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# Audit Committee *Brief*

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## The role of the audit committee throughout the M&A life cycle

Companies focused on boosting strategic growth often look beyond internal organic growth to consider merger and acquisition (M&A) opportunities. Shareholder pressure for continuing growth, favorable lending conditions, and large corporate cash reserves[1] provide additional impetus for considering M&A.

Governance bodies, including audit committees, are increasingly being asked to understand all aspects and stages of significant M&A deals, both to facilitate a specific transaction's financial goals and to help the company better manage the risks associated with deal planning, analysis, and execution. Areas of increased M&A oversight include deeper reviews of financial due-diligence findings and the development of new processes and internal controls in the post-deal organization. Oversight of post-deal activities, including post-merger integration and potential changes to the newly combined entity's risk management policies, is also increasing.

Risk oversight responsibilities can be structured in a variety of ways; some companies have a dedicated risk committee, while for others, risk-related issues are handled by the audit committee or the full board. Although the audit committee's primary responsibility is to oversee management's activities related to financial reporting and compliance, in some companies the demands on the committee have expanded to include risk assessment and the oversight of risk management policies. This entails understanding the broad range of risks the company faces and confirming that an effective risk management program is in place.[2]

Regardless of the governance approach taken, it may be helpful for audit committees to evaluate whether the practices related to

1 According to Moody's Investors Service, at the end of the second quarter of 2013, U.S. nonfinancial companies (rated by Moody's) held approximately $1.5 trillion in cash reserves.

2 Deloitte's *Directors' Alert 2013 – Lead or Be Led: Time to Take Advantage of the New Business Reality*.

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M&A discussed in this issue of the *Audit Committee Brief* are in place, and to understand how the audit committee can best support these efforts before, during, and after M&A transactions.

## Before the transaction

Even before a company considers an M&A transaction, the audit committee can help increase the likelihood for success by verifying that the company has effective M&A-related risk management policies and processes in place. To facilitate this oversight, it can be helpful to identify audit committee members who have experience with M&A activity. This evaluation of policies and procedures could be part of the audit committee's more general role of overseeing risk management protocols for the entire enterprise, including assessing major financial risk exposures and the steps management has undertaken to control them.[3]

**Questions audit committees can ask regarding management's M&A processes**

- What financial criteria are management using to identify potential targets?
- Who within management is taking the lead in confirming that the acquisition is consistent with the company's overall growth and business strategy, and what is their experience with M&A?
- How well have the company's previous M&A transactions met financial objectives? What can the company do better going forward?
- At what stage is the board being brought into the process?
- Do management processes take into account financial risks related to operations and compliance with environmental, health, safety, legal, and regulatory issues inherent in the post-acquisition merged company?
- Does management have well-developed financial due diligence and post-merger integration processes in place, as well as qualified advisors to execute them?
- What are the predetermined financial metrics that management will use to assess whether the acquisition has met projections for return on investment?

## Financial due diligence and beyond—the onset of the transaction

Audit committees have increased their focus on the processes and results of financial due diligence. The board of directors should be provided with a thorough picture of the scope of diligence performed, as well as a thoughtful analysis of the results. The audit committee plays a key role in providing this information and insight.

While many audit committees may be familiar with their role in financial and accounting due diligence, some have begun to dive deeper into other due-diligence areas for significant transactions, such as operational, information technology, and vendor diligence matters. These additional efforts can help provide a better handle on deal-related risks that could affect the transaction's financial results.

The success of an M&A transaction is largely measured by whether the ultimate value captured from the deal mirrors or exceeds the value envisioned at the beginning of the process. The crux of due diligence is to mitigate overall transaction risk through identifying, quantifying, and substantiating drivers and value inhibitors. It is also important to recognize the differences, if any, between these and the basis of the anticipated deal value at the beginning of the process.[4]

As part of financial due diligence, select historical financial statements and other accounting, financial, and operating data of the target company are analyzed, with a primary emphasis on the following:

- Quality of earnings
- Timing and risks related to cash flows
- Identification and quantification of exposures
- Quality of assets
- Tax and financial structuring

3 NYSE Corporate Governance Rule 303A.7(c)(iii)(D).

4 Deloitte's *CFO Insights – M&A Value Maximization: From Due Diligence to Finance Transformation*, 2010.

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**Additional questions the audit committee may wish to ask during the due-diligence phase**

- Should the potential operating risk and other inherent contingencies of the seller be reflected in the purchase price?
- How does the target manage risk, and how must that model be adjusted as part of the consolidated group?
- How is the target's finance function managed, and what changes will be required?
- Are the target's reporting standards in line with the buyer's reporting standards?
- Does the target's information system align well with the buyer's systems, and what will the cost be to integrate them?

## Oversight of internal controls and financial reporting

The target's existing internal controls and financial reporting are particularly important considerations. The audit committee should assess potential areas of risk and how the new entity will perform related activities. Elements of this assessment include:

- Understanding the target's key controls and reporting risk areas, as assessed by financial management, the internal auditors, and the due-diligence services provider
- Evaluating the transaction's corporate tax issues and implications, including optimal tax-efficient structuring for the combined entity
- Thoroughly considering the levels of authority and responsibility in key areas, including pricing and contracts, acceptance of risk, commitments, and expenditures
- Understanding significant judgments and estimates used by management and other stakeholders, and their impact on due-diligence findings and deal valuations
- Taking into account how pending financial reporting and regulatory developments may affect the target company or combined entity.

## Post-merger integration—after the deal closes

While not necessarily a traditional area of focus for audit committees, post-merger integration is a critical stage of any merger or acquisition, where synergies are captured or lost and value can be realized or squandered.

Effective post-merger integration plans should cover:

- Synergy targeting and realization
- Day One readiness and execution
- Supply chain, suppliers, research and development, and innovation acceleration
- Customer, sales, marketing, and back-office alignment
- Communications, culture, and change management.

## Other post-deal actions

At the conclusion of a completed M&A transaction—particularly one involving a significant acquisition—the audit committee, if it is charged with overall risk management, should consider whether changes to overall risk management processes are needed due to an increase in the company's size or changes to its structure.

When contemplating changes to processes, audit committees should strive to be risk intelligent.[5] Companies with risk-intelligent boards have risk management practices, strategies, processes, and approaches that:

- Encompass the entire business
- Address the full spectrum of risks
- Place significant weight on both probability and vulnerability
- Consider not just single events, but the interaction of multiple risks
- Make strategic decisions that arise from risk-informed processes.

5 Deloitte's *Risk Intelligent Governance: Lessons from State-of-the-Art Board Practices*, January 2014.

Audit committees should also consider post-acquisition reviews, including not just risks, but also relevant integration milestones and return-on-investment analysis, to evaluate the reliability of initial acquisition assumptions.[6]

## Conclusion

Strategic decisions about M&A transactions inherently involve risk. Whether oversight lies with the audit committee or with other governance bodies, the committee should be engaged before, during, and after the company undergoes transactions and other important events. Active oversight of the process can help confirm that shareholder value is kept at the forefront through a clear and efficient assessment of the transaction's goals, risks, and results.

6 Deloitte's *Audit Committee Resource Guide*, January 2013.

## Additional resources

*Directors' Alert 2013 – Lead or Be Led: Time to Take Advantage of the New Business Reality*

*CFO Insights – M&A Value Maximization: From Due Diligence to Finance Transformation*

*Risk Intelligent Governance: Lessons from State-of-the-Art Board Practices*

*Audit Committee Resource Guide*


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