EUROPEAN
AUDIT COMMITTEE LEADERSHIP NETWORK
ViewPoints

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Oversight of major transactions

Introduction

On 23–24 November 2015, members of the European Audit Committee Leadership Network (EACLN) convened in Barcelona for their 24th stand-alone meeting. In one session, members discussed board oversight of major transactions, specifically mergers and acquisitions (M&A).[1] For a full list of participants, see Appendix 1, on page 10.

Executive summary

EACLN members touched on three topics:[2]

- **Setting M&A strategy in the current economic environment** *(page 2)*

  Companies are turning to acquisitions for growth, particularly in consolidating markets, as organic growth remains weak. The impact of the digital transformation is also driving acquisitions for technology or innovation. From a market perspective, European companies that have held onto their cash through the economic downturn are now under pressure to spend it. Companies are also examining their existing portfolio and shedding businesses that no longer fit into their overall strategy.

- **Defining the board and audit committee's roles during due diligence** *(page 5)*

  While emphasizing that the board plays a more prominent role setting overall strategy and the audit committee plays a more central role in post-acquisition oversight, members highlighted a number of important board activities during due diligence such as testing management assumptions, assessing cultural fit, defining leadership and ensuring key talent is retained. Lastly, members offered differing opinions on what role the audit committee should play during the due diligence phase, with some saying the audit committee has little to no role and others saying the audit committee should play a central role as the financial experts on the board.

- **Overseeing integration and monitoring promised value** *(page 7)*

  Members were in agreement that the audit committee's main duties in a transaction come after the deal, overseeing the integration of an acquisition and then monitoring the ongoing value of the purchase. Among the activities highlighted were defining which metrics should be used to monitor the value of a deal.

For a list of discussion questions for audit committees, see Appendix 2 on page 11.

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[1] In another session, members discussed tax strategy and oversight of tax risk. See European Audit Committee Leadership Network, "The Evolving Tax Landscape and Oversight of Tax Strategy," *ViewPoints* (Waltham, MA: Tapestry Networks, 2016).

[2] *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 are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

Setting M&A strategy in the current economic environment

Multiple studies suggest that M&A deals fail to deliver on their expected value between 70% and 90% of the time.[3] Members and experts pointed to strategic misalignment as one of the leading reasons for failed deals. As a result, boards have increased their scrutiny of deals and are devoting more time to making sure M&A activity aligns with company strategy. *"We talk about M&A at every board meeting,"* a member commented. In the current environment in which deals may develop quickly, members said that the board can effectively play the role of strategy guardian if there are comprehensive discussions of what the strategic objectives are for M&A, rather than just ad hoc discussions when management comes to the board with a specific deal. *"The best practice now is you have a once-a-year deep dive into strategy so everyone understands the strategy, the environment we have to deal with and the disruptions that may impact us,"* a member said. By having a strategic M&A plan in place, companies can act quickly on a deal when it arises and avoid problems down the road, members and experts said.

Setting this strategy has become increasingly important in the past few years as the M&A environment has approached its pre-financial crisis levels: the $2.27 trillion in deals recorded in the first half of 2015 is nearing the high of $2.59 trillion recorded in 2007.[4] *"We are anticipating a lot of activity. We are in the midst of consolidation; we are selling and buying. The next three years will see strong activity as we optimize our portfolio,"* a member said.

The European M&A market

M&A activity is growing in Europe, but at a slower rate than in many other parts of the world. In the first half of 2015, deals by Western European companies accounted for approximately 18% of the global deal total, far below the 42.4% share of US-based companies.[5] By comparison, in 2007, Western European companies accounted for approximately one-third of the deals globally, nearly equal to the share of US-based companies at that time.[6] However, Europe is seen as an attractive market for buyers, particularly those from the United States and Asia, and deal activity is expected to grow.[7] In particular, the United Kingdom and Germany are in the top five most attractive markets for buyers, along with the United States, China and India. But certain areas of Europe are also seeing more activity on the buying side as well. Buyers from the United Kingdom, Germany and France are among the most active, along with those from the United States, South Korea and Japan.[8]

Global trends are shaping board discussions of M&A strategy

As deal making heats up around the globe and in Europe, members and experts noted several trends that are creating new dynamics and becoming central to board discussions about M&A strategy:

- **M&A is becoming an effective path to growth, particularly in consolidating markets.** While investment banks have advised companies to focus on organic growth, members said today's economic

[3] Clayton M. Christensen et al., "The Big Idea: The New M&A Playbook," *Harvard Business Review,* March 2011.

[4] CFO Innovation staff, "Global M&A Value up 37% in 2015, as Megadeals Hit Record Highs," *CFO Innovation,* 11 August 2015.

[5] Andrea Guerzoni, "Slow but Steady for European M&A Recovery," *Capital Insights,* Quarter 3, 2015, page 19.

[6] Ibid.

[7] EY, *Global Capital Confidence Barometer: Innovation, Complexity and Disruption Define the New M&A Market* (London: EYGM Limited, April 2015), page 17.

[8] EY, *Global Capital Confidence Barometer: Companies Embrace Sustainable M&A* (London: EYGM Limited, October 2015), page 17.

environment has made this difficult. *"We are seeing it becoming harder to grow organically and seeing acquisitions as a way to get the growth we need. I think this is set to run for a while as we struggle with organic growth,"* a member said. Another member added, *"We are looking at 2%, 3%, 4% growth in our budget plan; we are going to have to do acquisitions [to meet those goals], which will have implications for the audit committee."* This is particularly true in industries that are undergoing consolidation, such as technology, telecommunications and media. A few members suggested that in such environments, boards need to set M&A strategy to either be an acquirer or be the acquired: *"In our industry, where there is much consolidation in the market, we at the board decided we are going to be a consolidator,"* a member said.

- **Disruptive innovation is spurring M&A.** Beyond traditional acquisitions to increase market share or enter new markets, members and experts said that acquiring companies to alter a business and to take advantage of the digital transformation impacting nearly all sectors is increasingly a driving force in deals. *"Innovation will be disruptive, and there is no way a large, structured company can innovate in the way a small start-up company innovates. We can only do it through M&A,"* a member said. Members noted that such acquisitions can carry more risk and are often more complex, requiring extra board attention. *"When you move into disruptive, transformative acquisitions, that's when you get into trouble. When companies have tried to move into areas outside of their core areas, they traditionally have failed. But we are now in an inflection point with technology that people are going to have no choice but to acquire companies in which they have no competencies. It's a move from a mechanical world to a digital world,"* a member said. In a recent EY confidence survey, 67% of respondents said they planned to pursue acquisition opportunities in the technology sector.[9] Acquisitions for innovation also ranked high on the previous survey. "Innovation, disruptive forces, blurring of their own clear sector definitions and global megatrends are all combining to fuel M&A. In response, companies are making bolder moves to shift their business scope and maintain competitive advantage … More and more, companies are learning to anticipate future challenges to their business models and using acquisitions as a vehicle to accelerate their response."[10] Industries such as financial services, technology and media are already seeing this disruption, and members agreed other, more traditional industries such as manufacturing and energy will be impacted as well.

- **Companies are under pressure to spend their cash.** Members and experts said that pressure is mounting for European companies to spend cash reserves that they held onto during the economic downturn.[11] In a recent survey of European investors, 83% of respondents said M&A would be either a significant or moderate use of corporate cash in the next 12 months, while only 15% expected cash to be used for shareholder returns in a significant fashion.[12] *"When you talk to senior management about growth and shareholder value, the investment banks' best advice is to put resources toward organic growth. If organic growth is difficult, the second thing they say is put it toward M&A. They used to say return the cash to shareholders; now they are saying go do M&A,"* a member said.

- **Divestitures are part of strategy planning.** In a recent survey, nearly three-quarters of companies said they were using divestitures to fuel investments in the core business, or to make an acquisition.[13]

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[9] EY, *Global Capital Confidence Barometer: Innovation, Complexity and Disruption Define the New M&A Market,* April 2015, page 15.
[10] Ibid., page 13.
[11] Sarah Gordon, "European Companies Stash More Cash Away," *Financial Times*, 6 July 2015.
[12] FitchRatings, "Fitch: European Investors See Corporate M&A Spree Continuing," news release, 16 November 2015.
[13] EY, *Global Corporate Divestment Study* (London: EYGM Limited, 2015), pp 3, 5.

The leading triggers for the divestments include a unit's weak competitive position in the market, an asset not fitting with current corporate strategy and pressure from activist shareholders.[14] *"The portfolio is something a firm should look at all the time. Any company will find there are parts of the portfolio that are no longer relevant, and they are right to dispose of them. And any company will find small bolt-ons that add value. Big strategic shifts are a different ball game and have different considerations, but cleaning up the portfolio is a regular activity,"* a member said.

Deal hazards

Companies often engage in transactions for reasons that are not aligned with their core strategy. EY's Mr Guerzoni told Tapestry Networks in pre-meeting discussions that "the root cause of bad deals is doing deals just to demonstrate the company is growing." Members and experts cited a number of issues that raise warning flags:

- **Deal price**. Participants in Tapestry Network's and EY's InSights 2010 study on the audit committee's role in M&A noted that executives feel pressure from competitors, analysts and shareholders to grow the business, which may lead them to pay more for an acquisition than is warranted.[15] Members agreed on the prevalence of this issue. *"What I'm concerned about is pricing and delivering value to shareholders, that profits aren't diluted [by a deal],"* a member said. Members also noted the opposite may hold true: sometimes management aggressively pursues an acquisition simply because it is a good price. *"Ultimately, you have to be able to hold management accountable. You still have to ask how the deal fits into your strategy,"* a member said in pre-meeting discussions.
- **Deal drivers.** Members said it is important for the board to examine carefully the motivations behind the deal as they can indicate future issues. One member advised, *"When a deal is driven by revenue synergies and not cost synergies, be aware, because revenue synergies are often not attainable."* Another member warned against external reactions overriding board cautiousness: *"We sometimes look too much at the reaction of capital markets. If they react positively, we think it's a good acquisition. But maybe a year later there is a different perspective. You can't rely too much on the capital markets' reaction when you make strategic acquisitions, particularly when you are too focused on revenue synergies, which often disappear. We must be very cautious."* As with acquisitions, members said the board also needs to test management motivations for divestments. *"In some cases management likes to divest to make life easier. It's very tempting sometimes,"* a member noted.
- **Distractive deals.** Members also noted that part of the strategy discussion should be a close examination of the core business needs and making sure an acquisition will not disrupt the business unnecessarily. *"A major consideration is a deal that may distract everyone from something else important. You need to get intense clarity about why a deal is being done. When you ask management why we are doing a deal and you ask eight people and get eight different answers, you know it is not a good deal. I'm amazed at how often this is the case. You need to get very clear on what the goals are,"* a member said.

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[14] EY, *Global Corporate Divestment Study*, 2015, pp 3, 5.

[15] Tapestry Networks, "Increased Oversight of M&A: An Expanding Role for Audit Committees," *InSights* (London: EYGM Limited, 2010), page 5.

Members said once a specific deal is brought to the board then due diligence begins and the board needs to examine closely all the factors in the deal, including strategic fit.

Defining the board and audit committee's role during due diligence

Discussions also covered the role that the board and audit committee play during the due diligence phase, when the company begins to focus in earnest on a specific target. In this phase, boards typically focus on items such as valuation and financing structure, potential legal or tax liabilities, the target company's internal controls, compliance or fraud risks and accounting policies.[16] The quality of the valuation process has been the subject of lawsuits in recent years and seems to be getting scrutiny from securities regulators.

Beyond these areas, member discussions focused on a few key issues that they identified as critical, particularly when economic and political uncertainty can challenge assumptions and projections.

Testing management's assumptions

One area of board duties in due diligence is testing the management team's assumptions, which members pointed out is becoming more important and more difficult in a rapidly evolving environment. From currency volatility to disruptive technologies, a number of factors can change initial assumptions dramatically throughout the course of a deal. *"Today, when you buy a software company or a media company, you don't know what is going to happen in the next six months. New competitors, new business structures, new regulations appear. Everything can change quickly, so the level of risk is becoming much higher,"* a member said in pre-meeting conversations. Therefore, the board should challenge and thoroughly test management's assumptions about these evolving macroeconomic factors and industry trends, as well as query management about revenue forecasts, antitrust and regulatory risks, integration plans and expected synergies.

"There are two questions the board or audit committee should ask. One is 'why are we interested in this company?' As an investor in these companies, you want to look at the deal as an investor. The other question is 'what value are we going to get? How does it fit into our value chain?'" the member said. One member suggested that audit committees should have management *"stress their assumptions to see what the deal looks like when stressed. Management may have a rosy view. Asking to see it stressed can temper that."* Another member said management also needs to be queried about contingencies and risk mitigation plans. *"The reason so many big transactions fail is you can only see what you can see, and there are inadequate contingencies. There can be negative risks that inevitably exist, and there aren't contingency plans in place for them,"* the member said.

Scrutinizing cultural fit

Audit chairs noted that the board should assess the culture of the target company and consider how the two cultures will fit together. Mr Guerzoni said in pre-meeting discussions that one practice that helps with this issue is having people in the acquiring company spend time with people in the target company during the due diligence period to assess the cultural fit. "Living and breathing each other's culture was helpful. The reality is that the cultures of two companies are never identical, even when they look similar on paper," he said.

[16] For more, see Tapestry Networks, "The Oversight of Major Transactions," *ViewPoints* (Waltham, MA: Tapestry Networks, 2011).

Retaining key talent

Several members noted that keeping key talent is an important aspect of due diligence. *"If the target company's management is making a lot of money from the deal, they may transition out. You need to ask "What is the plan for dealing with that?", because that is an area where companies often go wrong,"* a member said. Another reported, *"We almost had a deal except no one decided beforehand who the next CEO was going to be, and the deal fell apart. For me, when the CEO comes in with a proposal for M&A and hasn't thought through this issue, it's a signal. If we haven't talked seriously about [post-merger leadership], then it's a problem."* Other members noted that this consideration needs to go deeper than senior management, saying that a successful transaction is dependent on defining clear leadership at all levels, from human resources to division heads, when the companies are integrated. As one member summarized, *"You have to put someone in charge and do ruthless portfolio rationalizing. You want the best of both worlds. If you take an objective look at who the best people are and what the best products are then you've got a chance. It takes a great deal of maturity, in terms of respect for one another, to figure out what the best assets are between the companies and how to preserve them.*"

Due diligence for innovation acquisitions

Buying small, innovative companies comes with its own set of risks. Members and experts said deals like those require an extra level of scrutiny. "The process of buying [assets] that don't typically belong in the realm of the traditional business is inherently more risky and more challenging for boards and management. Technology disruption is impacting many sectors, and it takes a different approach to M&A. Valuations are more difficult to assess. It takes a much more complex set of competencies to look into these deals. The processes tend to be lengthier and require a higher level of scrutiny. And these deals may have more strategic risk," Mr Guerzoni noted. For example, one member commented that *"when targeting start-ups, you need to ask if there is a proven revenue model. If it's a new space, you have no way to judge if the intellectual property has value or not. You want to see a proven revenue model."*

Mr. Guerzoni recommended that transaction teams include representatives from more than just the traditional areas of finance, human resources and legal. "You need more people in the organization involved in the pre-deal processes because it's more complex, riskier and requires better understanding of technology. You need to have more people involved than those at headquarters. You need marketing, IT and business-unit managers on the team because very often these deals involve a potential transformation of the business."

Board role and audit committee role in due diligence

Opinions diverged on what activities the audit committee should be involved in during due diligence. *"I'm not clear on what added value the audit committee provides going into an acquisition,"* one member stated. *"There is no involvement of the audit committee at this point at all,"* another member said. One member said the board as a whole needs to take a step back during due diligence and let management take over. Others said the audit committee can play a moderate role. *"It's not a big role, generally, except in the case of whether we can afford [the transaction]. The audit committee has more expertise here. But beyond that, I think it is right to focus the discussion on the full board,"* a member said. Some members said the value of the audit committee during this phase should not be underplayed: *"It is the role of the full board to decide* *on any acquisition, yes, but the audit committee is part of the board. It is necessary for everyone on the board to provide their expertise in an acquisition. Members of the audit committee have skills in compliance and financial due diligence to evaluate everything presented, from a risk perspective, to make sure management is taking it seriously. You should expect the [human resources] side of the board to do the same with who leads the new organization and with retention. It's dangerous to say we have no say as the audit committee. At the end of the day, someone must have a say on these issues. If looking at the financing model, the audit committee has the expertise to examine that, and should."* Another member said this phase presents an opportunity for the audit committee to get a head start on issues it will later have to handle: *"One useful thing we can do is ask questions about integration. You can learn a lot about integration at this stage."* Another member described how, for big deals, the member's board forms an ad hoc committee comprising experts from the various committees to examine deals thoroughly and work with management on due diligence.

Overseeing integration and monitoring promised value

Most members said the audit committee takes a more prominent role after an acquisition, overseeing integration and monitoring the delivery of promised value. *"Lots of metrics are reported internally. Just like with large investment cases, they come back to the audit committee to make sure delivery is consistent with the original sanction,"* a member said.

Integration

Participants in Tapestry Networks' and EY's InSights 2010 study on the audit committee's role in M&A were critical of companies' records with regard to integrations. They outlined three major mistakes that boards and audit committees should try to avoid during the integration phase: failure to assign accountability for achieving the objectives of the acquisition, failure to draw up a checklist of necessary integration tasks and failure to report regularly to the board on the progress of the integration.[17]

The challenges of cross-border cultural integration

For deals that cross geographic borders, where country-specific culture issues and language differences come into play, assessing company culture takes on additional complexity. One member said European companies may have *"a comparative advantage in these cross-culture deals because we are used to living in such a cross-culture environment. It doesn't mean it's easy, but we have more experience than companies in the [United States]."* Another member described how in one acquisition, in which the acquirer and acquired company were based in different countries with different cultures and languages, the board made the decision to keep the two companies separate: *"The only way we saved the transaction was that each company had strengths, and we didn't want to mess with them. We ring fenced them and let them get used to us and us with them."* A manager from the acquired company's home country was put in charge of the new unit and acted as an interpreter of the culture at the parent company: *"We knew that if we brought this company in to be run the [home country] way, they'd get frustrated and they'd leave the company. We kept it separate for three years,"* the member said.

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[17] Tapestry Networks, "Increased Oversight of M&A: An Expanding Role for Audit Committees," page 10.

Maintaining innovative cultures: integrate or not?

Acquisitions for innovation may also raise unique culture issues that present new challenges for companies. *"The challenge for some of us is that we need to buy into the digital area. As board members, we are not used to these kids we have meetings with. It's not just how we integrate them but how we look at them,"* a member said. Depending on the assessment, a company may decide to keep some or all of the acquisition separate. *"In research, you get more innovative stuff if you keep acquisitions separate than putting it all together, whereas for sales and marketing, it's important to have single management,"* a member noted. This was echoed by several members, including one who said, *"If we are buying a [technology] company, they cannot be integrated into our culture. They must be kept separate. They will lose their innovative capabilities if integrated."*

Several members mentioned incubator-type programs in their companies, in which the company either invests in start-ups or seeds innovative ideas, later merging them into the business if warranted. *"We finance a group of people devoted to developing new research on certain things. If successful, we can acquire it. They get accustomed to our environment, so we know the cultural fit,"* a member said. Another member's company bought a technology company and held onto it for five years, *"letting them grow up to a $3 billion IPO. We always made sure they were separate from the large, slow [parent] company."* Yet, members also said companies need to monitor the innovators to make sure they can deliver on promises or to make sure the funded innovation isn't rendered obsolete in a rapidly evolving market. *"We have venture capital units that do performance reviews and kill businesses fast if we need to. That's the rule of innovation: kill something off fast when it is not working,"* a member said.

Monitoring promised value

Members said one challenge in monitoring value is tracking synergies once the acquired company is integrated and reporting is consolidated. To help with this, some members recommended that the audit committee work with management before a transaction to define key performance indictors (KPIs) to be tracked. *"The audit committee should define KPIs together with management so that they can be checked regularly … You make sure compensation is linked to this,"* a member noted in pre-meeting conversations. But performance indicators are not the only issue members said need to be tracked. *"Part of it is about tracking indicators, but part of it is also about lessons learned. If things perform better than expected, people need to understand why. And if not, then people need to build why something didn't work into their thinking for the next go-around,"* a member said.

Conclusion

As M&A activity picks up in Europe and globally, boards are having to consider their strategy in a more economically volatile environment. Members and experts noted that the nature of deals today are different than they were just a few years ago, and companies need to consider a broader range of risks as they contemplate a deal, especially when the deal involves acquiring a company for innovation and to take advantage of the digital transformation. *"We are moving into digital user life more and more. We need software engineers, data analytics and algorithm experts. We catch [these people] more easily through acquisitions than recruiting,"* a member said. Such deals may also require a broad M&A team, with technology and marketing people joining the usual players. For audit committees, the important task is monitoring the integration and seeing that the value of the deal is maintained. *"The audit committee is an* *early warning. We can be a gatekeeper to say this thing is going off track. We can protect goodwill by identifying issues early on,"* a member said.

About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management and advisers who become systematically engaged in this dialogue, the more value will be created for all.

EYG no: AU3715

Appendix 1: Participants

Members participating in all or parts of the meeting sit on the boards of about 40 public companies:

- Dr Werner Brandt, Audit Committee Chair, Lufthansa and RWE
- Mr Aldo Cardoso, Audit Committee Chair, ENGIE
- Mr Carlos Colomer, Audit Committee Chair, Telefónica
- Mr Ángel Durández, Audit Committee Chair, Mediaset España
- Dr Byron Grote, Audit Committee Chair, Tesco, Akzo Nobel, and Anglo American
- Ms Liz Hewitt, Audit Committee Chair, Novo Nordisk
- Mr Lou Hughes, Audit Committee Chair, ABB
- Ms Shonaid Jemmett-Page, Audit Committee Chair, GKN
- Dame DeAnne Julius, Audit Committee Chair, Roche Holdings
- Dr Maurizio Lauri, Chair of the Board of Statutory Auditors, UniCredit
- Ms Hanne de Mora, Audit Committee Chair, Sandvik
- Mr John Rishton, Audit Committee Chair, Unilever
- Ms Guylaine Saucier, Audit Committee Chair, Wendel
- Dr Erhard Schipporeit, Audit Committee Chair, SAP
- Mr Jakob Stausholm, Audit Committee Chair, Statoil
- Mr Lars Westerberg, Audit Committee Chair, Volvo

EY was represented in all or parts of the meeting by:

- Mr Christian Mouillon, Global Risk Management Leader
- Mr Jose Luis Perelli, Country Managing Partner, Spain
- Mr Don Zimmerman, Global Assurance Strategic Accounts and Relationship Leader

Appendix 2: Discussion questions for audit committees

- How does the board ensure that the strategic context for acquisitions is sound? What kind of process should be in place for selecting acquisition targets?
- How are deals for intellectual property or technology that can transform the company addressed?
- How does the board consider the company's entire portfolio of assets? Is divestiture part of the M&A strategy discussion?
- How does the board or the audit committee oversee the due diligence process? What elements of the process are most important?
- How has the oversight of major transactions evolved in your companies? Where are improvements still needed? How should the committees involved and the full board allocate tasks and coordinate their efforts?
- How does the board deliberate on the merits of a particular acquisition? What red flags or triggers may require deeper audit committee involvement in due diligence? What risks warrant increased scrutiny?
- How do you assess the effectiveness of the integration plan? What aspects of the integration are the board and the audit committee most involved in?
- In what ways do the company and the board evaluate the long-term success of a transaction? What are the key indicators that should be tracked?
- How are lessons from transactions learned and applied?