SOUTHEAST
AUDIT COMMITTEE NETWORK
VantagePoint

October 5, 2007

TAPESTRY NETWORKS, INC · WWW.TAPESTRYNETWORKS.COM · +1 781-290-2270

The audit committee's role in major transactions

Introduction

The Southeast Audit Committee Network held its eighth meeting on September 11, 2007, to discuss the audit committee's role in major transactions. This document is a synthesis of insights and comments from the meeting. In a private session, members also identified and discussed other issues they are currently dealing with, including the constriction in the credit markets, handling a lead audit partner rotation, and best practices in running an audit committee investigation.

Collectively, members of the network in attendance at the September meeting sit on the boards of more than 35 large-, mid-, and small-cap public companies. Audit committee chairs attending were:

- Denny Beresford, Kimberly-Clark and Legg Mason
- Phil Cox, Duke Energy
- Brenda Gaines, Office Depot
- Renée Hornbaker, Eastman Chemical Company
- Sherrill Hudson, Standard Register Company and Publix Supermarkets
- Doug Ivester, SunTrust Bank
- Warren Jobe, WellPoint
- Dean O'Hare, Fluor Corporation and H. J. Heinz Company
- Tom Presby, World Fuel Services Corporation and INVESCO
- Erik van der Kaay, RF Micro Devices

Also attending the meeting were:

- Edwin Bennett, Southeast Area AABS Managing Partner, Ernst & Young
- Tom Hough, Vice Chairman and Southeast Area Managing Partner, Ernst & Young
- Steve Krouskos, Americas Transaction Advisory Services Accounts and Growth Leader, Ernst & Young

VantagePoint reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. Members' remarks appear in italicized quotes.

Executive summary

As directors are keenly aware, significant transactions – acquisitions and disposals – can present both substantial risks and rewards to a company. Audit committee chairs need to have an understanding of the risks that require monitoring, the challenges the transaction entails, and the resources they may call on for assistance. The issues that network members found to be most important are highlighted below, with more detailed discussion on the following pages:

- **Transaction oversight requires a team effort at the board level** *(page 3)*

  Audit committee members play a unique role on a board. Other directors look to them for opinions and advice on financial matters (especially during transactions), but committee members need to provide that guidance without undertaking the governance responsibilities of the full board. Audit chairs must find ways to encourage other directors to speak their minds in full-board sessions.

- **How do you stop the bandwagon?** *(page 3)*

  With large sums of money on the line, pressure building from shareholders and management, and investment bankers and lawyers pushing hard to move forward, it can be difficult to properly assess the merits of a transaction. "Deal heat" can cause a company to enter into a purchase or sale that should have been avoided. Members listed four steps fellow directors can take to avoid this: poll management; speak with key executives privately; ask for extra details on downside scenarios; and examine investment bankers' contracts.

- **Directors need sources of independent advice** *(page 4)*

  Directors must review copious amounts of information when evaluating a corporate transaction, but they have many resources to turn to for help in their evaluation. Internal auditors, external auditors, and others can all be called upon for advice, though when used, these resources must be used properly. Members expressed concern that internal auditors would not have the right skill set to add value during due diligence, but they could see a clear role for internal and external auditors post-transaction.

- ***Caveat venditor* is as important as *caveat emptor*** *(page 5)*

  While many boards are careful when it comes to undertaking mergers and acquisitions, most do not pay the same level of attention to disposals. The sale of a business requires unique skills and abilities and a full understanding of how that business unit ties into the rest of the corporation.

- **It is wise to analyze the completed transaction** *(page 5)*

  Corporations need to track and learn from both the successes and the failures that occur during transactions. These lessons will help directors better prepare the corporation for future transactions and will help them hone the skills they need when dealing with transactions.

Transaction oversight requires a team effort at the board level

The figure is familiar to most corporate directors in the United States: nearly two-thirds of corporate transactions end up as failures. In 2002, *BusinessWeek* conducted an exclusive survey of the last transaction wave: "The results? Fully 61% of the corporate buyers destroyed their own shareholders' wealth. Companies that paid for mergers solely in stock had the worst results. They overpaid much more readily than buyers using cash."[1]

Clearly, all board directors have a role to play during major transactions, but many audit committee chairs and members feel extra pressure to take the lead during discussions at the full-board level, as they typically have deeper financial expertise and better understanding of potential internal control issues. With regard to the financial implications of the transaction, one member remarked, *"You might take the lead [in the discussion], but not exclusively."* Another member said, *"There are questions only the audit committee members would think of asking. I push members in the full board to ask questions [during full-board conversations]."*

Members were overwhelmingly clear that no director should be *"disenfranchised from the full board* by being a member" of another board committee. As one member remarked, *"whether you have your audit committee member or board director hat on is irrelevant. Corporate governance is the responsibility of the full board."* Another member agreed, saying that, *"the full board is responsible, [which is] not to say the talents of the audit committee members in [dealing with] numbers and analysis are ignored."*

Members felt strongly that oversight of transactions should not be limited to members of the audit committee. Members remarked that discussions could also involve areas best addressed by members of *"the finance committee, if you have one,"* and that *"there's a role for the compensation committee to play in [compensation] alignment"* between the acquired and the acquiring companies. Other members pointed out that the risk committee, if one exists, can evaluate the risk-reward trade-off posed by the transaction.

How do you stop the bandwagon?

With large sums of money on the line, pressure building from shareholders and management, and investment bankers and lawyers pushing hard for a deal, it can be difficult to properly assess the merits of a transaction. Most directors have specific red flags that they look for. One individual, who had extensive experience with transactions, remarked that *"a recommendation to not do a deal [could] be based on the quality and sustainability of financial results, the underlying quality of information, specific exposures, or a gut feel about management."*

Members shared a number of situations that had caused deals to become difficult, even to the point of abandonment. One member described *"acquisitions blown out of the water because of HR policies that one company wouldn't change, and the other company wouldn't tolerate."* Another participant agreed that

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

cultural fit is important, but considered it just one of four reasons why deals fail: *"The four key reasons why deals fail are strategic fit, price tolerance, reputational risk, and cultural issues."*

Not all deals are appropriate for companies. *"When [management] can't justify [the price] to Wall Street," one member commented, "then it's labeled as 'strategic.' It's different if the board calls it 'strategic' than if the Street calls it 'strategic.'"* Another member agreed: *"If it's called a 'strategic transaction,' you're paying too much for it and trying to justify it."* That said, not all transactions have to be outstanding successes. One member compared corporate transactions to filmmaking: *"if you make 20 movies, 19 will lose money, but the 20th will make enough money to justify all 20."*

Even then, it's not easy to object to a superficially attractive deal. Boards may need to push back against management's eagerness. Likewise, individual directors must occasionally disagree with the rest of their board if they don't feel a specific deal is right for the company. One member remarked, *"I've been the only one hesitant on a deal. It's tough to have eight people in the boardroom looking at you sideways."*

"Deal heat" can cause a company to make a poor purchase or sale. When this begins to happen, *"how do you stop the bandwagon?"* Members recommended the following four steps for applying the brakes:

- **Poll management.** One member said that in one situation, *"I asked management if their view was unanimous. They all said yes, and I didn't believe them. A good management team would have differences of opinions."*
- **Speak with management privately.** Another member suggested that in addition to polling management, *"for big [deals], talk with management to discuss it in depth."* Another member agreed, suggesting directors *"talk to the key players in a private session [of the board of directors]. I've seen things come out in conversations like these."*
- **Ask for extra data on downside scenarios.** One member remarked, *"I want to see all downside information [on a potential deal]."* Another member agreed, stating that far too often, *"the success of the deals are like parlay bets in football,"* where gamblers win only if multiple victories occur in order – an unlikely occurrence in gambling and in corporate transactions.
- **Examine the investment bankers' contracts.** Frequently, *"investment bankers are paid [contingent fees] if the deal goes through."* Some members are concerned that this arrangement encourages the investment bankers to push companies into deals that are not appropriate for the company. As one member remarked, *"Investment bankers and lawyers have too much sway, and the board goes along with it."* Directors should be aware of the investment bankers' motivations.

Directors need sources of independent advice

The audit committee has a wide range of resources to draw on while examining transactions, both before the deal and afterwards. Members stressed the importance of using those resources to get a full and complete picture of the transaction, as no director wants to regret a transaction after the fact, especially if a mistake could have been easily avoided.

Most members believe that it is inappropriate to use internal audit for due diligence. One member said that *"internal audit doesn't always have the right skill set"* to address the issues they will come across during a transaction. Other members agreed, noting that while *"there's an underbelly of issues you want to get control over"* during a transaction, *"internal audit can't always do what you want them to do."* Not calling on internal audit suits one member just fine; that member said the board likes *"to keep internal audit as pure as white snow."*

While Sarbanes-Oxley does not prohibit the use of the external auditor in due diligence work (under Sections 201 and 202), one member was concerned about how this would be perceived by outsiders. The audit chair said, *"[I want to] do everything possible to keep [Institutional Shareholder Services] from banging on our door."*

Several members said that after a transaction, they were eager to *"get internal audit in right away,"* with one member suggesting that companies *"use internal audit to identify specific areas of risk and then use external [resources] to assist them."*

Caveat venditor **is as important as** ***caveat emptor***

While the board deals with all major transactions, it often puts more energy into examining purchases than it does into sales – yet a poor disposal can sap money, resources, and energy from a company. Members noted that companies tend not to be as good at disposals as they are at acquisitions: *"Disposals don't get a lot of attention. [Transaction] skills are not symmetrical; companies are good at one, but not at both."*

The impact of a failed disposal can be as significant as that of a failed acquisition. *"You can destroy as much value in disposals as in acquisitions,"* one member remarked. In most cases, this value destruction comes from not fully understanding the connections that the business unit being sold has with other parts of the corporation, including shared services and cross-boundary knowledge sharing between employees.

Members believe the audit committee and the board must *"take time to understand the numbers, the carve-outs, and the allocations"* during a disposal. If they do not, they may *"lose track of the costs"* and have an inaccurate view of the true impact of the disposal.

It is wise to analyze the completed transaction

While most individuals focus on pre-transaction issues and the execution of a deal, it is also important to spend time reflecting on completed transactions and lessons learned. One member believes *"it takes about 18 months to do the tracking and learn lessons"* from deals. Members noted that while companies can learn from both large and small transactions, most focus primarily on the larger transactions, in part because there is more at stake in larger transactions and larger transactions have a larger overall impact on the company. One member feels that *"small deals are tucked in quickly and [are] difficult to measure."* Another agreed and remarked, *"Small deals tend to be done okay, but big deals [get] screwed up."*

One member was of the opinion that *"any company that doesn't track [transaction] success is crazy."* Another member agreed and said that *"tracking the performance of transactions sends a signal to the company."*

Another felt that the board should be *"thinking about [management's] track record, synergies, and integration early in the game."* This was also recommended by a member who felt that goals for the deal should be discussed – and documented – from an early stage since *"people have a tendency to change the facts after a while"* when it comes to what goals they say they were expected to achieve. One member suggested that the board should *"tie [executive] compensation to the results, as it causes much more attention [to be paid] to achieving results."*

"The full board gets an annual report on actual versus expected progress [after the transaction]," one member told the network. The numbers are typically *"audited by internal audit"* before reaching the audit committee. *"The audit committee gets the report before the full board does and can ask questions on how the numbers were prepared."* However, one audit chair cautioned that reviewing post-transaction reports is *"the responsibility of the full board, as it's an indicator of how good management is."*

Conclusion

A major transaction requires participation and hard work from all board members. While audit committee members have a special role to play in reviewing the financial implications of a deal and monitoring post-transaction performance, the burden of oversight must rest with the whole board. With the support of independent experts, and through proper monitoring before and after a transaction, members of the audit committee can provide vital guidance to the full board to protect and enhance shareholder value.

About this document

The Southeast Audit Committee Network is a select group of audit committee chairs from leading North American 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 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.

The views expressed in this document represent those of the Southeast Audit Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.