



The role of the board and the audit committee in transactions

Introduction

The Pacific Southwest Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Pacific Southwest region of the United States. The network held its ninth meeting on February 20, 2008. This document is a synthesis of insights and comments from that meeting.

As previously agreed upon by members, the meeting discussion centered on the role of the board and the audit committee in transactions. In particular, members expressed interest in discussing governance principles, executing on a strategic plan, the board's role in due diligence and post-transaction activity, and the responsibilities more specific to the audit committee.

The members of the network participating in the meeting between them sit on the boards of over 15 large-, mid-, and small-cap public companies. They were:

- Barbara Alexander, Audit Committee Chair, Harrah's Entertainment
- David Engelman, Audit Committee Chair, Fleetwood Enterprises
- George Farinsky, Audit Committee Chair, Broadcom Corporation
- Steve Frank, Audit Committee Chair, Northrop Grumman Corporation
- Louis Lavigne, Audit Committee Member, BMC Software
- Mike Meyer, Audit Committee Member, City National Corporation

Ernst & Young participants included:

- Gary Birkenbeuel, Managing Partner, Pacific Southwest Area Assurance and Advisory Business Services
- Paul Macaluso, Partner, Transaction Advisory Services
- Peter Griffith, Pacific Southwest Area Managing Partner

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. Members' remarks appear in italicized quotes.



Executive summary

Members of the Pacific Southwest Audit Committee Network discussed ways in which they can play a more effective role in transactions at both the audit committee and board level. The following important ideas were highlighted:

- **Acquisitions often destroy shareholder value** (Page 2)

Members unanimously agree with the results of research showing that well over 60% of deals fail to deliver shareholder value. Pressure on companies to grow through ill-advised acquisitions, poor deal timing, and diversifying into new industry areas were offered as reasons why acquisitions have low rates of success.

- **Checking for alignment with a strategic plan tempers deal fever** (Page 3)

Being sure that proposed transactions are aligned with the company's growth strategy and maintaining good industry analysis are important ways to increase the likelihood that only beneficial transactions will be pursued. The board should take the primary role in overseeing a deal, and directors should make sure they ask hard questions in order to temper "deal fever."

- **Effective due diligence and integration capability can be a competitive advantage** (Page 5)

Few things are more important in a transaction than an effective due diligence plan and a thorough integration strategy. Members agree that companies with an acquisitive strategy need to have well-developed processes to evaluate deals and integrate new businesses.

- **Audit committees can help reduce transaction risk** (Page 6)

While the full board typically plays a greater role in transactions than the audit committee, many network members believe the audit committee can offer an important perspective that will reduce transaction risk. In particular, members discussed the objective role the audit committee can play in pre-transaction risk assessment and post-transaction monitoring and process feedback.

Acquisitions often destroy shareholder value

The statistic is familiar to most corporate directors in the United States: more than half of corporate transactions fail to deliver shareholder 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."¹ Mark L. Sirower's best-selling book *The Synergy Trap* put the number as high as 70%.² Indeed, one member remarked, "I would say it's a lot more than even [70%]. Two plus two seldom equals three, let alone four. It's usually more like one."

¹ "There's No Magic in Mergers," *BusinessWeek*, October 14, 2002. Available at http://www.businessweek.com/magazine/content/02_41/b3803160.htm.

² Cited in Gregory J. Millman, "Desperately Seeking Synergy," *Financial Executive* 16, no. 2 (March 2000). Available at <http://www2.financialexecutives.org/mag/articles/Synergy.htm>.



Almost all members share in the frustration of deals failing to deliver shareholder value: *“I had a guy call up and say he was concerned that the past [few] deals had failed, and I said, ‘Are you kidding me? If I could get 50% odds that a deal would deliver value, I would say ‘Where do I sign?!’”* Still, one member was quick to point out, *“I’ve seen lots of deals that don’t deliver value and lots that do deliver value. There aren’t many that are outright disasters and not many that are outright home runs.”*

Members discussed and offered several reasons why deals often fail to deliver value:

- **Increasing pressure to grow.** One member commented, *“I think it is the compulsion to grow that forces companies to make deals. That’s the norm now. Even if you’re a private company, the norm suggests that the easiest way to grow is to acquire.”* Another member added, *“When you’re overcapitalized and told you need to acquire, that’s usually a big driver. We did that with one of our companies, and we’ve paid the price for it.”* A third member pointed out, *“Staying the course isn’t necessarily sexy. You’re always getting pushed and pushed [by analysts] to do deals and grow the business.”*
- **Poor timing.** As one member pointed out, *“Many public companies consider doing deals at the wrong time in the cycle. They buy a company at the top, and oftentimes when you buy a company at the top of the cycle, you end up getting caught on the bottom.”* Another member added, *“The other trap is the debt you take on in an acquisition. If companies acquire companies and get caught in the wrong point of the cycle, pay too much, they ultimately take on more debt and end up strangled in a bad situation.”*
- **Diversification into non-core businesses.** Companies that enter new industries or sectors may be more prone to failed transactions. As one member explained, *“Companies don’t always understand the industry or understand the best way to strategically win, and it often sends them careening into destroying shareholder value.”*

Checking for alignment with a strategic plan tempers deal fever

Members agreed that aligning a transaction with the company’s strategic plan increases the probability of success. However, many members were quick to point out that few companies have adequately articulated that strategic plan. As one member remarked, *“I think the fundamental problem is that the strategies at most companies are not clear to begin with. Their strategy doesn’t always include acquisitions, and then [an acquisition] comes along and they go forward with it, but that’s putting the cart before the horse.”*

Members said companies first need to identify their strategic objectives and then build the requisite transaction capability. One participant said, *“From a governance standpoint, I think recognizing whether the company is seeking inorganic versus organic growth ... is very important for large companies.”*

Tempering deal fever

When it is caught up in the excitement of a deal, the board sometimes fails to ask the hard questions. As one member pointed out, *“Management can be presented with the opportunity to buy a company that is really intriguing to them, and without thinking too much about where the problems are ... they get ‘deal fever.’”* Members lamented that when this happens, *“people quit worrying about everything except getting the deal*



done ... It's hard to temper it." Members believe that by having a strategic plan in place, they are better equipped to manage and temper deal fever. Another member remarked that it is the board's responsibility *"to draw a line in the sand with management. It is [the board's] job to point out the downside and balance everything out."*

As a recent *Director's Monthly* article noted, the period before a transaction is completed "is not the time for nodding approval at reports and presentations. It's time for actively debating the major decisions, their implications, and the possible alternatives; and for analyzing how each will affect the company's overall performance and value."³ However, some members pointed out that boards don't always have enough time to engage in these discussions. One member said, *"The board has [only] a short time to decide if the underwriting done by management is acceptable."* Indeed, members report that oftentimes board approval of a proposed transaction can occur in a very short time frame, often a matter of days, and often by e-mail. In some cases, the board has hours rather than days in which to hold a discussion prior to a vote.

Handling transaction risk

Members agree that all board directors have a role to play during transactions. Most agreed that the audit committee should defer to the full board in matters of generalized transaction risk. In a discussion prior to the meeting, one audit committee chair voiced the opinion that *"transaction risk is more of a board issue. I'd be upset if I was on a board and the audit committee was making those decisions."* Another member agreed: *"If [transaction risk] were to come up in an audit committee meeting, the CEO and I would both say, 'right topic, wrong venue.' I think we should explicitly say what issues belong in the audit committee and what should be full board issues and be able to draw the line."* Regardless of where the discussion takes place, members agree that *"the board has a huge role in transactions. If [the board is] not front and center and asking management the tough questions, then there's a problem."*

Evolution of the board's role

Members discussed the role of the board in transactions and, in particular, how their responsibilities as directors have evolved in recent years. When time permits greater board involvement in the due diligence process, members point to the benefits. As one audit chair remarked, *"I think we've all seen the evolution of the board's role: it used to be that management would bring opportunities to you, and everyone would just nod their head ... Today, the whole board wants to get involved. There are numerous meetings, due diligence updates, site visits, and those sorts of things. All board members now take their responsibilities very seriously rather than just being spoon-fed the information."*

Some, however, expressed skepticism around the board's level of involvement. One member said, *"I don't think board members are equipped to get down into the weeds."* Another member added, *"If a board member wants to look at these things, they can, but a good management team will bring the board all the things they need; I think that's ideal. The board's role should be to listen, ask intelligent questions, and have faith in the management."*

³ Jackie Bassett, "Looking Beyond Reports: Maximizing Shareholder Value in an M&A," *Director's Monthly*, February 2007, 6. Available at <http://www.btind.com/documents/Bassett.DM.Feb07.pdf>.



Taking a standardized approach to transactions

Members pointed out that even companies with clear, agreed-upon transaction strategies do not always follow a rigorous process in moving from planning to execution. Some members reported that in an effort to address this issue, their boards have found success by standardizing their approach to transactions. In a conversation prior to the meeting, one member said, *“As a board, we came to the conclusion that the process wasn’t as consistent and thought-out as it could be. 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] that included everything from an 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 had worked out ... It’s a standardized cradle-to-grave process, and ... [it has] helped us assess, execute, and review acquisitions much more effectively.”*

Other members who agreed with the need for standardization also recommended a dual leadership structure for companies that make many acquisitions: *“I was at a company that did many deals, and we had two managements, one focused entirely on acquisitions and one that ran the business. I think that was the highlight of my career. Of the 130 or so deals that we did, I would say only about five of them failed [to deliver shareholder value].”*

Effective due diligence and integration capability can be a competitive advantage

A widely cited article about transaction risk noted, “Between recognizing the potential value of a merger or acquisition and achieving a new and fully integrated enterprise is a dangerous middle ground where anything that can go wrong will. Early on, the buying company needs to fully understand exactly what it’s getting and what it’s getting into. As mergers and acquisitions become increasingly complex, the activities of due diligence become ever more important. The danger is not that companies fail to do due diligence, but that they fail to do it well.”⁴

One meeting participant raised the issue of including the right people in the due diligence process: *“It’s important to ask, ‘Who is on your due diligence team?’ Are you making sure to include such people as the engineers, operators, etc.? You can look at numbers until you’re blue in the face, but a deal can still fail if you don’t have the right people involved.”* Some audit committee chairs question whether it is appropriate to use internal audit for due diligence. During a recent meeting of another network, one audit committee chair said that “internal audit doesn’t always have the right skill set” to address the issues that will come up during a transaction. Other members of that network agreed, noting that while “there’s an underbelly of issues you want to get control over ... internal audit can’t always do what you want them to do.”⁵

Although the integration strategy is not implemented until after a transaction, members underlined the importance and value of evaluating cultural fit prior to a transaction. One member with extensive

⁴ Jeffery S. Perry and Thomas J. Herd, “Mergers and acquisitions: Reducing M&A risk through improved due diligence,” *Strategy and Leadership* 32, no. 2 (2004), 14.

⁵ Southeast Audit Committee Network, “The audit committee’s role in major transactions,” *VantagePoint*, October 5, 2007, 5. Available at SEACN VP – http://www.tapestrynetworks.com/documents/Tapestry_EY_SE_ACN_Oct07.pdf.



experience integrating deals said that situations “where a big fish eats a small fish [are] much easier to digest. When big fish eat big fish, there is often too much of a cultural problem – there’s often too much resistance by the people being acquired.”

Other members said it was sometimes possible to only minimally integrate newly acquired businesses, thereby avoiding disruptive culture clashes: “[In a previous company I was associated with,] we only acquired companies that were already self-sufficient. We didn’t try to integrate them beyond the necessary financial integration. It proved to be very successful.”

As one member remarked, “What you really need is a well-oiled due diligence team and a well-oiled integration process. You can do great diligence but fail because of integration problems and vice versa.”

Audit committees can help reduce transaction risk

While members agreed that the audit committee plays a more limited role in transactions than the full board, they qualified that by saying that the degree of the audit committee’s involvement is often situational: “The audit committee’s role depends on the specific company and industry.” Another member said, “In a deal involving technology, the audit committee doesn’t stand a chance of grasping the full extent of the risk. [If you are] buying companies for the people and the knowledge, the audit committee is probably the least capable of taking the lead.” However, members felt the audit committee could still play a meaningful role in reducing transaction risk.

The audit committee’s role in risk assessment

Almost all members believe that the audit committee should have a role in transaction risk assessment. Indeed, certain risks may warrant more specific attention from the audit committee: “There are some transactions that can be more embarrassing for the audit committee if they fail – licensing, for example. Another meeting participant pointed out that “there are some transactions done in other countries where the [magnitude of the] risk is no longer [related to] the size of the deal – it’s the branding and reputational risk and determining who is taking ownership of what.”

Members also discussed how audit committee chairs have a role to play in serving as a check with management and the rest of the board: “The audit committee has to have the fortitude to tell the board and management that they can’t do a deal because, for example, they don’t have enough quality tier-two executives. You have to tell them they need to [postpone the acquisition plans] until they get more good people in place.”

Members discussed the possibility of using enterprise risk management (ERM) as a framework for identifying and mitigating transaction risk. One member said, “We haven’t had any deals run through our ERM template, but we insisted on using it in a new line of business. We want to make sure [the template is adding value] ... I think ERM could be very valuable when it comes to evaluating transactions.” However, other members were more skeptical: “I could see ERM as one of many approaches used to assess a deal, but I don’t see it being a focal point.”



SCIDs and the audit committee

Boards will often create a special committee of independent directors (SCID) to provide greater oversight of a specific transaction. One member shared, *“We have an ad hoc temporary committee we put together from time to time, as we are involved in transactions. They are pretty much just a listening post and provide some consultation to senior management in between board meetings.”*

Members pointed out that SCIDs allow the audit committee to look at specific risk-and-control issues more objectively. One member cautioned, *“Audit committees are supposed to be independent of management, and if you’re involved in doing a transaction, the fun stuff to talk about isn’t internal controls. We have a special committee now, and [the audit committee] only helps with internal controls and the post-transaction assessment.”*

The audit committee’s role after the transaction

Members discussed the value the audit committee can add in the post-transaction environment: *“Once a transaction is done, there’s plenty for an audit committee to do.”* As one member said, *“I would say audit committees have a significant role in the post-deal environment. Whether it would have the role as the primary board contact [for] monitoring the [integration of the] entire transaction depends on the company.”*

Members remarked that there is a lot of room left for improvement when it comes to post-transaction analysis at most companies: *“Even companies that do deals on a regular basis oftentimes do not do a good job at post-deal analysis. That is an area that needs a more robust process in the future.”*

Conclusion

Members of the Pacific Southwest Audit Committee Network agree that transactions are merely tactical steps in pursuit of a company’s broader strategic objectives. However, their experience suggests that transactions are likely to fail if the underlying strategy is unclear or does not consider a broad range of needs and resources (including capital requirements, management expertise, corporate culture, etc.).

How can the board play a more meaningful role in strategic planning? Each situation will of course be different. However, members see opportunities for management to develop – and for boards to insist on – more robust, internally consistent corporate strategies. Unless and until transaction planning is more fully integrated with the strategic planning process, the board’s ability to influence the success rate of transactions will remain constrained.

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