



## Board and audit committee oversight of transactions

On September 26, 2011, the Canadian Audit Committee Network (CACN) met in Toronto to discuss the board and audit committee's roles in the oversight of mergers and acquisitions (M&A). Members were joined by Tony Ianni, a partner in the transaction advisory services practice of Ernst & Young. This document synthesizes key insights from the discussion.<sup>1</sup> **For a list of network participants, see Appendix 1 on page 10.**

### Executive summary

Members focused on three broad areas, which are outlined below and described in more detail on the following pages:

#### **Economic uncertainty and market volatility have affected M&A activity** *(page 2)*

Global economic instability and significant stock market volatility have slowed M&A activity in many industries. Completed deals tend to be for stressed or distressed assets, and deals are taking considerably longer because companies are spending more time evaluating their targets. Not surprisingly, cross-border deals are increasing as companies in developed markets seek growth in developing markets.

#### **M&A governance has improved dramatically, though specific approaches vary** *(page 3)*

Members agreed that governance structures that provide for effective oversight of M&A deals have *“become significantly more robust over the last 10 to 20 years.”* They attributed this to CEOs becoming more conservative in deploying capital, directors becoming more engaged in transaction oversight, and boards and committees having more delineated oversight responsibilities. The full board plays a primary role in transaction governance at most companies, though members noted the audit committee and other committees are sometimes involved as well.

#### **Boards and committees have enhanced oversight practices throughout the transaction process** *(page 5)*

Boards have elevated their oversight of all transaction stages. Prior to any deal, many boards are spending more time evaluating the pipeline of potential targets. During the deal, they are focused on pressing management for more comprehensive due diligence and requiring accountability. After the deal, some members reported success with improving processes for tracking integration. Some are also taking oversight a step further by reviewing transactions after they are completed to capture lessons learned.

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<sup>1</sup> *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. Quotes in italics are drawn directly from comments made by CACN members before, during, and after the September 26 meeting; unitalicized, unattributed quotes are drawn from discussions with audit committee chairs in other audit committee networks. Quotes from guests are attributed and unitalicized.



## Economic uncertainty and market volatility have affected M&A activity

M&A activity in the beginning of 2011 seemed to be on the rebound: the value of Canadian mergers and acquisitions totaled \$51.2 billion in the second quarter of 2011, a 74% increase over the first quarter.<sup>2</sup> However, this activity has since slowed on account of continued market volatility and global economic instability. Based on the findings of a recent Ernst & Young survey,<sup>3</sup> Mr. Ianni said that 45% of Canadian companies were planning to conduct an acquisitions in the next 12 months, down from about 58% at the same time last year.

In general, Mr. Ianni observed, “The volume of deals in the second half of 2011 has been lower and the quality of the deals has also decreased. Most of the deals have been for stressed or distressed assets.” He attributed this slowdown in part to increased market volatility: “The volatility in the market has made a lot of companies lose confidence ... Sellers don’t want to be sellers anymore because they are not sure [their assets] are going to be valued correctly.”

Economic conditions and market volatility have created an environment where companies are:

- **More willing to hold cash on the balance sheet.** One audit chair said, “*It used to be the worst thing in the world for a company to sit on cash. Now it’s not ... No one is being punished for holding on to cash.*” Members agreed that companies are going to continue to be very conservative with their use of cash for as long as there is “*so much instability in the market.*”
- **Under less pressure to conduct a transaction.** One member said, “*Investors and analysts are not putting as much pressure on companies to do a deal right now ... Businesses are more efficient than they’ve ever been, so the pressure isn’t there to take on more risk right now.*” Members noted this is only temporary and said that “*the pressure to grow the top line will come back in time, probably 12 to 24 months.*”
- **Giving cash back to shareholders.** Mr. Ianni said he’s seeing more companies buy back their own stock. He explained, “Companies are increasing their number of buybacks. [Stock] prices are down, so they are paying less for their own stock and they are doing something with their cash.” Members also noted companies are increasing dividends: “*[Companies are getting] pressure from shareholders to give cash back, so you you’re seeing an increase in dividends ... This satisfies the shareholders and allows companies to keep some dry powder.*”

Although deal volumes have decreased overall, several members agreed with Mr. Ianni’s observation that the decline is very dependent on “geography and industry.” Prior to the meeting, one member observed, “*Prices of companies are down, so we are seeing scenarios where an acquisition that may not have been accretive before is accretive and looks attractive now.*” Where deals are still happening, Mr. Ianni and members identified key trends they are seeing in the market:

<sup>2</sup> Christine Dobby, “[Canadian M&A Activity Surges Back, Totals \\$51.2B in Second Quarter.](#)” *Financial Post*, August 11, 2011.

<sup>3</sup> Ernst & Young, “[Fit for the Future?](#)” *Capital Confidence Barometer*, April 2011.



- **Hostile deals have decreased.** Mr. Ianni noted that the number of hostile deals has gone down “because companies are more keen to get the deal done with less risk. Hostile deals have a lot more risk.”
- **Players are changing.** Where private equity firms used to be able to “beat out ‘strategics’” in going after a deal, Mr. Ianni suggested that in the environment today, the playing field has been leveled and corporate or strategic acquirers are just as strong, if not stronger than private equity acquirers.
- **Cross-border deals are on the rise.** Based on results from the Ernst & Young survey cited earlier,<sup>4</sup> Mr. Ianni said, “Cross-border activity has gone up dramatically.” In fact, Mr. Ianni reported that of the Canadian companies looking to conduct a transaction in the next 12 months, 43% said they were looking to expand to new markets.
- **Deals are taking longer to complete.** Mr. Ianni explained that this environment encourages companies to take more time evaluating deals. On a broad level, he said, “Deals are being done at a more measured pace and the companies have more methodical processes.” He explained that deals are taking longer because “companies are increasing the scope of their due diligence, there are more people involved in the review process, and the integration planning is happening earlier [in the deal process].” Mr. Ianni said he is also seeing more buyers “walk away from deals that have overly aggressive timelines.”

On a positive note, Mr. Ianni said that transactions done in this type of environment are typically more successful. He attributes this to companies being more selective in their deal making and taking more time to evaluate targets in the due diligence phase. He also noted that because asset values are down, “It is easier to add [shareholder] value with these deals.”

### M&A governance has improved dramatically, though specific approaches vary

Compared with earlier years, members said the quality of board oversight of M&A has “*improved dramatically.*” One member described an unsuccessful deal from a number of years ago and explained that it “*probably never would have happened today*” because “*the board would have asked more questions.*” Another member said, “*I think today boards in general are far more critical of management presentations and less likely to rubber stamp a deal that is put in front of them.*” Members described several reasons why the governance of deals has improved over the last decade:

- **Senior management is more conservative.** One member said, “*Management is more rigorous now: we see more conservative growth projections and discount rates than we used to.*” Another audit chair noted, “*Management knows the stats – that 50% of deals fail – and they know that when you’re doing a big deal, they need to spend a lot more time looking at it to make sure it will be successful.*”
- **Companies are dedicating more resources.** Members noted that more people are getting involved in deal reviews: “*There is an all-hands-on-deck approach when you are doing deals.*” Indeed, one member said that during a recent deal, “*The company sent three busloads of people to help with discovery.*”

<sup>4</sup> Ibid.



- **Boards have become more engaged.** One member noted, *“Boards ask a lot more questions today. Years ago, they didn’t press management as much and they didn’t spend as much time looking at deals.”*

### Governance structures vary by company and by deal type

Members emphasized that more formal and delineated roles for the board and committees have helped to improve the oversight of M&A. They defined the following roles:

- **The full board.** Members said the full board has ultimate M&A oversight responsibility, but the depth to which it evaluates deals varies. One member explained, *“The full board reviews all the deals because we don’t want any members of the board being [left out] of such an important discussion.”* Meanwhile, other members said the full board relies on board committees to take a leading role in oversight. In any case, members agreed that the full board is ultimately responsible for *“approving deals that align with strategy”* and clearly outlining the roles of committees if they delegate a portion of the oversight to them.
- **The audit committee.** Members said there is often a role for the audit committee in certain aspects of the deal, including overseeing *“accounting and reporting issues that come up throughout the process.”* At one member’s company, the audit committee acts as a transaction screen for the board: *“The audit committee, [which also has responsibility for finance and risk] acts as a precursor to the full board. We will take a deeper dive on the deal than the board will, and we have an opportunity to ask more questions. Then the audit committee reports to the full board and gives a recommendation on the deal.”* Other members noted that the audit committee is also well positioned to *“track integration after the deal is completed.”* [For more detail on post-transaction practices, see page 7.](#)
- **The finance committee.** While finance committees are still not prevalent, they have been established on some boards and can play a major role in transaction oversight. One member said the finance committee takes the lead on M&A oversight: *“The finance committee is a sounding board [during transactions]. Before the deal is proposed to the board, the finance committee will give feedback to the management team. We will say, ‘You better consider this and this because the board is going to ask about it.’”* The member explained, *“The finance committee reviews M&A and any capital allocation decisions.”*
- **A special committee.** Several members said their boards had used a special committee to review a deal. While some used special committees only in specific circumstances or for a large deal, others said special committees were used regularly to review deals. One member’s company convenes a special committee when timely oversight is necessary: *“A [special committee] is convened when there is a tight timetable. You can bring accounting, financial, and HR expertise together, and it makes availability easier. I’m not sure you could get a full board to meet five times in 30 days. It’s a lot easier with a smaller committee.”*

Regardless of oversight structure, members cautioned against granting too much transaction responsibility to any board committee, as that can create *“a them-and-us mentality on the board. You need [committees] to report back often to ensure the full board stays well informed.”*



## Boards and committees have enhanced oversight practices throughout the transaction process

Members largely agreed that their boards and committees have sought and adopted improved oversight practices in every stage of the transaction process: before the deal, once the transaction is set in motion, and after it has closed. These practices have helped improve their companies' M&A success by ensuring the board is appropriately challenging management on issues such as transaction value, leadership, culture, and risks.

### Before the deal

According to one M&A attorney, "Ten years ago, it was not that uncommon for a major acquisition to be presented and approved in the course of a single board meeting. That's almost unheard of today."<sup>5</sup> Indeed, members agreed that boards should never be "*presented with deals out of left field.*" To ensure there are no surprise deal proposals, members have adopted practices that allow them to better monitor potential transactions:

- **Understand the acquisition pipeline.** One member said, "*Management will lay out the potential acquisitions and show the board where each of them fits into the larger strategy grid that was presented at the strategy session.*" Another audit chair commented, "*We look at the universe of potential acquisition targets. We're not just looking at the list of companies, but also asking how they got there. How was it identified? How good is it? Where is private equity playing?*"
- **Spend time learning about international markets.** One member said, "*Boards are spending more time on country risk assessments because [doing a deal in some markets] can have an effect on a company's risk strategy. This affects a company's strategic planning.*" The member explained that the board will do a "*deep dive on country-specific risks*" on a regular basis at board meetings, even in the absence of a pending acquisition.

### During the deal

Once a transaction is set in motion, the board has a role in ensuring management thoroughly investigates the target to avoid being "*surprised*" by a discovery that may negatively affect the deal's value. Members described several ways in which their boards do this:

- **Evaluate the deal plan.** One member said, "*Boards really need to thoroughly understand the plan and ask a whole lot of questions.*" Members said they consider the following less-obvious items:
  - **Resource constraints.** Deals can place stress on the normal operations of the company if resources are sparse. One member said, "*Boards have to push management hard on how they are going to resource the deal and the acquired company.*"
  - **Accountability.** Members agreed that ensuring there are people accountable for each aspect of the transaction is very important. One member said, "*As the deal is being put together and well*

<sup>5</sup> Beverly Behan, "[Effective Board Oversight of M&A.](#)" *Bloomberg Businessweek*, September 11, 2009.



*before it is completed, we need to see deliverables, revenues, cost savings, and who is responsible for each ... It does not always have to be the CEO, but someone has to have accountability.”*

- **Integration plan.** Because so much of the work to make an acquisition successful occurs in the integration phase, members said it is imperative that management teams include integration plans early in the due diligence process. One member said, *“You need to make sure the integration plan is done before the deal is done. That is then what you use to go back and check progress against [during the integration phase].”*
- **Exit strategy.** One member said acquisition plans should include worst-case scenarios, such as an exit strategy in the event the transaction is unsuccessful: *“We approach deals because we think they are going to be long-term, but if key value drivers go away, have we thought about an exit strategy?”*
- **Ensure due diligence is comprehensive.** Members cited incomplete due diligence as one of the key reasons some transactions fail, and agreed that boards are now *“questioning management about their due diligence scope and findings”* more than ever. One member’s company breaks down due diligence responsibilities into functional areas: *“When we look at a deal, we use our dedicated areas of expertise to evaluate the other company and report back to the board. The HR people will look at HR policies and practices. The people who look at contracts will review the contracts.”*

In addition to insisting on improved management practices, boards are also seeking more information during due diligence, including the following:

- **More realistic projections.** One member said, *“We used to see hockey-stick revenue projections. You don’t see that anymore – we make sure that costs and different scenarios are built into projections.”*
- **Assessment of extreme scenarios.** One member’s board asks, *“What are the bookends? What if we have to pay 20% more? What if key people leave – what happens to the value of the company?”*
- **Identification of key value drivers.** One member said, *“I want the key value drivers [in the target company] identified, whether it is a key person or a key business. And I want to hear how we intend to keep those key value drivers after the acquisition.”*
- **Standardized reporting formats.** The company described above that breaks down due diligence into functional areas also has developed standardized reporting for the process: *“The teams will provide us with a report in a standard template. It includes what they looked at and what they found. They present this to the board and also have someone there to answer questions.”*
- **Address leadership decisions early.** Nearly every member agreed that *“the soft issues,”* such as cultural differences and leadership decisions, *“are exceptionally important and can make or break deals.”* One member said that leadership decisions *“need to be transparent from the very beginning of the deal”*



process ... The board should address who will be running the company up front rather than waiting for the deal to be completed.” Members also acknowledged that decisions about which directors will stay on the board after a merger can be a “delicate issue,” but should be discussed early in the due diligence process. “At one company, management kept putting it off, saying ‘we don’t want to talk about that now,’ and it was part of the reason why the deal unraveled in the end,” one member said.

- **Understand international challenges.** Members said that with cross-border deals on the rise, it is increasingly important for boards to understand the markets that companies are entering and how the regulations there may affect future financial results. One member said, “Understanding the laws in other countries is incredibly important if some of your synergies are dependent on [reducing head count]. It can be very difficult to cut employees in some markets.” Another member said, “When you go overseas, there are so many more aspects to consider. What are the market risks? What are the politics of the country? Is it stable? How are [consumer] demands different? How will the pricing be different? The board needs to make sure that all of these are considered.”
- **Involve internal auditors.** Some members said that internal audit has a role to play in “looking at the internal audit function and the internal controls of the target company,” but that it is not often involved in broader due diligence. By contrast, other members described a larger role for internal audit. One member said, “We brought in internal audit because they were very attuned to risk. They were very helpful in evaluating the [target] company.”
- **Seek the perspective of third-party advisers.** Most members said that their boards regularly receive reports from management’s investment bankers or legal advisers as part of due diligence discussions. In a conversation prior to the meeting, one member reported involving the external auditor early on: “It’s helpful for the auditors to see the new organization as quickly as possible. The best is when the audit partner will tour the operation with you and gets engaged quickly.” Some members said they seek additional outside perspectives when conditions warrant. One member whose board routinely engages its own advisers said that it does so “to make sure management isn’t sweet-talking us into something.”

### After the deal

Many members agreed that the integration phase of a transaction can often be “the most challenging [phase] to oversee.” Progress can be difficult to track, and boards with limited time on their agendas may have difficulty detecting issues unless management raises them explicitly. In light of this, members have adopted a number of practices that help the board better oversee integration progress:

- **Ensure integration challenges are reported in real time.** Many members said that even though their boards receive integration progress reports, it is important that “boards hear about issues as they occur if they are materially important.” Members acknowledged it can be challenging to track quantitative results after a merger, especially over time. However, as one audit chair observed, “Do we really need to ask for numbers, or should we just ask if the transaction was successful? Smart CEOs and CFOs know the answer intuitively.”



- **Make cultural decisions clear.** Members said it is often best for cultural differences to be addressed early on to ensure all employees understand the culture of the new combined company. One member said, *“If you remove the emotional aspect [of cultural issues] and say, ‘We are doing it this way,’ integration happens quicker. You will end up with a lot of people functioning well, and if you lose one or two, you lose them. There are no irreplaceable people.”*
- **Ensure staffing decisions are made quickly.** One member said, *“Managing people in transition is difficult, [and when companies can,] they should make decisions about who is staying and who is going right away.”*

Members observed that audit committees can play an important role in the post-transaction phase. One member said, *“Controls, financial reporting, and systems integration become an agenda item for [the audit committee in the integration phase].”*

Once integration is under way or completed, few members said their boards conduct formal post-transaction reviews. One member explained, *“We do not [have a formal practice] for reviewing deals, but we will spend time looking at deals that didn’t produce the results we expected. It is a reactive process.”*

Interestingly, many members said that often it is a *“goodwill impairment or write-down that will alert the board that the deal wasn’t as successful as expected.”* A few members said their boards have a relatively formal process for reviewing deals; however, one still noted that boards can do *“more fine tuning in the post-deal phase.”*

## Conclusion

Members were generally satisfied with the enhancements in transaction oversight their boards have adopted in the last decade. However, they acknowledged that postmortem reviews of transactions at many companies are still conspicuously informal and reactive, even though *“the board can learn a lot from reviewing transactions with 20/20 hindsight.”* Why is it that more boards do not capitalize on opportunities to learn from the successes and failures of past transactions? One member offered a reason: *“Boards do not always want to rehash their mistakes ... When the conversation turns to an unsuccessful deal, a lot of heads go down.”* Another member pointed out in a pre-meeting conversation that although postmortems may be good practice, *“the board only has a certain amount of discretionary time to spend together. When you have to choose between the future and the past, the board will choose the future every time.”*

In the end, members agreed that they learn a lot about integration progress and the ultimate success of a transaction by listening to the views of the investor and analyst communities. As one member put it, *“What does the market know that we don’t? The Street is a great signaler.”*



## About this document

The Canadian Audit Committee Network is a group of audit committee chairs drawn from leading 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.

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## **Appendix 1: meeting participants**

The following network members participated in the meeting:

- Bev Briscoe, Audit Committee Chair, Goldcorp
- John Caldwell, Audit Committee Chair, IAMGOLD
- John Clappison, Audit Committee Chair, Sun Life Financial
- Alan Horn, Audit Committee Chair, Fairfax Financial Holdings
- David Leslie, Audit Committee Chair, Enbridge
- Jane Peverett, Audit Committee Chair, EnCana
- Ted Reevey, Audit Committee Chair, Bell Aliant
- Bob Steacy, Audit Committee Chair, Domtar
- Barb Stymiest, Audit Committee Chair, Research in Motion

Ernst & Young was represented by the following:

- Tony Ianni, Partner, Transaction Advisory Services, Ernst & Young Canada
- Tom Kornya, Managing Partner, Greater Toronto Area, Ernst & Young Canada
- Rob Scullion, Managing Partner for Assurance, Ernst & Young Canada

The following members took part in discussions before and/or after the meeting:

- Peter Case, Audit Committee Chair, Fortis
- Michel Labonte, Audit Committee Chair, Metro
- Eileen Mercier, Audit Committee Chair, CGI Group
- Tom O'Neill, Audit Committee Chair, Loblaw
- Stuart Smith, Audit Committee Chair, Yellow Pages Income Fund
- Ron Tysoe, Audit Committee Chair, CIBC
- Paul Weiss, Audit Committee Chair, BCE



## Appendix 2: questions for boards and audit committees

- ? What is your assessment of the current M&A environment? What signals and indicators are you monitoring?
- ? What pressures do companies face to use cash in this type of environment?
- ? How is the current economic environment affecting how boards evaluate cross-border deals?
- ? What are the formal roles of the full board and its committees leading up to a transaction? What are the informal roles?
- ? What cases can be made for more – or less – audit committee involvement in transaction oversight?
- ? When is it appropriate to form a special committee? What skills and expertise are required on a special committee?
- ? How does the board get comfortable with the amount and quality of due diligence? How has oversight of due diligence changed over the last several years?
- ? How can boards better oversee cultural issues during and after a deal?
- ? How does the board assess the effectiveness of the integration plan and the combined leadership team?
- ? How can the board ensure that lessons learned from past transactions are institutionalized and applied to subsequent deals?