The Board’s Perspective on M&A:
From due diligence to Day 1 and beyond
As deal activity gains momentum from 2008 lows—fueled by high stock prices, low interest rates, and cash-heavy balance sheets—many boards will be faced with the challenge of helping to ensure a deal delivers the value that it should. That’s no easy task given the challenges posed by an increasingly complex M&A and business environment.

Deal activity has increased steadily from its 2008 low, but prospects for 2014 are uncertain. In 2013, announced value for U.S. M&A topped $1.1 trillion, a 28 percent increase from the year before; deal volume remained essentially flat, according to Thomson Reuters. However, confidence remains the key to whether M&A will make a stronger comeback. Several factors point to a possible rebound of M&A activity: Stock prices have reached record territory; despite recent fluctuations, interest rates remain near historic lows; and corporate cash balances and cash flow are at record levels. And for many companies, M&A is the key to growth, given the limited opportunity for organic growth in existing markets. It is also likely that companies will continue to engage in M&A “bolt-on” activity to fill gaps in products or channels, and acquire talent and technology.

At the same time, companies and their boards are sensitive to shareholder concerns regarding M&A success rates. A significant number of deals fall short of achieving their projected shareholder returns for a variety of reasons, ranging from valuation overreach, to overly optimistic projections and assumptions, to lack of a rigorous due diligence process, to failure to develop a robust postmerger integration plan and monitor the execution of that plan. We believe that companies can create more successful deals by engaging their boards to improve both the M&A process and its results. “Directors have a unique opportunity to help their companies meet strategic goals through M&A,” says Tracy Benard, Accounting Advisory Services, Americas and U.S. Partner in Charge. “Frequently, a board will have experienced directors who have worked on many more acquisitions than the management team, and will be in a unique position to add value to the M&A process.”

According to a recent KPMG survey of directors, there may be an opportunity for boards to do more to improve the M&A process and deal performance. About one in three of the directors surveyed say their board could be more involved in shaping M&A strategy and in evaluating deals proposed by management.

Based on our experience in the M&A process, and interviews with directors who have served on numerous boards and worked through scores of M&A transactions, we offer the following suggestions as to the role the board and the audit committee can play in the M&A process, and how they can help their companies capture more value—and help minimize the risk of failure—in M&A:

• Test alignment of the deal with the company’s strategy, and challenge the value creation potential of the deal.
• Be sensitive to possible management bias and maintain the board’s objectivity—don’t fall in love with the deal.
• Closely monitor key aspects of the due diligence process before approving the deal.
• Examine the postmerger integration plan in detail, and track performance against the plan.
• Ensure the company has a rigorous M&A process and the right M&A leadership.
• Build a diverse board with different roles and perspectives.
Cal Darden, a director at The Coca Cola Company and Target, Inc., believes directors should participate in their companies’ strategy sessions “to gain a better understanding of what’s in the deal pipeline and whether there is a strategic fit.”

As part of its oversight role, the board should understand the company’s strategy, including its organic and strategic growth opportunities as well as key “gaps” (e.g., talent, technology, new products and markets, etc.) in achieving the company’s objectives, and monitor whether the company’s deal pipeline has the potential to fill those gaps. Generally, deals aligned with long-term strategic goals have higher success rates than more “opportunistic” transactions.

Cal Darden, a director at The Coca Cola Company and Target, Inc., believes directors should participate in their companies’ strategy sessions “to gain a better understanding of what’s in the deal pipeline and whether there is a strategic fit.” According to Bob Finocchio, a director of Broadcom Corporation, when management proposes an M&A opportunity large enough for board consideration, “the board should challenge the alignment of the deal with the company’s strategy. What is the reason behind the deal? Is it to acquire technology? To enter a new market?” Simply “increasing revenue” is not enough, says Finocchio.
Another important role for the board is to test the value creation potential of the deal. “The audit committee can play a key role here,” according to Rob Coble, a KPMG Transactions & Restructuring partner, “by scrutinizing the financial assumptions behind the deal, and understanding the economic impact of the deal, including the financing.”

Finocchio also emphasizes the audit committee’s role in testing the economics of the deal. “How will the deal affect our own cost of capital? Will we be able to do another deal anytime soon? How will the deal affect our balance sheet and Wall Street’s assessment of our financial strength?”

Be sensitive to possible management bias and maintain the board’s objectivity—don’t fall in love with the deal

Challenging management’s assumptions and limiting some of the enthusiasm for a deal is one of the most important roles the board can play in M&A. “Management is not going to propose any deal unless it believes in the deal and its value-creating potential for the company,” says Rita Foley, a director of PetSmart, Inc. and Dresser-Rand Group, Inc. “That’s to be expected, and the board needs to be particularly sensitive to management bias and maintain its own objectivity.”

To help ensure a more balanced decision-making process, Foley says it’s important for the board to probe deeply into the potential value created by the deal and its strategic fit, and make sure that the discussion is data-driven to the extent possible.

“Having access to better data and deeper analysis helps directors ask the right questions,” says KPMG’s Phil Isom, U.S. head of KPMG Corporate Finance & Restructuring. “It’s more important than ever to understand if valuations are consistent with industry norms, and value creation is realistic for the market.”

Closely monitor key aspects of the due diligence process before approving the deal

“A rigorous due diligence process is an essential element of any successful M&A transaction,” says Coble. The directors we interviewed identified a number of critical areas of focus during the due diligence phase, including:

- Test the valuation and synergy assumptions.
- Vet the financial and strategic health of the target.
- Understand the key transaction risks including financial, tax, operational, and commercial matters.
- Understand the cultural issues and roadblocks.
- Determine management’s ability to execute.
For example, Finocchio says he wants to know what assumptions are being made about the market and competitors, what do the projections assume about customer behavior and loyalty, and where are the target’s products in their life cycle? What are the key assumptions on sales and channel strategies? Further, how dependent is the deal’s success on the people, customers, key vendors, and suppliers of the target company?

Foley, an audit committee member at PetSmart and Dresser-Rand, emphasizes the key role the audit committee plays in ensuring that management understands the target’s accounting. “Do they lean aggressive or conservative? What is their policy on reserves? Due diligence should also assess the target’s general culture around compliance and internal controls. Are there FCPA or antibribery concerns in the countries they may do business? What is the assessment of risk in the supply chain?” She also emphasizes the need to focus on the relevant Sarbanes-Oxley requirements, and ensure that the target has the required processes in place.

Examine the postmerger integration plan in detail, and track performance against the plan
The board also plays an important role in monitoring execution of the company’s postmerger integration plan in order to help ensure that the strategic objectives of the deal—including synergies and cost savings—are achieved. Yet, according to a recent KPMG survey of directors, most directors see opportunity for improving board oversight in this area. According to Benard, “an inadequate postmerger integration plan is a huge risk to any deal. A very detailed and robust plan needs to
be developed early on, and it needs to be adjusted during the due diligence process as risks are identified.”

For audit committees, the postmerger integration plan is a particularly important area of focus “early on” because the committee’s oversight responsibility for the acquired company’s financials—e.g., financial reporting and controls, establishing reserves, internal audit’s focus, controllership, etc.—starts on Day 1 and the quarter close will be fast approaching.

After the deal closes, integration risk and execution risk—including cultural integration—remain critical areas of focus for the board. “Even with a robust and detailed postmerger integration plan, execution risk can be high, and directors need to focus on execution risk, and track performance closely against the merger integration plan,” says Benard.

For international deals, execution risk is often tied to resource allocation and distance from the acquirer’s primary operations or headquarters. According to Foley, “if the deal involves a remote target, with the management time and attention that is required—boards need to ensure that management has the bandwidth, time, and resources required for a successful integration.”

Darden says that it is important for the audit committee or board to assess the status of the overall deal—and particularly execution of the postmerger integration plan—perhaps quarterly, and certainly after 6, 12 and 18 months to make sure that the acquisition is meeting the company’s overall objectives. “If the deal is not on target, we have to figure out how to fix it,” he says.

Ensure the company has a rigorous M&A process and the right M&A leadership.

Boards should make sure that the management team has a disciplined M&A process and employs that process uniformly for every deal. Management’s M&A process needs to be rigorous and incorporate a well thought out methodology for each phase of the transaction—strategy, valuation, financing, due diligence, synergy identification and capture, closing the deal, and integration. Boards should understand the company’s M&A playbook and carefully challenge deals that are not consistent with it.

Finocchio adds that it’s also crucial for the deal to have “an owner,” who is accountable for both the transaction as well as the postmerger integration. “No deal can succeed unless there is an operating person who owns the deal, not just the business development person presenting the deal,” he says.

Diane Baker, most recently the chairman of the board at Sleep Innovations, Inc., emphasizes the importance of an M&A postmortem as part of the company’s overall M&A process. She stresses that “postmortems must be done painstakingly. You need to be meticulous in reviewing the entire process, strategy, due diligence, the adequacy of the postmerger integration plan, and how management executed the plan.”

One important area of focus during the postmortem is whether key sources of information within the company—e.g., HR, tax, legal, IT—are comfortable that the concerns they expressed during the due diligence process were appropriately considered.
Build a diverse board with different roles and perspectives

Having a board with the right composition—a diversity of director backgrounds, perspectives, skills and experiences—can greatly enhance the board’s effectiveness and value-add in the company’s M&A process, according to Isom.

Foley explains that a diverse group of directors can contribute to M&A process in at least two different ways, both of which are crucial. For example:

• Directors who have experience in a similar industry often have industry connections and may know the target and its reputation. They will also be in a better position to understand the strategic value of the deal and assess the valuation multiples in light of what they have seen in similar deals.

• Directors from outside the industry may have a range of other experiences and perspectives that enable them to see the transaction through a different lens—and avoid some of the industry biases. They may also offer different expertise and perspectives important to the success of the deal in critical areas such as emerging technologies, globalization, and compliance.

Darden agrees that diverse perspectives add significant value. “By actively sharing our opinions, informed by diverse experiences, we can greatly enhance the M&A process,” he says.

Final Thoughts

Boards and audit committees can play an important role in helping their companies capture more value during the M&A process and reduce the risk of failure. The question for every board and audit committee is “how”—how can the board best add value to the M&A process? The answer will certainly vary from board to board and from transaction to transaction based on a number of factors, including the size and complexity of the deal, the sophistication of management’s M&A team and processes and the volume and scale of deals they typically handle. We encourage every board to consider how it can best add value to its company’s M&A process.
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