

The business risk of M&A activity and the role of internal audit function in the risk management process

NIKOLAOS P. DOUNIS, BBA, Msc, PhD
Senior Internal Auditor, Cosmote Mobile Telecommunications S.A., Greece

I. Introduction

Mergers and acquisitions represent a dynamic process of corporate culture and strategy. Empirical evidence indicates a high rate of failure of M&A's to create value for the shareholders of the firms. M&A projects encounter a great number of risks and often end up in failures and loss of shareholder wealth. These exposures are often the reasons that lead to major failures in the financial or operational area for the recently constructed entity. On the other hand, internal audit has evolved significantly during the last years from its traditional role of control orientation to a more proactive, risk based and consultancy role. But despite this evolution, internal audit function has no effective contribution during the M&A activity.

Mergers and acquisitions tend to represent the ambition of adding value to the new company and internal audit function can prove that is a "value added activity" during the process and the various stages of a merger or acquisition. This paper will analyze the various risks that are present during the various stages of an M&A project and the role of internal audit activity, taken also into consideration the evolution of internal audit profession to a pro-active risk based function. The increasing importance of merger and acquisition activity to corporate strategy and the record of failure of such strategies in creating value gave the motivation to further analyze the role internal audit function possibly can play in the process.

II. The business risk of M&A activity

Evidence assembled by several studies in the United States, United Kingdom and other countries points to a high rate of failure of mergers and acquisitions to create value for the company and the shareholders. Briefly, the reasons for this trend can be summarized as follows (*Jensen & Ruback, 1983; Aggrawal et al, 1992; Loughran & Vijn, 1997; Rao & Vermaelen, 1998*):

- Cultural differences (Darnell D.C. 1999; Zaheer et al, 2003)
- A weak core business of the acquirer (Very, 1993)
- Overly optimistic appraisal of market potential (Diericx and Koza, Sept. 1991)
- Overestimation of synergies (Clarke and Breman, April 1990)
- Poor technology assessment (Singh, 1995; Johnson, June 1989)
- Inadequate due diligence (Gates, Nov/Dec 1988)
- Clashing management styles and egos (Datta, May 1991; Lane et al, June 1998; Weisbach, 1995)
- Overbidding (Choi and Lee, 1996; Franks et al, 1988; Eccles et al, Jul/Aug 1999)
- Poor post-merger integration (Galpin, Jan/Feb 1997; Altier, Jan/Feb 1997)

Risk is present in all companies and it can occur in most business processes, financial or non-financial. In the case of mergers and acquisitions some of the risks that can be associated are summarised in the following table (Davison, 2001):

Table 1 - Risks associated with M&A activity

Market risks	Poor sales Projections	Market share shrinking	Loss of market share	Interest rates go up
Technology risks	Software licences	Incompatible systems hard and software	Data security	Data integrity
Human resources risks	Culture differences	Benefits/ pay scales	Trade unions	Job security
Internal control risks	No controls	No policies/ procedures	Inadequate segregation of duties	Incompatibility of internal control structure
Financial risks	Overbidding	Accounting irregularities	Unrecorded liabilities	Overvalued assets
Legal risks	Product liability	Antitrust concerns	Environmental concerns	Patents/ copyrights/ trademarks
Corporate image risks	Brand image	Hostile M&A process	Potential layoffs	Unhealthy products
Culture risks	Corporate culture	Cultures not compatible	Perception of quality production	Retention of key personnel
Regulatory risks	Lack of familiarity in industry	History of regulatory non-compliance	Heavily regulated target or acquirer	Acquiring a public company

Source: Davison, 2001

The value of internal audit activity comes in the objective assurance and advice that it provides to boards, on the effectiveness of both the risk management processes and the ways in which risks are managed and controlled. Establishing and embedding effective risk management processes is of fundamental importance to all companies. Internal audit has a major role to play in an organisation's risk management control and governance processes. The new *Standards for the Professional Practice of Internal Auditing* emphasises adopting a clearer risk based approach to internal auditing. This links also with the current definition of internal auditing (*Institute of Internal Auditors, 2000*) as an independent and objective assurance and consulting activity.

According to the Institute of Internal Auditors – United Kingdom and Ireland (*Position Statement on Risk Based Internal Auditing, IIA-UK*), risk based internal auditing starts with the organisation's business objectives and then focuses on the risks that have been identified by management. The role of internal audit under this approach is to review the

risk management processes (as opposed to purely internal controls) that are in place to reduce these risks to a level that is acceptable to the board (the risk appetite).

Management of the company has operational responsibility for the risk identification, whilst the role of the Board is to ensure that risk management processes are in place and obtain reasonable assurance from management, internal audit or other functions that the processes are adequate and effective. Risk management is about identifying and assessing key risks and also designing and implementing processes by which those risks can be managed to, and maintained at, a level acceptable to the board.

Risk-based internal auditing refers to a means of assessing how well an organization identifies and manages the major threats to the achievement of its key objectives. Such an approach enables internal audit to provide assurance to the board and the audit committee of an organization, at least annually, that there is an effective overall process to identify and manage the key risks. We must note that careful consideration should be given as to how gain the necessary knowledge and skills in order to undertake this type of internal auditing and also requires a good understanding of risk management processes, tools and techniques at the same time as relying on the basic internal auditing skills of communication, interviewing and objective analysis.

Another important issue of risk-based philosophy is the *Enterprise Risk Management Framework* initiated by the *Committee of Sponsoring Organizations (COSO)* in order to develop a conceptually sound framework providing integrated principles and common terminology. The underlying premise of enterprise risk management is that every entity exists to provide value for its stakeholders and face uncertainties and risks in order to meet its objectives. On the other hand, management has to determine how much uncertainty the entity is prepared to accept as to strive to grow stakeholder value.

Internal auditors play a key role in evaluating the effectiveness and recommending improvements to enterprise risk management process. The scope of internal auditing should encompass risk management and control systems and this includes evaluation of reporting reliability, review of the effectiveness and efficiency of operations and compliance with established laws and regulations. The internal audit function does not have primary responsibility for establishing or maintaining enterprise risk management, but internal auditors should assist both management and the audit committee by monitoring, examining, evaluating, reporting and recommending improvements to the adequacy and effectiveness of management's enterprise risk management process.

Briefly, we can note that risk-based internal auditing provides independent assurance to the board that the risk management processes within the organization (covering all risk management processes at, for example, corporate, divisional, business unit, business process level) are operating as intended and also the responses which management has made to risks are both adequate and effective in reducing those risks to a level acceptable to the board. The scope of risk-based internal auditing covers business risks relating to all business activities and the key starting point are to determine that appropriate objectives have been set by the organization.

III. Empirical evidence on the internal audit role during mergers and acquisitions

Although there is a great number of articles concerning the issue of mergers and acquisitions, little research has been done for the issue of internal auditing contribution to the various stages of a merger. According to *Roger Cook (1993, pp. 28-32)*, the internal audit function is potentially in a strong position to improve the quality of management

throughout the acquisition process, and provide a service, which can significantly affect the organisation's profitability.

This potential depends on two major factors, organisational status and knowledge. For the first issue, internal audit's ability to contribute to the acquisition process will depend on the department's scope of review, the resources available and its authority to gain access to records and personnel. Internal audit should also be closely involved in reviewing systems with the acquired company and establishing control by the holding company over the activities of its subsidiaries.

The second issue relates with the knowledge and understanding of the acquirer's advantages and disadvantages at the pre-acquisition stage. During this stage is where the scope for review is likely to be most limited but may be of real benefit to the organisation. The internal auditor's contribution at this stage is moderate although it can have a more expanded role (*Selim et al, 2002*). This happens because often companies focused on making the acquisition happen and then worried about integration and auditing. The role of internal audit varies at different times during the M&A stages. At the pre-acquisition stage is where the scope for review is likely to be most limited but it may be of real benefit to the organization. Also, at the post-acquisition stage there is a need to rapidly establish effective potential control of the new entity.

According to *Robert Cook (1993)*, at the pre-acquisition stage internal audit can review the candidate and start on preliminary review of its control environment. In this review internal auditors should have in mind the potential fit of this candidate. The likelihood of achieving a successful combination of the businesses can be assessed in three ways: business fit, financial fit and organizational fit. The purchase of an existing business provides opportunity but is also a high risk strategy. Despite the speed and uncertainty which can accompany acquisition decisions, internal audit should seek to become involved as early as possible. Once an acquisition strategy has been determined, the value of audit review is enhanced if findings are geared towards preparing the company for diversification. If appropriate systems, structures and a control environment are already in place then the battle is half won before it begins.

Traditionally, internal auditor's contribution on a merger is greater at the stages of due diligence and post acquisition integration. *Selim et al (2002)* observed that the actual participation of internal auditors at these stages is high. Also, *Davison (2001)* suggests that most of the auditors, who responded to a survey conducted by the Institute of Internal Auditors in 1998, stated that they performed only due diligence testing in regard to new mergers activity.

It is critical that the internal auditors involved in the merger process provide due diligence. Due diligence can mean the difference between M&A success and failure (*Aldhizer and Cashell, 2000*). Unfortunately, the internal auditing literature on due diligence is fairly sparse and the literature that does exist concerns only with due diligence associated with joint ventures (*Applegate, 1998; Aldhizer and Cashell, 1999*). Given the short time period and lack of familiarity with the business, it is possible to overlook key business risks, significant control weaknesses and fraudulent financial reporting before signing an acquisition agreement. The comprehensive M&A integration strategy analysed below is currently under development by IBM and includes internal auditing as an important member of the integration team (*Aldhizer and Cashell, 2000*). It is made up of four phases:

- Forming a business resources team and generating cooperation among M&A stakeholders.
- Conducting pre-acquisition due diligence.

- Developing the post acquisition integration strategy.
- Conducting post acquisition due diligence.

Post-acquisition management and integration has been called ‘a most important, albeit difficult, task’ (Jones, 1982). The key to success is to implement effective control while at the same time motivating management to maximise performance. There is an opportunity for internal audit function to make a significant contribution to the development of more effective post-acquisition management skills, by promoting techniques of effective control combined with measures that ensure people are highly motivated. Also, internal audit reports presented to both senior management and the board can alert company directors to the lurking dangers to which they may be exposed if the company is not diligent in its post-acquisition management (Cook 1993).

One of the most useful things that internal audit can do in an acquisition situation is to conduct ‘current-state assessment’ of the business processes of both the acquired and the acquiring company. Also, audits can assist in post-merger implementation by helping to plan the integration efforts and, in addition to all the financial and physical integration plans, develop a separate human resources and cultural integration plan (Davison, 2001). At this important stage it is critical for bidder firm to put in place the merged organization that can deliver the strategic, synergy and value added results, taken into consideration that during post-acquisition stage merged organizations must have the capabilities to overcome all difficulties and obstacles with well defined goals, communication plans, benchmarks, etc. This period is also a time of great uncertainty for all employees and thus a well planned integration plan should include strong communication channels in order to facilitate and smooth integration process.

An initial diagnosis of the subsidiary should address three key areas of control and the internal audit team should have delegated authority to require the subsidiary to meet the parent’s standards where necessary. This diagnosis can split in two phases. The first phase is concerned on the establishment of control over subsidiary through reporting systems, structures and people. The second phase analyzes the possibility to extract synergy through operational audits on the use of assets, economy and efficiency and finally the comparison of the outcomes with original strategy and review effects of integration on products and communication.

A good example of practice on risk-based internal auditing and the transformation from traditional audit techniques during a merger is the case study of California Federal Bank (Lindow, 2002). According to this case study, California Federal Bank set as strategic objective to become a first-class West Coast financial institution. To make this happen it required numerous acquisitions and integration as well as the development of new business lines and products. How the company managed risk from all these changes was critical to success.

In order to identify risk areas and continuously monitor the company’s risk profile, they had to transform the internal audit department from its traditional role-performing checklist activities – to one that focused on corporate and business unit goals, strategies and risk management processes. To achieve this restructuring, the steps were as follows:

- Define internal control
- Adopt best practices (monitor business activities and key performance indicators, co-ordinate with other risk management functions, develop the audit plan based on risk priorities, get involved in technology projects)
- Become part of the process (loss management, auto lending, wire transits etc.)

- Develop a strategic plan (provide for a mix of skills sets within the audit group, ensure that auditors update risk assessments and monitor the risk indicators on an ongoing basis, establish the team's communication strategies and reporting formats)
- Create client service teams
- Deliver services and communicate findings
- Gain respect

Internal auditors can be used also as bridge builders between the merging parts. For example, in the case of California Federal Bank (Lindow, 2002), audit facilitated a meeting between the merging parts, which led to a redesigned loan-funding process using more automation and increased cost savings. The internal audit team also attended meetings between the subsidiary's underwriting and loan service groups, participated in discussions and reviewed reports.

On the other hand and as the role of internal auditor continues to evolve, the recent emphasis of the new definition of internal auditing to consulting activities has brought new questions and concerns regarding the ability of internal auditors to function in an independent and objective manner. *Brody and Lowe (2000)* examined whether the internal auditors' judgements are dependent on their company's role (buyer or seller) in an acquisition. Results revealed that the role of the company in the negotiation process did influence judgments. This suggests that internal auditors are likely to assume the position that is in the best interests of their company.

Finally, we can note that when audit teams integrate into other functions throughout the business and go beyond traditional methods, they have the ability to add value by offering better, more proactive audit services and improving an organisation's risk management strategies. With investors, regulators and the media placing companies under greater scrutiny in today's climate, internal auditors can expect to have a more prominent role as part of the risk management processes.

IV. Conclusion

This paper tried to explore the internal audit role during the various stages of M&A projects. M&A projects encounter a great number of risks and, in the majority of studies, end up in failures and loss of shareholder wealth. These exposures are often the reasons that lead to major failures in the financial or operational area for the recently constructed entity. On the other hand the role of internal audit function has changed during the last two decades. Internal auditors have evolved from their traditional role of internal control experts to a more proactive and risk-based approach. This means that they moved forward from the assessment of internal controls to a more advisory and consulting role and from a primarily control-based approach to a predominantly risk-based approach.

Although the perception that internal audit profession has evolved from a "box-ticking" activity to a more risk-based and consultancy function in the organizations, internal audit practitioners often are reluctant to change embedded management view about the roles and responsibilities of internal audit function during an M&A project. The main responsibility for a future greater level of internal audit participation in M&A projects remains to top management but, on the other hand, management of the internal audit department has to give the direction and convince audit committee for the quality of its opinion.

A possible opportunity for a possible future expansion of internal audit's role in M&A project is the introduction of **Sarbanes–Oxley Act (2002)**. The Act does not explicitly mention mergers and acquisitions; however acquisition minded companies that fail to consider the Act's implications may be in unpleasant surprises. Since the certification and attestation requirements of Sections 302 and 404 apply to internal controls over the company's entire financial statements – including acquisitions completed before the reporting date – the Act may have an impact on certain merger and acquisition processes. The practical impact for companies is that Section 302 assessments will have to include acquired entities, beginning with the first quarter – end after the acquisition. Management must also consider the impact of acquisition on its 404 assessment.

Knowing that management's certifications under Sections 302 and 404 of the Act will ultimately apply to acquisitions, internal audit team can consider the materiality of a target relative to the business and also the quantitative and qualitative elements of materiality. Internal audit teams can be involved at the pre-acquisition stages in order to assess the materiality (alongside with top management of the target company) and also assess the ways management will accomplish compliance. After the acquisition, internal auditors can participate on the documentation of internal controls; assess their design and operating effectiveness as well as the level of compliance with those of the bidder firm.

Management could fail also to identify and anticipate non-recurring transactions such as mergers and acquisitions or also fail to establish appropriate policies and procedures. Internal auditors can ensure the existence of non-routine written policies and procedures and consult, for example, on the completeness of specific responsibilities or the procedures for the flow of communication of working group with senior management or the audit committee.

The role of internal auditor continues to evolve and the recent emphasis on consulting activities has brought concerns regarding the ability of internal auditors to function in an independent and objective manner. Internal auditors need to explore their consulting role as one in which they provide objective feedback to management. Internal auditors must continue to demonstrate that they add value to their organization but they need also to perform their consulting role very carefully in order to maintain their unique aspect of independent and objective assurance in the organization.

This new role and task should not jeopardise their “traditional” role as internal control experts and overcome major operational or compliance risks and controls in the organization. Management of the internal audit department, audit committee and the Board of Directors are in a position to define and use internal audit function as important tool for the attainment of corporate objectives and their participation in specialized projects such as M&A. On the other hand, we must note that there is no evidence in this paper that mentions a surely positive outcome for the bidder company if internal audit function actively participates in an M&A projects and best practices were followed.

By providing an objective and proper assessment or evaluation of business risks attached during an M&A project, internal audit function can challenge and find new opportunities for the expansion of their role to a more pro-active and consulting role apart from its “internal control” based role. In order to effectively meet predefined objectives, it is essential that internal audit function and internal auditors have access to all appropriate information, sites, systems, processes and people. In addition, management of the internal audit department should ensure that the remit of internal audit function is understood and respected at all levels within the organization, communication with internal audit is on an honest and open basis and also internal auditors are not excluded but seen as valuable function within a new environment.

Also, significant emphasis on verbal and flexible communication with management at the planning and pro – active stages is essential, because on going communication with management during the assignment execution ensures that factual matters are confirmed and verified. This communication can be facilitated, if internal audit function has sufficient status within the organization, in order to perform its work free from interference. It can be enhanced by having direct access and periodic meetings with the audit committee and also open communication lines with senior management to ensure critical issues are addressed on a timely basis.

Finally, management of the internal audit department should also ensure that internal audit function is adequately resourced in terms of budget and staff and sufficient level of knowledge and experience of the business processes, business risks, best practice controls, regulatory requirements and audit tools and methodologies. This level of expertise can be supported with the implementation of an effective training process that will provide the internal audit department with a range of skills in order to fulfil its mission effectively. A well designed training program enable internal audit's ability to provide and demonstrate its value service and facilitates the transfer of accumulated skills and experience into the business.

The people who are responsible for the expansion of internal audit role during the stages of M&A projects are primarily internal auditors (and more specifically management of the internal audit department) and top management. On the other hand, audit committee and Board of Directors can set a disciplined framework and the appropriate “tone at the top” in order to guide internal audit function to a more consulting role in the organization and more actively participation in M&A projects as a service to risk management process of the company.

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Nikolaos P. Dounis (BBA, Msc, PhD) is a Senior Internal Auditor at Cosmote Mobile Telecommunications S.A., Athens, Greece. Prior to joining Cosmote he was at PriceWaterhouseCoopers, Athens, Greece working as internal audit consultant. His Master's and PhD degrees were awarded at Cass Business School, City University, London. His main research areas are internal auditing, risk management and corporate governance and his working experience is mainly in Sarbanes-Oxley compliance projects and operational audits. In 2005, he received a PhD colloquium award for distinctive performance and best presentation at the Third European Academic Conference in Internal Auditing & Corporate Governance by the IIA - UK & Ireland and his research was partly funded by the Institute of Internal Auditors Research Foundation.

Cosmote Mobile Telecommunications S.A. is the leading mobile operator in Greece. It is a member of OTE Group of Companies and the market leader in Greece and also has a major market share in the Southeast Europe mobile telecommunications subscribers.