Internal Audit's role during the strategic transactions life cycle
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Throughout the strategic transaction process, Internal Audit (IA) should act as a business advisor to the organization. IA can assess and monitor program management activities, review controls and provide key insights, while maintaining independence and objectivity.
Background

Strategic transactions such as mergers and acquisitions (M&A) and divestitures remain some of the most risk-heavy initiatives that any organization can undertake.

According to Ernst & Young’s Capital Confidence Barometer (April-October 2012), a survey of senior executives from large organizations around the world, global confidence in the economic recovery is markedly more optimistic. More than 50% of executives now think that the global economy is improving. In fact, companies are looking to grow – 52% cite growth as a primary focus, the highest response since the survey began in April 2010.

This optimism is feeding an increased appetite for acquisitions. Emerging market investment appears particularly enticing for the following sectors: financial services, life sciences (including health care), consumer products, oil and gas, and technology.

We are also seeing the appetite for divestitures growing. In the Ernst and Young 2012 Global Corporate Divestment Study, respondents noted that:

- Seventy-seven percent intend to accelerate divestment plans over two years.
- Fifty-eight percent would ramp up divestments but are concerned about the weak economy.
- Forty percent said buyer competition helped drive up divestment values recently.

We are seeing an increase in M&A and divestitures: some geographies are still suffering from the crisis; and therefore, the divestitures continue. In other geographies the expectations are already more positive, with an uptick in M&As as a result. However, the conditions for completing the transactions remain challenging. Our study noted that increased stakeholder scrutiny and preparation are challenging buyers and sellers in terms of scope and areas of focus.

Likelihood of closing M&A deals is expected to be greater than it was six months ago.
Dozens of studies in the past few years have identified strategic transactions that did not give desired results to the stakeholders and discovered a need to do something different. A large percentage of buyers have actually destroyed shareholder wealth, and few have produced significant returns.

For years, many organizations have suffered poor strategic transactions results because they did not have appropriate deal processes in place. However, organizations have since made a number of improvements to improve deal value.

Most companies no longer wait for the close to prepare to integrate or spin off. Integration or spin-off planning often starts as part of due diligence and negotiations. Some companies have started using integration “clean teams” to facilitate early decision making affecting people, products, suppliers and customers. The “strategic transaction factory” concept – integration or spin-off as a repeatable process – has become quite well accepted, with permanent, full-time internal staff dedicated to integration/spin-off procedures now being common for serial acquirers and/or greater involvement in integration by corporate development.

Yet, despite these improvements, strategic transactions remain one of the most risk-heavy initiatives that any organization can undertake.

Given the high-risk profile of these key transactions, the proactive involvement of IA before, during and after the merger, acquisition or divestiture can help management identify issues and opportunities related to the transaction that might not otherwise be addressed. In following pages, we highlight why IA should play a role during such strategic transactions and discuss the roles an IA department can play to support management and enhance the value to the organization.

When do you expect to initiate your next divestment?

- In progress/planning: 15%
- 6-12 months: 14%
- 1-2 years: 17%
- Not planning but am open to opportunities: 35%
- None in the foreseeable future: 19%

Forty-six percent are in the process of divesting or planning to divest in the next one to two years.
Why IA should play a role during strategic transactions

Financial statements are only as good as the risk and control environment that support them. IA can play a role in divestitures by ensuring that controls remain strong during the financial statement carve out, and operational and IT transition. Similarly, without IA’s involvement, the acquiring organization will not know whether the control environment has sufficient rigor, or if the state of risks and controls were taken into account at the time of valuation of the acquiring organizations. Organizations often underestimate the challenges associated with the acquisition or divestiture of a company or line of business. Without IA’s insight, costs could range from a loss of opportunity to additional investments required to fix the issues that were missed. Emerging market growth, valuation, the complexity of the control environment, increasing regulatory pressures – these are all urgent issues where IA can provide critical input and strategic value early in the strategic transactions life cycle.

The Ernst & Young Future of Internal Audit study, which included chief audit executives (CAEs), C-suite executives and board members, noted that 37% of IA departments are doing more than just integrating their own function during M&As. The study also shows that CAEs are taking leadership roles in the strategic transactions, and IA teams are often involved in the project management of the integration.¹

Without IA’s involvement, the acquiring organization may not know whether the control environment has sufficient rigor or whether the acquisition or divestment is properly valued.

¹ Ernst & Young – The future of internal audit is now: increasing relevance by turning risk into results
How IA can help during strategic transactions

- Provide increased visibility and transparency to key risks related to strategic transaction changes (i.e., highlight potential finance, IT, HR or operational risks)
- Reinforce ownership that risks and controls are the responsibility of management
- Identify gaps in the integration or separation project management plan
- Suggest opportunities for additional synergies that would boost the acquisition's return on investment (ROI) or cost savings as a result of the separation
- Call out the impact that the acquisition and its integration, or the divestiture, may be having on other parts of the business
- Highlight potential gaps in the internal control structure
- Support management’s prioritization of risks of transition and organizational readiness for the effective and efficient allocation of resources to address the risks and controls
- Provide increased visibility of process changes impacting management’s 302 certification process.
Role of IA during M&A

There are four key areas where IA can play a crucial role in an organization’s M&A life cycle.

M&A life cycle

1. Strategy  
2. Due diligence  
3. Deal approval and close  
4. Integration

IA M&A program management process

Throughout the M&A process, IA should form a part of the program management team so that it can assess and monitor program management activities and provide key insights. IA can also audit program management activities to highlight process gaps and areas of future improvements.

IA should review the deal approval process to make sure that short- and long-term goals are defined before the deal closes.
## Role of IA during M&A

### 1. Strategy

An organization may have a target in its sights, but before it makes a move, IA should review the corporate strategy process, assess the risks to the organization and evaluate the business case process. This will ensure that the organization can determine from the beginning whether the acquisition target aligns with the organization’s corporate growth strategy (i.e., whether it is the right fit).

<table>
<thead>
<tr>
<th>IA objective</th>
<th>Assess corporate strategy process</th>
<th>Assess the risks to the organization</th>
<th>Assess business case process</th>
</tr>
</thead>
</table>
| Process      | ▶ Alignment with corporate vision for growth  
               ▶ Evaluate process for targeting acquisitions  
               ▶ Management effort on value-creating initiatives:  
               ▶ Near- and medium-term goals for which the M&A team can be held accountable  
               ▶ M&A strategy formal documentation | ▶ Identification and prioritization of potential risks related to targeted merger/acquisition:  
               ▶ People  
               ▶ Customers  
               ▶ Business operations  
               ▶ Finance and IT infrastructure  
               ▶ Evaluate and/or assist mitigation actions | ▶ Costs identified and projections clearly stated  
               ▶ Synergies identified and projections clearly stated (value and timing)  
               ▶ Consideration of dis-synergies unavailable (e.g., benefit plans, facilities)  
               ▶ Assumptions for exit costs accurately applied in the business case  
               ▶ ROI projections and monitoring process |

| Value | ▶ Validation of alignment with corporate vision  
               ▶ Enhancement of risk identification and mitigation  
               ▶ Validation of business case |

### 2. Due diligence

During the due diligence process, IA can assess the valuation process, the risks and internal control environment and the synergy validation process. These assessments will enable the organization to determine whether the price is right, and provide early insights on any risk or control issues that may be lurking beneath the financial statements; also, what kind of synergies the acquisition target offers to improve the buyer’s return on investment.

<table>
<thead>
<tr>
<th>IA objective</th>
<th>Assess valuation process</th>
<th>Conduct internal controls and risk diligence</th>
<th>Assess synergy validation process</th>
</tr>
</thead>
</table>
| Process      | ▶ Purchase price support:  
               ▶ Valuation with and without synergy considerations  
               ▶ Revenue and profitability projections  
               ▶ Financial statement analysis  
               ▶ Tax implications | ▶ Provide early insights on risk coverage and management:  
               ▶ Strategic – governance, reputation  
               ▶ Financial – IT systems, credit/economic risks, tax  
               ▶ Operational – IT systems, customer, supply chain  
               ▶ Regulatory compliance (SOX readiness, FCPA, OSHA, EPA, etc.) | ▶ Assess synergy assumptions and variables and compare them with past experiences from similar transactions and benchmarking  
               ▶ Assess or assist with validating deal synergies and feasibility of fully realizing stated synergy goals  
               ▶ Provide early insights on opportunities to increase or accelerate transaction value and ROI |

| Value | ▶ Validation of valuation process including deal synergies  
               ▶ Early insights on internal control environment and overall compatibility |
Before the organization signs the agreement, IA can review the deal approval process to make sure that short- and long-term goals are defined before the deal closes. IA can also assess the monitoring of the valuation process leading up to the deal close to determine the impact that any changes in the risk and control environment may have on the company; for example, changes in anticipated synergies, and/or changes being made to key personnel.

### 3. Deal approval and close

<table>
<thead>
<tr>
<th>IA objective</th>
<th>Assess deal approval process</th>
<th>Assess monitoring of valuation process leading up to close</th>
</tr>
</thead>
<tbody>
<tr>
<td>Process</td>
<td>Executive management and Board provided appropriate business case analyses and supporting documentation:</td>
<td>Purchase price adjustments</td>
</tr>
<tr>
<td></td>
<td>► Business valuation and purchase price</td>
<td>► Impact of any changes in risks and control environment</td>
</tr>
<tr>
<td></td>
<td>► Cost and benefit analysis of forecasted synergies</td>
<td>► Impact of any changes in anticipated synergies:</td>
</tr>
<tr>
<td></td>
<td>► Evaluation of risks and controls</td>
<td>► Evaluate if synergy realization is off track – eliminate/mitigate root causes</td>
</tr>
<tr>
<td></td>
<td>► Long-term and short-term goals/objectives defined before approval</td>
<td>► Identify any new synergies</td>
</tr>
<tr>
<td></td>
<td>►</td>
<td>► Impact of any changes to business and/or key personnel</td>
</tr>
</tbody>
</table>

### Value
- Validation of deal approval process adequacy
- Prevention of deal value leakage leading up to close

### 4. Integration

IA should form part of the integration team and should be involved in integration design and planning processes, integration project management and execution, and the transaction value assessment. IA can also help to mitigate the risk of deal value leakage through the integration life cycle.

<table>
<thead>
<tr>
<th>IA objective</th>
<th>Assess integration planning process</th>
<th>Assess integration project management</th>
<th>Assess and monitor integration execution</th>
<th>Transaction value assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Process</td>
<td>► Human resources</td>
<td>► Adequacy of resources</td>
<td>► HR – personnel changes; roles and responsibilities:</td>
<td>► ROI analysis</td>
</tr>
<tr>
<td></td>
<td>► Finance</td>
<td>► Milestones and timelines</td>
<td>► People issues triggered by the merger</td>
<td>► Gap analysis</td>
</tr>
<tr>
<td></td>
<td>► Systems</td>
<td>► Communication protocols</td>
<td>► Impact on business due to any loss of key staff in acquired business</td>
<td>► M&amp;A process improvement opportunities</td>
</tr>
<tr>
<td></td>
<td>► Operations:</td>
<td>► Monitor identification and mitigation of integration risks and issues</td>
<td>► Synergies tracking</td>
<td>► Impact assessment on existing business due to the attention given to the acquired business</td>
</tr>
<tr>
<td></td>
<td>► Sales and Marketing</td>
<td>► Monitor identification and implementation of improvement opportunities (e.g., additional synergies, standardizations)</td>
<td>► Policies</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► Customer management</td>
<td></td>
<td>► Treasury</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► Products and services</td>
<td></td>
<td>► Financial reporting</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► Supply chain</td>
<td></td>
<td>► Legal entity consolidation/reporting</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>► Merged operations</td>
<td></td>
</tr>
</tbody>
</table>

### Value
- Integration process adequacy monitoring and validation
- Integration process improvement opportunities
- Mitigation of deal value leakage risk through integration cycle
Role of IA during divestitures

While there are many similarities in IA's role in the M&A process, there are some differences as indicated in the graphic below.

Divestitures life cycle

1. Strategy  
2. Due diligence  
3. Deal approval and close  
4. Separation

IA divestitures program management process

Leading practice calls for IA to be embedded as part of the program management team and be involved throughout the divestiture life cycle.

IA can help to mitigate the risk of deal value leakage throughout the separation life cycle.
Role of IA during divestitures

1. Strategy

Similar to M&A, IA should assess the corporate strategy for divestitures. IA should have visibility to the proposed divestiture changes and the separation timing and should help management identify, assess and prioritize potential risks to the control environment. IA will need to check that there is clear ownership of risks by management and that strong governance over roles and responsibilities of various stakeholders is in place.

<table>
<thead>
<tr>
<th>IA objective</th>
<th>Assess corporate strategy process</th>
<th>Assess the risks to the organization</th>
<th>Assess business case process</th>
</tr>
</thead>
<tbody>
<tr>
<td>Process</td>
<td>Alignment with corporate vision</td>
<td>Identification and prioritization of potential risks related to separation:</td>
<td>Identification of costs and clear statement of projections</td>
</tr>
<tr>
<td></td>
<td>Management effort on value-creating initiatives:</td>
<td>People</td>
<td>Consideration of expected savings</td>
</tr>
<tr>
<td></td>
<td>Near- and medium-term goals for which the M&amp;A team can be held accountable</td>
<td>Customers</td>
<td>Assumptions for exit costs accurately applied in the business case</td>
</tr>
<tr>
<td></td>
<td>Separation strategy formal documentation</td>
<td>Business operations</td>
<td>Evaluation of financial impact</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Financial and IT infrastructure</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Evaluate and/or assist mitigation actions</td>
<td></td>
</tr>
<tr>
<td>Value</td>
<td>Validation of alignment with corporate vision</td>
<td>Validation of business case</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Enhancement of risk identification and mitigation</td>
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</tr>
</tbody>
</table>

2. Due diligence

In the divestiture process, IA can not only assess the valuation process, but also can provide important insights on the risks and the internal control environment related to strategic (governance and reputation), financial (credit and operational), operations (customer, supply chain and IT) and compliance (e.g., SOX readiness).

<table>
<thead>
<tr>
<th>IA objective</th>
<th>Assess valuation process</th>
<th>Conduct internal controls and risk diligence</th>
<th>Assess organizational readiness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Process</td>
<td>Purchase price support:</td>
<td>Provide early insights on the impact of the separation on risk coverage and management:</td>
<td>Identify, assess and prioritize:</td>
</tr>
<tr>
<td></td>
<td>Valuation</td>
<td>Strategic – governance, reputation</td>
<td>What is changing?</td>
</tr>
<tr>
<td></td>
<td>Revenue and profitability projections</td>
<td>Financial – IT systems, credit/economic risks, tax</td>
<td>What are the risks to the control environment?</td>
</tr>
<tr>
<td></td>
<td>Financial statement analysis</td>
<td>Operational – IT systems, customer, supply chain</td>
<td>How significant are the risks?</td>
</tr>
<tr>
<td></td>
<td>Tax implications</td>
<td>Regulatory compliance – SOX readiness, FCPA, OSHA, EPA</td>
<td>Provide insights on business/ systems separation plans and controls</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Evaluate adequacy of service-level agreements, including performance metrics and price</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Assess allocation of resources and check that appropriate skills remain/ are available after separation</td>
</tr>
<tr>
<td>Value</td>
<td>Validation of valuation process</td>
<td>Early insights on internal control environment and overall compatibility</td>
<td>Evaluate and/or develop mitigation strategy</td>
</tr>
</tbody>
</table>
### 3. Deal Approval and Close

During divestitures, the IA department should identify if there are any changes to the control environment and assess the effectiveness of “interim” controls put in place to mitigate risks. IA should also monitor the operation of high-risk controls during the transition period.

<table>
<thead>
<tr>
<th>Process</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>IA objective</td>
<td>Assess deal approval process</td>
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<tr>
<td>Executive management and Board provided appropriate business case analyses and supporting documentation:</td>
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<td>Business valuation and purchase price</td>
<td>Impact of any changes in risks and control environment</td>
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<td>Cost and benefit analysis of forecasted synergies</td>
<td>Impact of any changes to business and/or key personnel</td>
</tr>
<tr>
<td>Evaluation of risks and controls</td>
<td>Long-term and short-term goals/objectives defined before approval</td>
</tr>
<tr>
<td>Long-term and short-term goals/objectives defined before approval</td>
<td>Validation of deal approval process adequacy</td>
</tr>
<tr>
<td></td>
<td>Prevention of deal value leakage leading up to close</td>
</tr>
</tbody>
</table>

### 4. Separation

At the time of separation, IA can assess and monitor separation project management, which can include areas of HR, finance, systems and operations. IA can also identify value leakages during the time of separation.

<table>
<thead>
<tr>
<th>Process</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>IA objective</td>
<td>Assess separation planning process</td>
</tr>
<tr>
<td>Human resources</td>
<td>Adequacy of resources</td>
</tr>
<tr>
<td>Finance</td>
<td>Milestones and timelines</td>
</tr>
<tr>
<td>Systems</td>
<td>Communication protocols</td>
</tr>
<tr>
<td>Operations:</td>
<td>Monitor identification and mitigation of risks and issues</td>
</tr>
<tr>
<td>Sales and marketing</td>
<td>Monitor identification and implementation of improvement opportunities</td>
</tr>
<tr>
<td>Customer management</td>
<td></td>
</tr>
<tr>
<td>Products and services</td>
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</tr>
<tr>
<td>Supply chain</td>
<td></td>
</tr>
<tr>
<td>Internal and external communications</td>
<td></td>
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<tr>
<td></td>
<td>Separation process improvement opportunities</td>
</tr>
<tr>
<td></td>
<td>Mitigation of deal value leakage risk through separation cycle</td>
</tr>
</tbody>
</table>
Conclusion

CAEs should work closely with their corporate development teams to involve IA during the entire strategic transactions life cycle, whether acquisition or divestiture, with IA representatives forming part of the program management team for the execution of such strategic transactions:

- Strategically, IA can determine an organization’s readiness for the transaction.
- During due diligence, IA can alert the organization to potential risk, or control or regulatory issues that would cause the organization to overpay or undervalue.
- Prior to deal close, IA can help prevent deal value leakage.
- From a post-transaction perspective, having IA involved in critical components of the execution can create organizational efficiencies and ascertain proper control monitoring of new or changes in processes.
- Finally, throughout the strategic transaction life cycle, IA can assess the management of the program to identify any improvement opportunities.

IA provides a critical perspective to strategic transaction deals that many executives may not consider. Without that perspective – right from the start – the organization could find out far too late that the price was not right, or that it has to spend a significant amount of money to fix issues that IA could have identified and helped the organization avoid.

Most organizations understand the value IA can bring during business as usual. What they do not often think about is the value IA can provide before, during and after a strategic transaction.
Call for action

• CAEs should assess the IA function readiness for strategic transaction support and enhance the capabilities if necessary.

• CAEs should conduct a diagnostic assessment of the strategic transaction process and identify the areas where the value can be added.

• CAEs should collaborate with the corporate development team to clearly define the IA role for each transaction: (a) audit, advice and consultation and (b) before, during and/or after.
Global corporate divestment study: maximizing divesting success in an uncertain economy

Rise of the cross-border transaction: the serial transactor advantage

Divesting for value

Turning risks into results: how leading companies use risk management to fuel better performance

Global Capital Confidence Barometer: 7th issue, Outlook October 2012 - April 2013

Rise of the cross-border transaction: the serial transactor advantage

Toward transaction excellence: Ernst & Young's 2011 corporate development study

5 Insights for executives: are you getting what you pay for?
http://www.ey.com/publication/vwluassets/internal_audit_can_add_value_to_the_m_and_a_life_cycle/$file/5-insights_m&a_lifecycle.pdf

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