



The role of the board and the audit committee in major transactions

Introduction

The North Central Audit Committee Network¹ met on April 15, 2008, to discuss the role of the board and the audit committee in major transactions. Members identified ways boards might improve oversight of transactions, especially acquisitions, to ensure they create shareholder value and what specific role the audit committee has in this oversight.

The network's discussion focused on the following themes:

- Boards may need to be more proactive to ensure transactions create value
- Discussion of major transactions is part of strategic planning
- Audit committees focus on core oversight responsibilities
- Few boards have standardized processes for transaction oversight
- Cultural fit is essential for successful acquisitions, yet often overlooked

The members of the network present at the meeting, who sit on the boards of 17 large-, mid-, and small-cap public companies between them, were:

- John Baily, Audit Committee Chair, Erie Indemnity Company
- Jim Boland, Audit Committee Chair, Goodyear Tire & Rubber Company
- Gordon Harnett, Audit Committee Chair, Lubrizol Corporation
- Bill Lawrence, Audit Committee Chair, Ferro Corporation
- Mike Monahan, Audit Committee Chair, CMS Energy
- John Shuey, Audit Committee Chair, Cooper Tire & Rubber Company
- Gary Valade, Audit Committee Chair, Wabtec Corporation

Ernst & Young participants in the meeting included:

- Steve Klemash, North Central Area Managing Partner, Audit and Advisory Business Services
- Al Paulus, Senior Client Service Partner
- Mark Short, Partner, Transaction Advisory Services leader for the North Central sub-area

¹ The North Central Audit Committee Network is a group of audit committee chairs from leading North American 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 committee environment.

VantagePoint 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. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* 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.



VantagePoint 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

Members discussed the role they can play in overseeing transactions as both directors and audit committee chairs. Members agreed that transactions often fail to deliver anticipated value and discussed how boards might engage with management to improve performance and what role the audit committee plays in transaction oversight. The network's discussion focused on the following themes:

- **Boards may need to be more proactive to ensure transactions create value** (*page 3*)

Members suggested that their efforts to avoid interfering with management may mean that they have not been not engaging as actively as may be required to ensure successful transactions. They outlined ways the board can support management's efforts: by creating a sense of urgency following transactions, challenging management's assumptions, aligning incentives with objectives, following up after the transaction, and ensuring that deal fever does not impact prudent decision making.

- **Discussion of major transactions is part of strategic planning** (*page 4*)

Major transactions, especially those of significant scale, require engagement from the full board. Generally, M&A activity is integrated with broader strategic planning, so that when transactions arise, the full board is aware of the activity and is able to agree with management as to how a given transaction aligns with strategic objectives.

- **Few boards have standardized processes for transaction oversight** (*page 5*)

Network members' boards generally do not have a set approach to reviewing transactions, instead focusing on ensuring the appropriate questions are raised relating to the transaction at hand. Many transactions work their way up from business units to corporate involvement before the board is asked to review them.

- **Cultural fit is essential for successful acquisitions, yet often overlooked** (*page 5*)

Cultural fit can be broadly defined to include interpersonal issues, differences in management style, and a company's approach to value creation. Members noted that these issues are often overlooked either when assessing a transaction or during integration, yet they can have a significant impact on the success of a merger or acquisition.

- **Audit committees focus on core oversight responsibilities** (*page 6*)

Although members have seen audit committees take a lead role in integration efforts and in monitoring some transactions, members said they generally focus on areas that fall within their traditional oversight responsibilities, such as the impact on financial reporting, understanding the risks involved, and the use of internal audit and the external auditor in due diligence and post-merger integration activities.



Boards may need to be more proactive to ensure transactions create value

In 2002, *BusinessWeek* conducted an exclusive survey of the last transaction wave: “The results? Fully 61% of the 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.”² Responding to this data, one member quipped, “*I’m surprised that 39% create value. When you think about it, one entity knows all the facts and the other expects to create a lot of value.*” Another meeting participant suggested that transactions tend not to meet expectations for one of the following reasons:

- The company fails to recognize an opportunity to create value
- Events or actions cause recognized opportunities to be lost
- Opportunities are deferred: the timing is not what the acquirer expected

The relative success of private equity firms in executing transactions elicited comparisons and suggested some lessons for public company boards. Specifically, members noted that private equity firms take an active approach to governance, implement effective incentive structures, act quickly to change management when necessary, and plan for an exit before the acquisition is closed. Some elements of the private equity model may not be practical or desirable for public companies to adopt, but a member wondered, “*Is there a middle ground between the private equity approach and public company boards? The empirical evidence is that corporate America hasn’t been that successful [in executing transactions].*”

Members discussed a number of ways in which a proactive approach might help public company boards improve their oversight of transactions:

- **By creating a sense of urgency.** A member noted the speed with which private equity owners aim to create value with acquired assets: “*Some private equity firms have a rule of thumb that if they don’t change [the company] within 90 days, then they won’t get the value they expected. [Public] companies don’t take that approach.*” Another member observed, “*If you’re going to pay fair value for an asset today, you usually pay more to get the deal done. You need to act quickly to create value, to do something different with that asset.*” A third member said public companies are often “*slow to deal with bad management issues when they’re trying to integrate. They hang on too long, don’t get costs out fast enough, don’t achieve synergies, and lose sight of revenue.*”
- **By really challenging assumptions.** One member contended that overly optimistic assumptions are often to blame for disappointing results from a transaction. Another member said, “*The board needs to focus on the quality of the assumptions, which is hard to do at the board level. It is a lot of the reason for using outside advisers.*” Those who are making an acquisition often “*assume they won’t make the same mistakes [as the acquired company], but then realize some things are not easy.*”
- **By aligning incentives.** Members agreed with one audit chair who said, “*One thing the board can do is make sure the compensation system is neutral as to whether deals get done or not,*” and

² “There’s No Magic in Mergers,” *BusinessWeek*, October 14, 2002. Available at http://www.businessweek.com/magazine/content/02_41/b3803160.htm.



another suggested that the board “*set incentive compensation targets such that the incentive is to beat targets and make [transactions] work.*”

- **By following through on integration efforts.** Integration is often an area where the audit committee has a central role at the board level, but a member said, “*On larger acquisitions, the integration plan is more than the financial results. Should the board be looking at integration processes?*” Members’ boards have ways of “keeping score” for integration efforts, but the reports often come after the fact: “*By the time you get to the post-acquisition audit, it’s too late.*” A network member compared it with “*reading the box score of yesterday’s game.*” Though one member said the board discusses “*critical deals*” at every meeting, another said, “*Boards don’t follow up enough. We’re told not to micromanage. Even management doesn’t oversee the management of an acquired company that closely.*” The board does not need to dig into all of the critical items that need to get done, however; one member suggested that the board’s involvement is sufficient “*if management knows the board will be following up and there are compensation consequences.*”
- **By not getting caught up in the momentum.** A common challenge members have seen is “*deal fever,*” in which “*momentum can carry you, and you can’t turn back at the end.*” A network member acknowledged that “*board members get excited too, caught up in the momentum.*”
- **By not being afraid to challenge management.** A network member said, “*Boards try to be good stewards for shareholders, but don’t want to rock the boat. How do I express my concerns in a positive way? You need guts to do it in a public forum at a board meeting. It’s not easy, and it’s hard to do well.*”

Discussion of major transactions is part of strategic planning

One network member stated, “*It starts with strategy.*” Though a special committee may be formed to monitor transactions in some instances, transactions are generally a part of regular discussions of corporate strategy among the full board. One member said, “*Transactions are part of most board meetings and part of strategy discussions.*”

Members noted that if the board and management have worked together and have a mutual commitment to strategy, “*acquisitions don’t come as a surprise, because they fit with the strategy,*” and conversely, “*if the board isn’t actively involved in strategic considerations, they’ll be ill prepared if and when [a transaction] comes up,*” whether an acquisition or divestiture. Often, transaction opportunities arise from individual business units: “*Every division has its own strategic plan, with candidates for acquisition. When an opportunity arises, they bring that to the board.*”

How deeply the board gets involved in reviewing a transaction depends on a number of factors, but members noted that if an acquisition appears to be opportunistic – a red flag for several members – then the board should engage management in more intense discussions about how the acquisition fits with the agreed-upon strategy and how it helps the company achieve its objectives.



Members also consider the level of in-house expertise and transaction experience, including the frequency with which the company engages in M&A activity and the level of success with integrating previous acquisitions. If the company has experience and executives with M&A expertise, the board tends to be more comfortable that they will execute transactions successfully. One member said that when management has significant experience and expertise, the board monitors due diligence less closely and just *“wants to know where there are issues.”*

Importantly, one member said, *“Size matters”*: the larger the transaction, generally the closer the monitoring. One member sat on the board of a company that made a very large acquisition, one for which the company essentially *“bet the farm.”* In that case, the board insisted on close oversight of due diligence through the advisers the company selected and active monitoring of integration activities. The size of the board also matters. Limiting the size of the board may be a way to ensure all directors are fully engaged in board activities, including reviewing transactions. One member said, *“We keep the size of the board down to ten members to avoid delegating to a committee.”*

Few boards have standardized processes for transaction oversight

Few network members reported having set processes for how companies and boards handle transactions. Companies frequently involved in transactions are more likely to have a standardized process; conversely, one member said, *“We don’t do enough transactions to have a standard process.”*

Despite the lack of a standard process, members broadly agreed with one who observed that successful transactions often follow the same pattern: *“The best [deals] start in the business units and then get to a point where corporate gets involved to help think through it and then bring in external advisers.”* The member noted that the next step was board involvement and said, *“There are no boxes we have to check, but a thoughtful approach to asking the right questions.”* Another member said scenario planning is an effective way to raise the right questions and get the board to engage management effectively: *“Scenario analysis is necessary. You can debate the assumptions. They are a good discussion vehicle.”*

When the board reviews divestitures, one member said key questions include *“What are we going to measure on a pro forma basis? What price do we need to get [and how will it be] invest[ed] in order to replace the earnings of the divestiture? What can we do to reinvest dollars to create shareholder value?”*

Cultural fit is essential for successful acquisitions, yet often overlooked

A network member raised an issue that, in members’ view, rarely receives the attention it deserves: *“All directors say [transactions] need to fit strategy, so why don’t more succeed? I think it is [lack of] cultural fit ... Even people in the same industry don’t do business the same way. What adviser do you turn to for cultural due diligence? We tend to gloss over it because we don’t really know how to assess it.”* Another member wondered whether the issue is a failure to assess cultural fit for a merger or acquisition beforehand or a failure in execution during the integration process. This member said, *“Cultures are always different. The question is, how much do you pay attention to that during integration?”* One member felt that some cultural challenges may be inevitable, and said, *“We usually put together an integration plan up front, [but]*



then there's the 'captured tribe' syndrome ... Something happens there." There are also the inevitable inter-personal issues that arise, or what one member described as the *"me-you-they attitude."*

One member asserted that *"there are things called 'cultural' that aren't really."* This member said companies in similar businesses may actually take very different approaches to their value proposition or focus on different aspects of the same product or service, in which case, *"value creation may not align."* Another member questioned, *"Is culture one aspect of strategic fit?"*

Audit committees focus on core oversight responsibilities

Though several members said they had seen the audit committee take a central role in monitoring transactions, including due diligence, similar to the role special committees sometime play, most agreed with one member who asserted, *"Audit committees would be a poor substitute [for the full board]. The audit committee should look at the numbers etc., but there's no way the audit committee should take the lead."*

Network members outlined issues related to transactions that are particularly relevant to audit committees and where the audit committee may take a lead role:

- **Understanding the risks involved.** Because audit committees tend to have some responsibility for oversight of risk management, one member noted, *"The audit committee ought to understand the risk profile that [an acquisition] adds to existing risks and [should ensure] that those [risks] are covered by management."*
- **Using the external auditor in transaction work.** Members observed that boards generally let management determine which advisers to use, but when considering if and how to involve the external auditor, the audit committee will often step in and play a coordinating role. One question audit committees consider is *"Do we want to keep non-audit fees down?"* Most members agreed with one who stated, *"Clearly, unless the external auditor is doing a lot of additional work, it is preferable from the audit committee's perspective to have the external auditor do as much financial due diligence as possible because they'll inherit the financial statements. You don't want surprises after [a deal] closes."*
- **Integration planning.** Audit committees often play a role in up-front planning and post-acquisition integration. According to one member, *"The audit committee is mostly thinking ahead to the issue of integration. In IT, internal controls, [and] financial systems, what are the problems likely to be?"* Audit committees will consider the impact of a transaction on financial statements and any tax issues involved. One member said the audit committee requests updates at successive audit committee meetings, which also gives the audit committee chair a reason to discuss how integration is proceeding between meetings.
- **Reviewing internal controls and overseeing internal audit involvement.** Members agreed with one audit chair who said that audit committees tend to become more directly involved in oversight after the acquisition, when they are reviewing traditional audit committee agenda items: *"That's where audit committees do start to play a role looking at the control environment etc.,"*



especially if you use internal audit in due diligence, so they are already inside and know some of the players in the [acquired] business.” One member also noted the impact on the internal audit plan and personnel if the staff is spending time on transactions: “Something’s got to give. You need to supplement staffing, or internal audit cannot do as much as they did before [the transaction]. I want internal audit involved up front and on integration.”

Members were also critical of the new M&A, tax, and fair-value accounting standards, which are likely to increase audit committee work related to transactions. Members see potential complications emerging from new rules on recording and disclosure of expenses related to transactions, and they also predict an increase in restatements. One member commented, *“This will be very unhelpful to shareholders.”* Others suggested that the new expense disclosure requirements would limit the use of outside advisers, and one said, *“Outsiders will need to really add value versus checking boxes.”*

Conclusion

Public company directors are often wary of getting too involved in management of the company and crossing the bright line between the board and management. Yet North Central Audit Committee Network members suggest that transactions may be one area in which effective board oversight requires a more active approach. The board may have to step in to ensure that the appropriate issues are raised in assessing a transaction and that management acts quickly to follow through and create value after a transaction. Successful transactions must fit company strategy, and cultural fit is one important element to consider when reviewing mergers and acquisitions. Though few companies or boards follow a set procedure for reviewing transactions, audit committees have a particular role in ensuring the proper use of company resources and advisers, overseeing integration efforts, and reviewing the impact of transactions on financial statements – a responsibility that may prove increasingly challenging as new accounting standards come into effect.

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