lessons into improving the M&A process?



Conclusion

M&A activity is expected to return over the next 12 to 18 months; indeed, in some regions, it has arrived already. Large companies with strong balance sheets will be well placed to capture the opportunities as deal activity builds.

However, history shows that size and financial strength do not ensure success in mergers and acquisitions. Few public companies can claim routine success in capturing the value promised to their shareholders from corporate transactions.

Those that can, have honed the art of acquisitions by focussing on the following areas:

- Have a clear picture of their firm's strategy and the role acquisitions will play in that strategy.
- Have an acquisitions process that is disciplined throughout: from target selection, through due diligence, to post-acquisition integration. They hold business leaders who champion acquisitions accountable for the outcomes of those acquisitions.
- Treat acquisitions as a learning opportunity. Reviewing weaknesses increases the likelihood that the next acquisition will be more successful.

Participants say that outside of "mega-deals," few boards do enough to ensure their company's M&A approach is rigorous. Even fewer audit committees play a lead role. Yet participants agree that if audit committees are willing to become more involved, they can provide real value.

Appendix:
Research participants

From August to October 2010, Tapestry Networks interviewed a broad range of directors and subject matter experts. All discussions were held under a modified version of the Chatham House Rules whereby views expressed during private discussions are not attributed to individuals or their organizations. Over 40 directors were interviewed, including members of the European Audit Committee Leadership Network (EACLN), as well as leading subject matter experts:

- **Laurence Capron**, *Programme Director of M&A and Corporate Strategy*, INSEAD
- **Aldo Cardoso**, *Audit Committee Chair*, GDF Suez
- **Arnaud de La Cotardière**, *Global Head of Commercial*, Linklaters
- **Caroline Grounds**, *Transaction Advisory Services*, Ernst & Young
- **Andrea Guerzoni**, *Global Transaction Support Leader, Transaction Advisory Services*, Ernst & Young
- **Max Martin Habeck**, *EMEIA Operational Transaction Services Leader, Transaction Advisory Services*, Ernst & Young
- **DeAnne Julius**, *Audit Committee Chair*, Roche
- **Florian Kaestle**, *Partner*, Baker & McKenzie
- **Stephen Kaufman**, *Senior Lecturer, Harvard Business School and former CEO*, Arrow Electronics
- **Chris Masterson**, *Chairman*, Montagu Private Equity
- **Jennifer Midura**, *Director of Corporate Strategy, Mergers, and Acquisitions*, AkzoNobel
- **Anders Nyren**, *Audit Committee Chair*, SCA
- **Vincent Ponsonnaille**, *Corporate Partner*, Linklaters
- **Roberto Quarta**, *Managing Partner*, Dubilier & Rice
- **David Redfern**, *Chief Strategy Officer*, GlaxoSmithKline
- **Larry Slaughter**, *Head of EMEA Corporates*, JPMorgan Chase
- **Tom de Swaan**, *Audit Committee Chair*, GlaxoSmithKline
- **Dieter Turowski**, *Global co-head*, Natural Resources Group, Morgan Stanley
- **Bernd Voss**, *Audit Committee Chair*, ABB
- **Lars Westerberg**, *Audit Committee Chair*, The Volvo Group
- **Chris Young**, *Head of Takeover Defense*, Credit Suisse

About Tapestry Networks
Tapestry Networks is a privately held professional services firm that brings leaders together to solve complex problems. Since 2002, networks convened by Tapestry Networks have tackled some of the most significant strategic challenges facing institutions and society, including raising standards in corporate governance in the United States, Canada and Europe, developing strategies for a more sustainable health care environment in Europe, and enhancing national security in the United States through public-private collaboration. Tapestry Networks convenes eight audit committee networks sponsored by Ernst & Young that collectively consist of chairs of more than 200 audit committees who sit on over 320 boards at some of the world's most admired companies. For more information, please visit www.tapestrynetworks.com.

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young
Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com

About Ernst & Young's Assurance Services
Strong independent assurance provides a timely and constructive challenge to management, a robust and clear perspective to audit committees and critical information for investors and other stakeholders. The quality of our audit starts with our 60,000 assurance professionals, who have the experience of auditing many of the world's leading companies. We provide a consistent worldwide audit by assembling the right multidisciplinary team to address the most complex issues, using a proven global methodology and deploying the latest, high-quality auditing tools. And we work to give you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our work worldwide. It's how Ernst & Young makes a difference.

© 2010 EYGM Limited.
All Rights Reserved.

EYG no. AU0724

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.