The Role of Internal Auditing During Mergers & Acquisitions: The European Union Experience

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ABSTRACT

Mergers and acquisitions (M&As) represent a dynamic process of corporate culture and strategy. Empirical evidence indicates a high rate of failure of M&As to create value for the shareholders of the firms. On the other hand, internal auditing has evolved dramatically from its traditional role of control orientation to a more proactive, risk-based, and consultancy role. Despite this evolution, the evidence shows that it has not effectively contributed to the M&A activity. This study will try to analyze the present level of involvement of the internal audit function during the M&A activity and compare it with the preferred and ideal levels of involvement. This comparison will lead to the identification of possible gaps between these three different levels. This gap analysis will identify the possible reasons for this low level of involvement and possible means and prerequisites for participating more actively in specialized M&A projects. Finally, we will try to formulate and validate a best practices model of a more expanded level of involvement at the different stages of M&As, as well as a list of potential prerequisites and actions for this expansion.

EXECUTIVE SUMMARY

Evidence assembled by several studies points to a high rate of failure of mergers and acquisitions to create value for the shareholders of the acquiring firm, and it can occur at any of the stages of an M&A. On the other hand, although the internal auditing profession has expanded its role beyond traditional assurance activity to a more proactive and consulting function, mergers and acquisitions does not seem to be an area that has an effective contribution apart from the post-acquisition stage.

A sample of 120 bidder companies that pursued mergers and acquisitions in the European Union area during the sampling period (January 1, 2000 – June 30, 2003) were selected and a postal questionnaire was sent to chief audit executives (CAEs) to collect preliminary data. Thirty-four (34) questionnaires were returned (28% response rate) and data was analyzed. Furthermore, we 1) selected a number of internal audit managers and practitioners different from those participating in the first stage of the research, 2) conducted semi-structured interviews, and 3) validated our descriptive data results.

Descriptive and empirical data analysis has revealed a number of interesting points concerning the current and preferred situation in the internal auditing departments in the sample organizations. A number of gaps identified during the descriptive data analysis were discussed and validated through the interviews, providing also the motivation to collect interviewees' opinions on the possible prerequisites in order to bridge the gaps between current and preferred roles.

Finally, through descriptive and empirical data analysis we collected and evidenced a number of current and preferred best practices that can prove quite useful as a benchmark for an internal auditing department contributing at any of the stages of an M&A project.

I. Introduction

The internal auditing profession faces many challenges in the new millennium. Motivated by the universal mandate to minimize expenses and boost or at least maintain profits at a reasonable level, internal auditing departments are desperately seeking ways to add value and prove that they can still "do the business" for their employers.

The topic of this research is concerned with the internal auditing role during specialized projects such as mergers and acquisitions, with specific reference to organizations in the European Union. Internal auditing's role has changed over the years from traditional to risk-based, proactive, and internal consultant. Unfortunately, even though internal auditing has expanded its role in many business processes throughout organizations, mergers and acquisitions activity does not seem to be an area that has effective contribution, apart from the due diligence stage. Perhaps one of the reasons is that management does not feel that internal auditors have the necessary skills to be actively involved in all stages of a deal.

In 1998 The Institute of Internal Auditors (IIA) conducted a survey and asked auditors at random where they felt internal auditing was heading, given all of the mergers and acquisitions activity (Davison, 2001[1]). The answers were as follows:

- Most of the auditors who responded stated that they only performed due diligence testing with regard to new mergers and acquisitions activity.
- Audit directors seemed to be involved at least in the preliminary discussion stages of any new business combination.
- Most respondents felt that more value could be added to the mergers and acquisitions process by the auditing department if their roles were allowed to expand.
- For those auditing departments involved in the mergers and acquisitions activity, "specialized" auditors were usually taking the lead rather than a team of auditors from the internal auditing department.
- Most respondents agreed that culture differences and poor planning were the top two reasons for mergers and acquisitions failure.
- Almost all of the respondents felt like they needed more training in mergers and acquisitions in order to sit at the same table with the planning and implementation team.

We can conclude from this that there is a potential and a need for a thorough study in the internal auditing role in European Union mergers and acquisitions. The internal audit function is potentially in a strong position to improve the quality of management throughout the M&A process and this research will try to analyze its contribution to the various stages and provide a basis for further analysis.

[1]Davison, Barbara, *Understanding the Mergers and Acquisitions Process* (Altamonte Springs, FL: The Institute of Internal Auditors), 2001.

Managers and top management often do not understand the importance of effective internal auditing in all the stages of a merger. In an international study conducted (Selim et al., 2001[2]), the internal auditor's actual participation in the different stages of mergers and acquisitions was as follows:

- Strategic planning — 27%
- Specific acquisition planning — 14%
- Deal structuring and negotiation — 82%
- Post-acquisition integration — 86%
- Post-acquisition audit — 41%

The need for this project arises from the increasing importance of mergers and acquisitions in an organization's strategy. It will focus on the European Union companies trying to "decipher" the unique business environment in which they operate. It will also analyze the interdependence of the various functions in the M&A process and the contribution internal auditing can bring to the table.

II. Research Objectives and Questions

The main objectives of this research are to:

1. Describe and understand the role internal auditing currently plays in the European Union companies that pursue mergers and acquisitions.
2. Examine the relative contribution of the internal auditing function to the various stages of M&As.
3. Describe and analyze the preferred role internal auditors would like to play in European Union mergers and acquisitions.
4. Develop a normative model based on the extensive literature review.
5. Identify and analyze the gaps between the current, preferred, and ideal situation.
6. Develop a best practices model valid for internal auditing departments in the European Union mergers and acquisitions.
7. Provide a list of prerequisites that are essential for internal auditing in order to play a more active role in the M&A process.

The extensive literature review provided empirical evidence assembled by several studies in the United States, United Kingdom, and other countries that support the hypothesis of a high rate of failure in the mergers and acquisitions process. This failure can occur at any of the stages mentioned: corporate and acquisition strategy, valuation and due diligence, post-acquisition integration, and post-acquisition audit. The increasing importance of mergers and acquisitions activity to corporate strategy and the record of failure of such strategies in creating value, both in the United States and the European Union, gave us the motivation to research the role internal auditing can play in the process.

This research highlighted the role of internal auditing in leading-edge organizations in the European Union. By providing a proper and objective evaluation of business risk, internal auditing can contribute to minimizing the various risks in the process. By analyzing the following research questions (see Table 1) the researcher hopes to decipher some useful findings which will make a significant contribution to the issue of the internal auditing role in European mergers and acquisitions and obtain useful results and feedback in order to validate and update the best practices model.

[2]Selim, G.M., Sudarsanam, S., and Lavine, M.K., *Mergers, Acquisitions, and Divestitures: Control and Audit Best Practices* (Altamonte Springs, FL: The Institute of Internal Auditors Research Foundation), 2002.

Table 1
Summary of Research Questions

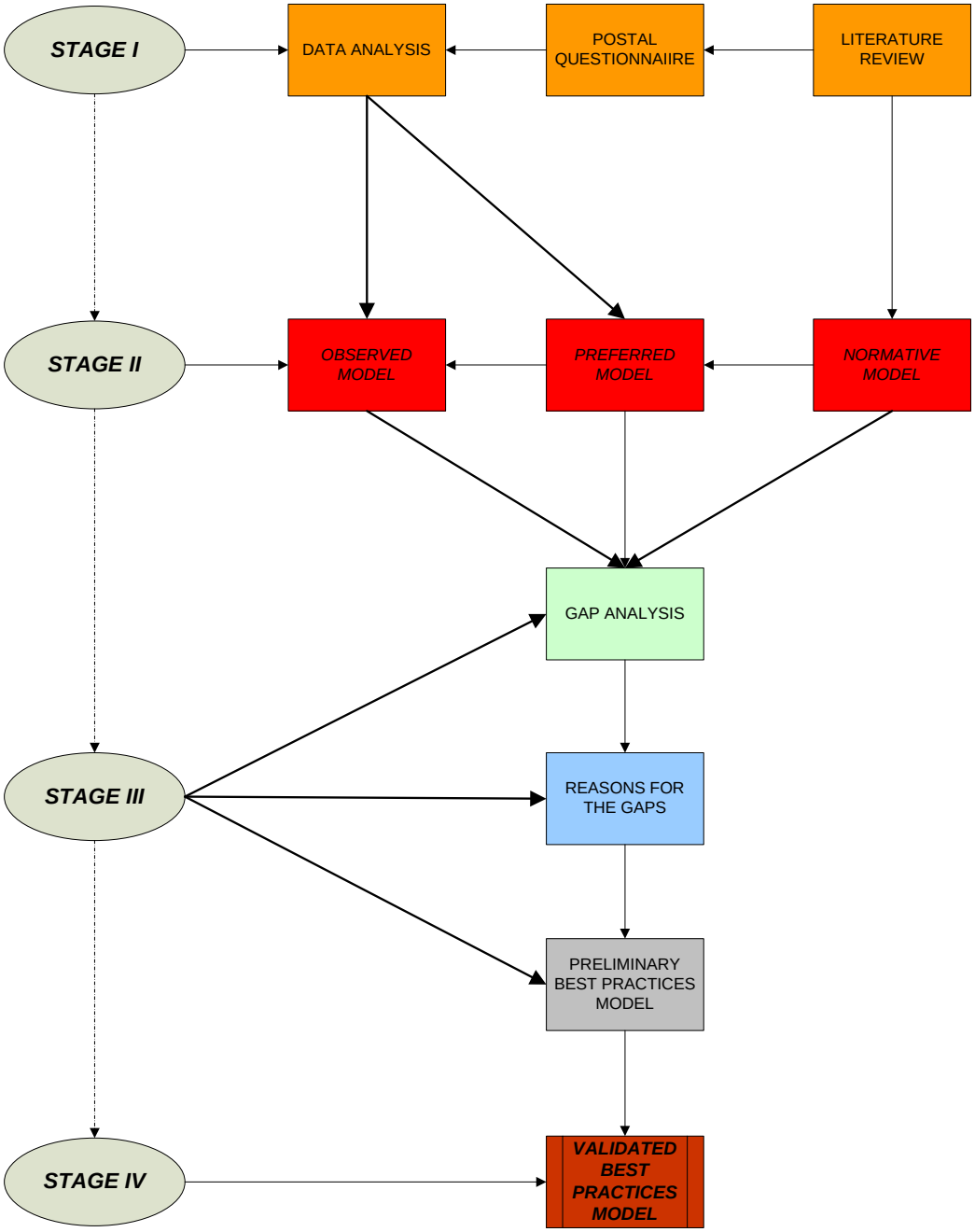
Q1:	What is the role internal auditing currently plays in leading-edge organizations in the European Union that pursue mergers and acquisitions?
Q2:	What is internal auditing's contribution to the various stages of a merger, and what role can it play in complementing and enhancing the other functions involved?
Q3:	What are the preferred roles internal auditors would like to play in the mergers and acquisitions process?
Q4:	What is the "ideal" situation for internal auditing's involvement in the mergers and acquisitions process according to empirical evidence and literature review (normative model)?
Q5:	Is there a gap between the current, preferred, and "ideal" role internal auditors would like to play and, if yes, what are the reasons for this gap?
Q6:	Can we develop a model(s) of best practices of the internal audit function that would enhance the effectiveness of the merger process of European companies and help firms achieve their strategic objectives?
Q7:	What are the prerequisites that are essential for the internal audit function in order to play a more expanded role, and how will they interact with the best practices model suggested for European companies?

The research methodology for collecting and analyzing available data in order to finally suggest a best practices model is described below (see Figure 1). The *first stage* includes the literature review. From that we can more easily explore and develop a normative model of what managers and internal auditors should do in the mergers and acquisitions process. The literature review included reference texts on mergers and acquisitions, internal auditing and risk management, and also various texts from journals.

The literature review was conducted using:

- The university's collection of books and articles;
- A wide range of available databases (e.g., ABI Research Inform, Thomson Financial) to search for publications in the area of internal auditing in the case of mergers and acquisitions written by academics as well as practitioners.

FIGURE 1 – RESEARCH METHODOLOGY



The literature review led to the formulation of a questionnaire. Then we conducted a selection of European Union companies merged in the period January 1, 2000, to June 30, 2003, from *Thomson Financial DataStream*, and the questionnaires were distributed by post. In total, 120 CAEs took part in this survey. The questionnaire was accompanied by an explanatory letter, and a follow-up questionnaire was mailed out two or three weeks later.

The *second stage* included the analysis of the returned questionnaires. From their view and perception we can analyze the observed situation — how internal auditors and managers act in a merger. This observed situation was then linked to the preferred situation — what the managers and internal auditors like to do during a merger.

In the *third stage* these three models (observed, preferred, and normative) were linked and a gap analysis was performed. Analyzing the reasons for the gaps, we formulated a preliminary best practices model for the role of internal auditing in European Union mergers and acquisitions.

In the *fourth and final stage* we selected a number of organizations, representative in terms of sector and country, and conducted semi-structured interviews in order to validate the model formulated at the previous stage. The response rate was low. Finally, we conducted interviews with ten practitioners in the internal auditing area whose organizations participated in M&A projects. These key findings formulated the best practices model, action plan, and recommendations for a more effective internal audit contribution to European Union mergers and acquisitions.

III. Descriptive Data Analysis

The data description phase provides the researcher with the necessary means in order to present the collected data in a comprehensive manner through the use of tables and figures. Data description analysis provides useful insight as to the nature of responses obtained and shows in absolute or relative terms how often the different values of the variable are among the units of analysis. In this research the statistical package *SPSS 11.0 for Windows* was used in order to facilitate the actual statistical analysis.

In total, 120 CAEs took part in this survey. Each director received a questionnaire, an accompanying letter explaining the purpose and objectives of the study, and a "glossary of terms" that explained some key words in the questionnaire. Out of 120 questionnaires that were mailed, 34 (28%) were eventually completed and returned by September 1, 2004. Data analysis revealed the representation of industrial sectors included in the sample. Figure 2 shows the proportion of industries included in the sample in two general categories — manufacturing and services. Figure 3 displays the primary industry of the organizations that took part in this survey.

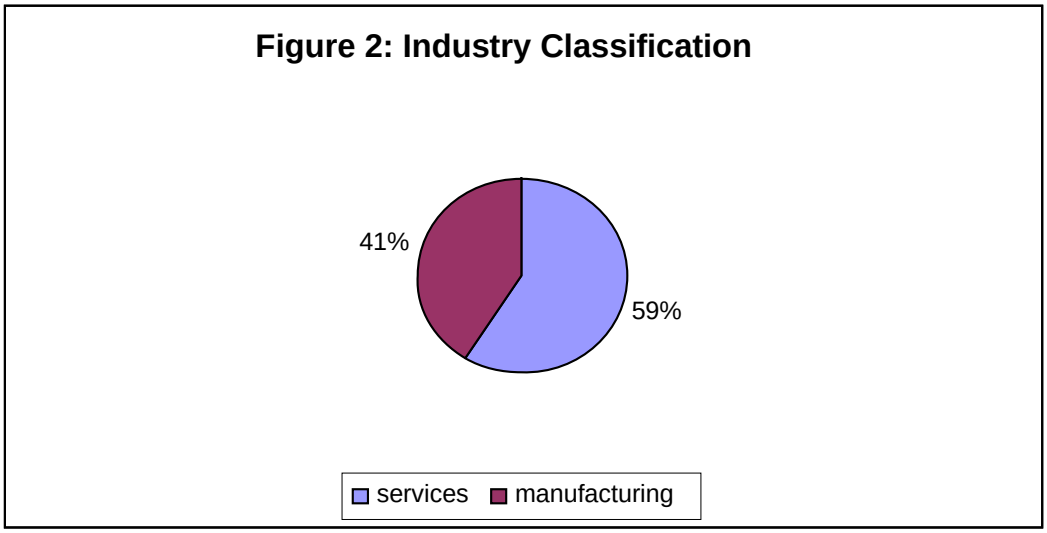
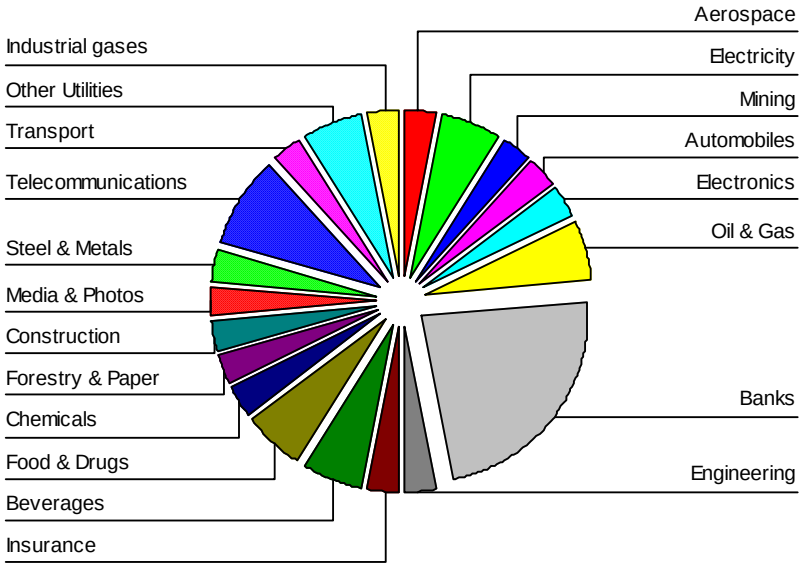
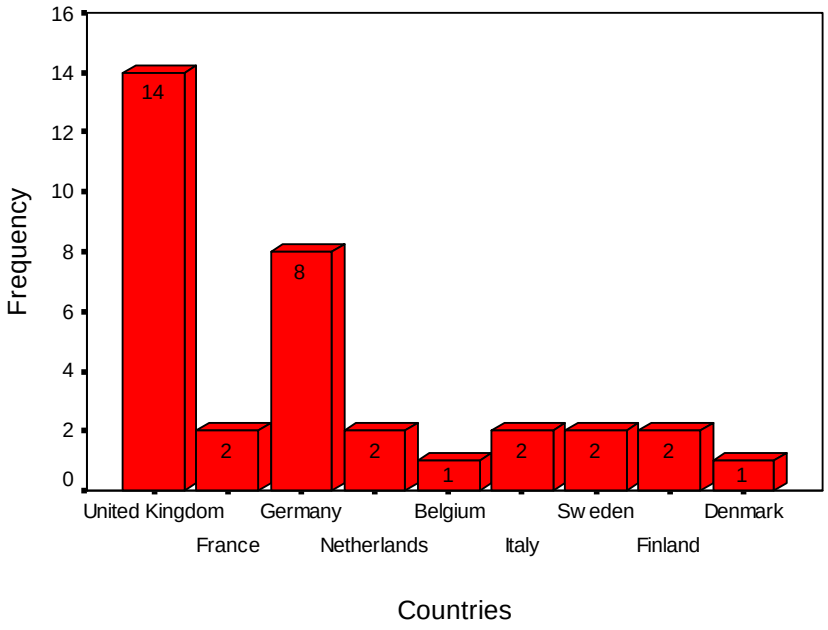


Figure 3: Specific Industry Classification



Because of the nature of the European Union, we have included companies from all 15 countries of the Union in the sample. Figure 4 represents the distribution of returned questionnaires by country.

Figure 4: Country Classification



The results also illustrated that a majority of participating internal auditing departments were established in the organizations for more than 20 years (67.6%) and only a small percentage was established the previous year (2.9%). It was also illustrated that 19 out of 34 organizations (55.9%) employ more than 20 auditors and 6 out of 34 organizations (17.7%) employ more than 10 auditors, indicating that the majority of the organizations employ more than 10 auditors in their organizations.

In our study the majority of audit executives responded that internal auditing has a role to play in the M&A process (strongly agree, 20%; agree, 50.6 %), and a small percentage were either uncertain (11.8%) or disagreed (17.6%). Another interesting point that forms the basis for the analysis of the current and preferred roles of the internal audit function during an M&A is that most of the respondents felt the preferred role of internal auditing in their organization should be more proactive rather than post-mortem. Twenty-four out of 34 directors (70.6 %) agreed that they prefer their roles expanded at all stages of the merger.

Keeping in mind their rich organizational expertise, we asked them if internal auditing, from their point of view, can add value to the M&A process. The CAEs agreed (64.7%) and strongly agreed (17.6%) that internal auditing can add value to the M&A process with a small percentage uncertain about the "value added" role. Also, we asked them if internal auditing could add more value to the M&A process if allowed to expand and cover all the stages of the deal.

Results are not surprising and show the trend of CAEs perceiving that a more proactive internal auditing contribution can possibly add more value to the process. More specifically, half the respondents agreed that a more expanded role could offer greater value for the deal.

On the other hand, 32.4% of respondents indicated they are uncertain about the contribution and value of an expanded role.

A high percentage of respondents agreed that internal auditing can add value to the M&A process. But if we summarize the actual against the preferred role of internal auditors (Table 2), we can conclude that although a high percentage (82.3%) prefer to act "after the fact" and coactively as risk-based auditors or internal consultants, 29.4% currently act as watchdogs and internal control experts, 5.9% as box checkers, and 8.8% have no role during the M&A process.

Table 2
Summary of Actual vs. Preferred Role

ROLES	CURRENT ROLE	PREFERRED ROLE
Box Checker	5.9 %	2.9 %
Watchdog & Internal Control Expert	29. 4 %	8.8%
Risk-based Auditor	35. 3 %	58. 8%
Internal Consultant	8. 8 %	23. 5%
No Opinion	5. 9 %	2. 9%
None	8. 8 %	-
Other	5. 9 %	2. 9 %

The next step in this study was to analyze the contribution of internal auditing at the various M&A stages according to the current and preferred situation. Starting from the current situation (Table 3), we note that the great majority of respondents are not involved or have no involvement during the strategy development stage.

Surprisingly we can note the same trend for the due diligence stage. Finally, at the post-acquisition integration stage we note a balance between no or little involvement and moderate or major involvement, and in the post-acquisition audit stage the majority of respondents had moderate or major involvement.

Table 3
Summary of the Contribution of Internal Auditing at the Various M&A Stages – Current Situation

Stages / Extent of Involvement	M&A Strategy Development	Due Diligence	Post-acquisition Integration	Post-acquisition Audit
Major Involvement	-	8.8 %	11. 8 %	52. 9 %
Moderate Involvement	2. 9 %	11. 8 %	35. 3 %	26. 5 %
Little Involvement	20. 6 %	32. 4 %	26. 5 %	8. 8 %
Not Involved	67. 6 %	41. 2 %	20. 6 %	5. 9 %
None	8.8 %	5. 9 %	5. 9 %	5. 9 %

Summarizing the results for the preferred situation of the contribution of internal auditing to the M&A stages (Table 4) we note that apart from the strategy development stage, a great majority of respondents do not prefer to be involved or prefer to have little involvement. At the other three stages (due diligence, post-acquisition audit, and post-acquisition integration), the majority of respondents prefer to have a greater level of involvement.

Table 4
Summary of the Contribution of Internal Auditing at the Various M&A Stages – Preferred Situation

Stages / Extent of Involvement	M&A Strategy Development	Due Diligence	Post-acquisition Integration	Post-acquisition Audit
Major Involvement	-	17. 6 %	23. 5 %	73. 5 %
Moderate Involvement	11. 8 %	47. 1 %	41. 2 %	17. 6 %
Little Involvement	38. 2 %	14. 7 %	14. 7 %	-
Not Involved	32. 4 %	14. 7 %	11. 8 %	-
None	17. 6 %	5. 9 %	8. 8 %	8. 8 %

In summary, the stages, in the descending order of the degree of internal auditing's involvement, are as follows:

- Post-acquisition audit
- Post-acquisition integration
- Due diligence
- M&A strategy development

When comparing the normative model to the observed and preferred practitioner models for M&A activities, a number of gaps have been identified. Although a great majority of CAEs prefer to expand their roles during the M&A process, data analysis revealed that almost a third of respondents continue to act "after the fact" and not proactively. Also, their contribution to pre-acquisition stages (such as strategy development and due diligence) is low to moderate.

At the third stage of this research, we conducted semi-structured interviews with practitioners in the internal auditing area in order to identify and present the reasons for the gaps previously analyzed. These gaps can be categorized as *general*, *management related*, and *internal audit related*. Also, useful recommendations for an effective internal audit involvement in M&A activities could be used to present a variety of opportunities for internal auditing to actively participate in and respond to the needs of their organization in a more proactive and consultancy role.

We must also note that this expansion can be achieved if certain prerequisites can be incorporated into the internal auditing department's philosophy and scope. A number of specific suggestions were made by interviewees in order to assist internal auditing departments achieve these prerequisites. According to the literature, these prerequisites can, for example, be a good understanding of the various sources of risk to which business units are exposed, experience in operating businesses, good interpersonal skills, recognition of the usefulness of internal auditing's contribution to improved systems and processes, and risk management.

The gaps identified during the analysis of descriptive data are:

- A large number of respondents (70.6%) believe that internal auditing has a role to play during the M&A process, and also that their preferred role should be more proactive than postmortem.
- Although the majority of CAEs prefer to expand their roles during the M&A process, this survey reveals that almost a third of respondents continue to act "after the fact" and not proactively. Almost 35% act as "box checkers" and "internal control experts," although almost 90% prefer to act as internal consultants and risk-based auditors.
- Also, their contribution in the pre-acquisition stages (such as strategy development and due diligence) is low to moderate. On the other hand, data reveals that internal auditors prefer to participate earlier — at the pre-acquisition stages — rather than after the fact on post-acquisition audit projects.
- A large number of respondents believe that internal auditing can add value to the M&A process. On the other hand, there is also an important segment of respondents who are uncertain or disagree about the contribution and the value added of a possible expansion of internal auditing into a proactive process.
- Internal audit managers and CAEs believe that their departments are in a position to provide value-added services during specialized M&A projects, but management and the audit committee have the perception that internal auditing continues to act after the fact.

At this stage, we selected a number of CAEs from organizations in the European Union and conducted a number of semi-structured interviews to validate our descriptive data. Participants represented organizations operating in various industries such as banking, manufacturing, and telecommunications, and various countries such as the United Kingdom, Netherlands, Italy, and Greece.

During the interviews we ascertained their views about the current and future potential of the internal audit function, and the information gathered was used to construct the preliminary empirical and observed models in M&A projects. We also tried to analyze and gain understanding of important key issues in the comparison of these three models, such as:

- The reasons for the gaps between current and preferred roles of internal auditing during the M&A process.
- The reasons for low to moderate involvement in proactive roles, despite the great evolution of the internal auditing profession from its traditional "after the fact" role to a proactive activity. These reasons can be categorized as management related, internal audit related, and general.
- Some possible prerequisites in order to expand internal auditing's contribution to the various stages of a merger and convince management to allow a more effective contribution.

We also sought to:

- Indicate, from their rich organizational experience, best practices that can contribute effectively to the internal auditing department in order to provide more value to the merger.
- Provide a potential preferred action plan in the case of a more expanded role and participation of their internal auditing department during the merger.
- Indicate a possible opportunity for the internal auditing profession to expand its role during M&A in the future.

The following table presents the gaps identified in terms of audit scope, focus, level of involvement, and methodology.

Table 5
Gap Identification and Analysis

Models / *Internal Audit*	OBSERVED MODEL	PREFERRED MODEL	NORMATIVE MODEL
FOCUS	Post-acquisition Audit	Due Diligence Integration	M&A Process
SCOPE	Limited	Expanded	Full
LEVEL OF INVOLVEMENT	Low	Moderate	Moderate
METHODOLOGY	Limited Audit of Target Processes	Risk Management	Risk Management
ROLE	Post-mortem	Proactive	Proactive

IV. Reasons for the Gaps

As indicated in the previous paragraphs, the internal auditing profession has evolved through the years, progressing from a control orientation to a risk and consultancy focus. On the other hand we indicated that it has low to moderate involvement in typical proactive stages of a merger such as strategy development and due diligence. We also indicated a number of gaps when comparing the three different models —observed, preferred, and normative. Through semi-structured interviews, practitioners as well as academics indicated the possible reasons for these gaps can be divided into three main categories — management related, internal auditing related, and general.

A. Management-related Gaps

1. The use of internal auditors during the pre-acquisition stage is often prevented by the owners of the target company — they do not want to present their control weaknesses and thus reduce the price of the deal.
2. Management often prefers outside consultants because they believe they have the necessary skills and the needed expertise in order to successfully overcome audit issues. This is also clear from the descriptive data analysis that indicates a great number of deals with the direct involvement of third parties such as investment banks, audit firms, or both. This synergy will often lead to a full package of financial and audit services and thus lower cost.
3. Responsibility remains a key issue because, for example, outsourcing due diligence means shifted responsibilities.
4. Internal audit involvement could be time consuming. Often management wants the deal to be done early and be based on the strategic needs of the organization. Strategic decisions take into consideration possible positive synergies for the bidder company and management does not want to know about control weaknesses.
5. Often, management is not sure about the outcome of the deal structuring process and the negative outcome of preliminary conversations. For time management reasons, management wants to override internal audit involvement, delay the final deal, and allow possible competitors to take part in the deal structuring process.
6. Management of the target company does not want to show or report operational weaknesses.
7. Perception of management that if internal auditing is participating in strategic decisions, there is a danger of impaired objectivity and independence.

B. Internal Auditing Related

1. The attitude of the business is that internal auditing guarantees the control system and thus the role is limited to after the deal is done, not in pre-acquisition stages.
2. Specific tools (such as control self-assessment, risk management, and specialized audit software) are recently introduced and they cannot effectively evaluate mergers and acquisitions. The existing internal auditor's toolkit cannot undertake M&A projects.
3. Internal audit management does not make efforts to change management's perception and does not want to take responsibility for possible failure.
4. Internal auditing departments do not have, in the case of cross-border acquisitions, the necessary knowledge of local regulatory frameworks, economical environment, and political environment.
5. It is often expensive to develop the skills needed in order to effectively and efficiently oversee an M&A project.
6. It is very expensive to develop, through training seminars or employment of experienced staff, a stable M&A team in order to participate in such projects.
7. Small audit departments do not have the necessary budget to participate in M&A projects.

8. In order to participate in M&A projects, the internal auditing department needs to deviate from the yearly audit plan. This type of decision needs the verification of the audit committee and supposes careful planning.

C. General

1. Target companies are reluctant to disclose confidential information to the possible buyer, who is often a competitor, and prefer outsourcing audit consultants who sign confidentiality agreements and report to the buyer in a controlled and confidential manner.

2. In the case of a failed deal, the target company does not want to disclose confidential and sensitive information to the buyer.

3. The buyer's shareholders and management need an independent view and audit of the target company, whereas an internal auditor, working as an employee for the buyer, may be considered to be less independent and biased, depending also on reporting line (often internal auditing departments that report straight to the audit committee are more independent than those reporting to management).

4. Practical experience shows that the buyer is not allowed to use the internal auditing department in the pre-acquisition phase.

5. Some tasks, especially in cross-border acquisitions, have to be executed by local internal auditors (often outsourced) for cultural and effective communication reasons.

6. Administrative functions and legal departments are usually involved instead of internal auditing and they often perceive that possible involvement of the internal auditing department can overlap their activities.

During the descriptive data analysis stage we identified a number of gaps when comparing the current, preferred, and ideal situation. During the interviews we tried to analyze the reasons for the gaps that were presented in the previous chapter. We also tried to analyze the prerequisites in order to bridge the identified gaps. These prerequisites were indicated during the interviews with internal audit practitioners who participated in M&A projects or had great experience in the internal auditing area. The possible expansion of internal auditing's role in the various stages of an M&A project and the use of the best practices that will be presented can be achieved through the incorporation of the prerequisites presented below:

- ***Intention to participate in M&A projects*** — The head of the internal auditing department must intend to participate in specialized audit projects such as mergers and acquisitions or strategic alliances. A good selection of human resources with specialized knowledge and background (e.g., finance, accounting, local and international regulatory framework) can be the basis for the formulation of specialized audit teams in the case of M&A projects.

- ***Active participation of the CAE in the audit committee*** — Possible active participation of the CAE on the audit committee can be helpful and constructive in convincing top management to participate in M&A projects. The audit committee has the responsibility and credibility to convince top management of the possible participation of the internal auditing team in the M&A process.

- ***Independence*** — Internal auditors and CAEs must report directly to the board and the audit committee. Internal auditors should have the support of the board in order to be independent and objective.

- ***Objectivity*** — Internal auditors must remain objective in their performance of consulting activities and make a balanced assessment of all the relevant circumstances. They must not be influenced by their own interests or by others in forming their judgments and thus reflect an unbiased assessment of the situation and the circumstances. This desired level of objectivity and professionalism will not result in a perceived or actual loss of objectivity and thus can assist in effectively playing the role of both monitor and advisor while remaining objective.

- ***Evidence and cases of the effective contribution of the internal audit function in M&A projects*** — Presentation of case studies or evidence of mistakes and failures in M&A projects due to the low level of involvement of internal auditing departments, while underlining the possible value added in cases of a more expanded role, can be helpful for the reversal of top management's perception about the possible role and contribution of the internal auditing department in the M&A process.

- ***Rotation of staff*** — Rotation of staff between internal auditing and administrative functions can be helpful and constructive in gaining experience in the various processes and procedures in the organization.

- ***Use of specialized toolkits*** — Introduction of specific audit toolkits and software with correct parameters for M&A projects could be helpful for the internal audit team assigned to specialized M&A projects. This toolkit can comprise risk assessment software, specific audit programs suitable for the various stages of M&A, and electronic working papers. This bulk of audit work could be saved in a repository database in the internal auditing department.

- ***Responsibility for internal audit opinion*** — Responsibility remains a key issue because, for example, outsourcing due diligence also means shifted responsibilities. The head of the internal audit function can expand internal auditing's involvement in M&A projects if he or she can underline the internal auditing department's level of responsibility in the case of a negative or positive outcome in M&A projects.

- ***Organizational culture*** — An organizational culture that perceives the internal audit function as a value-added activity and encourages and motivates internal audit input as monitor, adviser, and consultant.

- ***Professionalism and professional proficiency*** — Top management's perception that internal auditors have the necessary knowledge and skills in order to monitor, audit, and consult on the target company's systems, processes, and procedures. Top management must also be convinced that the internal auditing department has the necessary expertise to assess control environment and activities of the target company and facilitate opinion at the pre-acquisition stage, as well as have a general overview if the deal is done.

- ***Annual audit coverage plan*** — Because of the nature of the internal audit function, there is always a bulk of audit projects, assignments, and needs. Management and the internal audit function need to establish priorities and obtain the audit committee's formal approval of the plan.

- ***Risk assessment*** — The internal auditing department, together with the management of the bidder and target companies, needs to identify functional and risk areas, prioritize risks, and create the risk profile of the target company.

- ***Reporting findings on key risks and recommendations against the risk profile*** — The key controls and findings of the preliminary audit and subsequent recommendations form the basis for future audit of the newly formed business after the merger.

- ***Good understanding of the target company*** — The internal auditing department needs to function effectively as a member of the newly formed company. It must understand control environment, reporting lines, information systems, and the structure of the target company in order to smoothly integrate the post-acquisition audit.

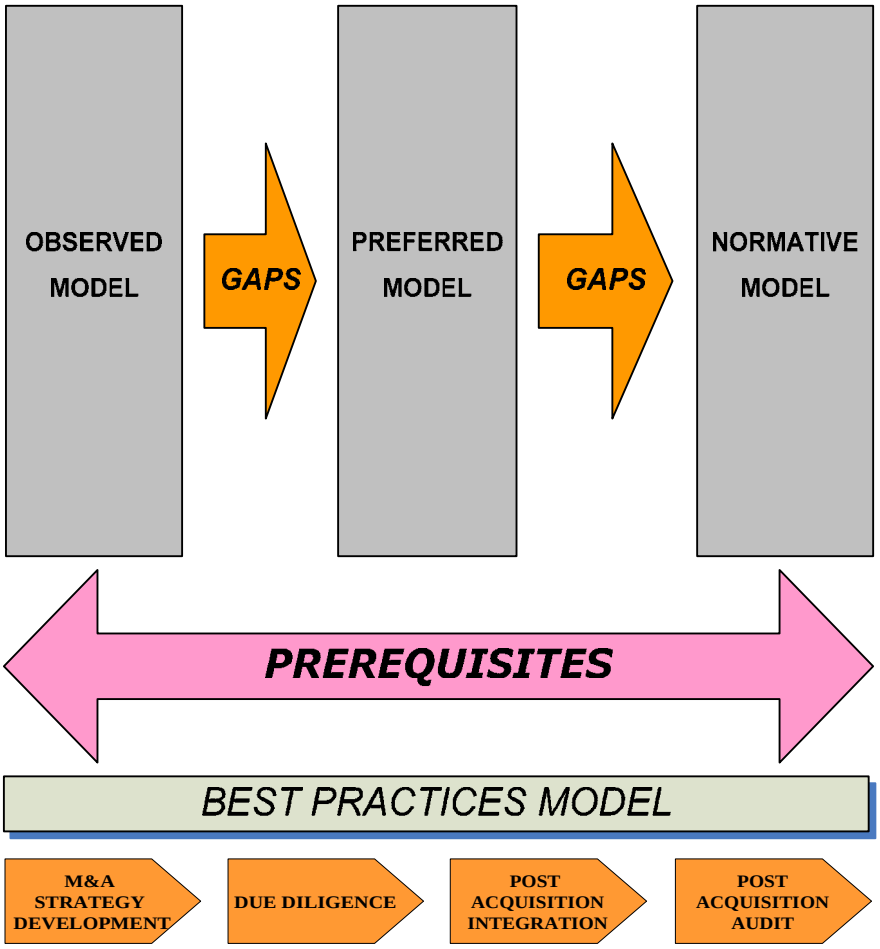
- ***Responsiveness to management needs*** — The ability to respond to future management needs follows from the understanding of the organizational environment and challenges of the target company.

V. Best Practices Model for Effective Internal Auditing Involvement during the Various Stages of M&A Activities

Using the findings derived from the descriptive data analysis and the semi-structured interviews with a number of internal auditing practitioners who participated in M&A projects, we can now present and analyze a variety of best practices valid for internal auditing departments in order to respond to the needs of their organizations and their new proactive and more consulting role during the various stages of M&A.

The previous chapter presented a number of prerequisites in order to fill the gaps between current, preferred, and ideal situations. These prerequisites form the basis for a more effective internal auditing involvement in these types of projects. Figure 5 demonstrates this flow.

FIGURE 5 – BEST PRACTICES MODEL
DURING M&A STAGES



A. M&A Strategy Development Stage

The first stage of every M&A activity is the strategy development stage. Corporate and business strategy has evolved in recent years. Mergers and acquisitions can be seen as major strategic moves in order to gain competitive advantage. Strategy can be effective if goals are simple and long term, through profound understanding of the competitive environment and objective appraisal of resources.

As noted previously, a great majority of internal auditing departments are either not involved at this stage or have little involvement. On the other hand they prefer to have a greater level of involvement despite strategy development being seen as the sole responsibility of top management. Practitioners in the internal auditing area noted their experience and reported a number of useful current or preferred practices derived from their involvement in M&A projects:

- ***Audit the process used in assessing and managing risk*** — A risk-based approach focuses on the identification of risks and can help companies determine what events or circumstances could cause an obstacle in order to meet corporate objectives. According to the new approach introduced by The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Enterprise Risk Management Framework*, the organization identifies risks before the impact of control measures, and measures and considers controls only after risk identification is complete. Internal auditing can play a greater role as facilitator in the event identification and as consultant in the risk assessment stage during an M&A project.

- ***Receive communication about deals from the corporate strategy department*** — The internal auditing department must have all the necessary information about current or future deals, and also about changes in corporate objectives or strategy. If the department does not receive enough information, it cannot effectively assess the possible control environment or entity-level issues of the target company.

- ***Investigate whether control issues were addressed in the planning process*** — M&A deals often are accomplished in a limited timeframe and top management does not take into consideration major control issues or deficiencies of the target company. Internal auditing can assess and indicate whether control issues were not taken into consideration.

- ***Advise on systems and processes that could reduce acquisition risk*** — Integrated internal auditing departments can have the necessary expertise to advise on systems and processes that could help their company reduce or mitigate acquisition risk.

B. Due Diligence Stage

Due diligence is the process of identifying and confirming or disconfirming the business reasons for the proposed capital transaction in the M&A. Internal auditing had not always participated in the due diligence process and, if they did participate, their involvement began later in the process. But internal auditors can provide senior management with vital information about the value of the company being acquired, its financial condition, and any strengths or weaknesses in its financing or internal controls. Because senior management already has partly decided the planned M&A, often due diligence is more of a fact finding mission than a critical step in the decision process.

Very often management perceives internal auditors as fact checkers and not as a source of important new information. This trend, that the majority of internal auditors had little or moderate involvement, was also indicated in the descriptive data analysis of the returned questionnaire. On the other hand, most of the respondents wanted a greater level of involvement during this stage because they already have knowledge of the operations and employees in every important area in the acquiring company and thus can be extremely valuable as key advisers to senior management throughout the M&A process.

Best practices indicated by practitioners and through the questionnaire at this stage are:

- **Conducting due diligence alongside other functions such as finance, accounting, human resources, law, etc.** — During an M&A project, several functions are involved in the process. A good communication level between several functions of the bidder company can help to avoid unnecessary duplicates or additional efforts and inefficiencies. The direction of the bidder company's due diligence efforts depends heavily on what the company expected to gain from the transaction in terms of employees, processes, products, or customers.

- **Developing plans in order to integrate internal audit of merging firms** — It can be useful and time effective to develop preliminary planning for the audit of the newly merged firm. This can be done through preliminary review of the target company's processes, organizational status, and entity-level controls.

- **Ensuring due diligence covers financial, operational, and compliance issues** — Another useful activity of the internal auditing department is to ensure that due diligence has covered all the key and major issues concerning financial, operational, and compliance areas. This objective can be achieved through detailed review and assessment of the documentation carried out by other functions of the firm.

- **Auditing the internal audit function of the target company** — A major issue after the merger process is the integration between the new departments of the merged firm. This can prove time consuming and often leads to corporate failure because of the low level of integration between the various departments of the new firm. The internal audit function of the bidder company can communicate, benchmark, and assess the internal auditing department of the target company. This assessment could lead to a gap analysis between the two functions and planning of the newly merged function in order to bridge these gaps.

- **Ensuring weaknesses identified in due diligence are considered in finalizing the deal** — Internal auditing can assess and follow up on the major issues identified in due diligence. At this point internal auditors can assess the level of compliance with the deficiencies identified and report on the issues that were not considered and that can be proved risky for the success of the M&A project.

- **Working with external consultants carrying out due diligence** — It is common practice to have third-party involvement (such as audit and law firms) and outsource the due diligence stage. The internal audit function has the necessary knowledge and expertise to cooperate and facilitate the work of external consultants, leading to cost and time savings for the organization.

- **Advising on risks and implementation to ensure risks are taken into account** — The internal audit function can help top management during the risk assessment stage and advise on risks and controls in order to mitigate these risks. Risk assessment

allows an entity to consider how potential events might affect the achievement of the objectives during an M&A project.

- **Ensuring awareness of regulatory and other compliance matters** — Mergers and acquisitions are bounded with tough regulatory frameworks concerning the issue of competitive advantage and avoidance of monopolies or oligopolies. These frameworks (especially in the European Union) had been the reason for large M&A failures and cost heavily in order to comply with these regulations. Internal auditors can help during the M&A process based on their expertise and documentation of different regulatory issues. A main aspect of the COSO framework is compliance with laws and regulations, and the main responsibility of this compliance rests with the internal audit function.

- **Auditing the business processes of the target company** — Another important factor in the M&A process could be the audit of the business processes of the target company. A diagnostic review of the main processes and mapping of the main risk areas and control activities in place can be quite useful for future audits. This review can save time during the post-acquisition audit that can be focused on the testing of documented controls.

C. Post-acquisition Integration

The term "post-acquisition integration" refers primarily to the combination of two or more companies. The first post-acquisition stage, along with well integrated mergers, can be a positive force for the successful completion of the deal. At this important stage, the main objective is to integrate smoothly into one merged firm and accomplish the planned level of synergy. Integration can be risky because it is a time of great uncertainty for human resources, especially in the target firm.

As indicated earlier in this research, internal auditors have a greater level of involvement during this stage. They prefer also to have a greater level of involvement and help the company generate cost savings and possibly minimize acquirer's risk and possibility of failure. According to the practitioners, internal auditors at this stage are able to:

- **Play advisory roles to functions carrying out the integration** — Internal auditors can play an advisory role and work as bridge builders between the various functions of the merged firm. During this stage there are various changes in the internal environment of the new firm and merging firms' management, or employees may often be distracted. Internal auditors can ease their fears and effectively communicate the objectives of the new firm. Their expertise and knowledge of the control environment can assist other functions such as finance, information systems, or human resources in overcoming possible obstacles in the integration stage.

- **Prepare a checklist of activities necessary to actualize expected value from the acquisition** — Another important task can be the formulation and preparation of a checklist of activities necessary to actualize expected value from the acquisition. Development of such a list requires mapping and setting up core processes and systems that need to integrate in order to gain synergy and lead to value added from the deal.

- **Help with the development and implementation of a communication policy to inform acquired company's staff regarding systems, procedures, risk** — One of the main objectives of the COSO framework is the development of an effective communication system in the company. Internal auditors can work as facilitators and

implement a communication policy in order to inform personnel about the new situation. All personnel need to receive clear messages during this turbulent period in order to smoothly integrate the new systems and processes. For such information to be reported timely there must be open channels of communication and a willingness to listen.

D. Post-acquisition Audit

The final stage comprises the post-acquisition audit. Internal auditors traditionally have a greater level of involvement at this stage. The crucial part is the level of involvement at the previous stages. In a case where the internal auditing department has little or no involvement, it is difficult and time consuming to gain understanding of the key risks and processes in order to document key controls and develop an audit plan. On the other hand, if internal auditors have a deeper knowledge of the newly acquired company, then the audit planning will be more detailed and will focus on the key areas. This involvement can also be cost and time effective. As indicated in this research, internal auditors have the greater level of involvement at the post-acquisition audit in order to report main control deficiencies to management.

Current and preferred best practices at this stage are:

- **Audit integration process to identify control weaknesses** — One of the audit team's main tasks is to audit the integration process. When the internal audit function has active involvement at the integration stage, it is easier to document and identify control weaknesses. The main areas of focus at this stage will be assessment of the entity level's control environment, existing policies and procedures of the target firm, and information and communication lines.

- **Report findings to business units, audit committee, board of directors** — Another important task of the internal audit function is auditing and reporting the main findings to business units, the audit committee, and the board of directors. The report must contain the audit scope and objectives, documentation of the target company's internal control system, main control weaknesses, and a possible remediation plan for compliance with the control environment of the bidder company. The audit committee and board of directors need this report in order to have a picture of the acquired company and take necessary measures to integrate and operate as "one" company.

- **Risk-based audit of policies, procedures, and controls in the merged/acquired company** — To audit various policies, procedures, and controls of the acquired company, internal auditing can use the risk-based approach. This means that the audit plan will be based on a risk assessment and corporate objectives set by the new management. Internal auditors can then define the scope and objectives of the audit and proceed to the documentation and assessment of the various risks and controls in place in order to mitigate these risks. This approach can identify the gaps in the control procedures and prepare a remediation or compliance plan to proceed to an integration of policies, procedures, and controls.

- **Investigate whether the specific goals of the acquisition have been achieved** — Another important task during the post-acquisition audit can be the investigation of and the level of compliance with the specific goals and objectives of the acquisition. This task can be exercised more effectively and efficiently if the internal audit function participates actively in the pre-acquisition stage where these goals and objectives have been set by top management.

- **Prepare "lessons learned" document about the integration process** — Many organizations significantly underestimate the amount of time and resources, and experience resource constraints toward the end of the M&A project. This results in higher levels of increased inefficiencies. Toward the end of the project there is an opportunity to reflect back and document significant "lessons learned" from their experience. This document can include the most significant observations and comments from the participation of the various stages of an M&A, and also recommendations relating to project management, scoping, risk assessment, documentation of internal controls, and evaluate deficiencies.

Another important issue about a possible expansion of internal auditing's role is the introduction of the U.S. Sarbanes-Oxley Act of 2002. Sarbanes-Oxley does not explicitly mention mergers and acquisitions; however, acquisition-minded companies that fail to consider the implications may be in for 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 — Sarbanes-Oxley may have an impact on certain mergers and acquisitions 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 the acquisition on its Section 404 assessment.

Knowing that management's certifications under Sections 302 and 404 will ultimately apply to acquisitions, the internal auditing team must consider the materiality of a target relative to the business and also the quantitative and qualitative elements of materiality. Teams can be involved at the pre-acquisition stage to assess the materiality of the target company and assess the ways management will accomplish compliance. After the acquisition, internal auditors can participate on the documentation of internal controls and assess their performance and level of compliance with those of the bidder firm.

VI. Conclusion

As we can derive from the descriptive data analysis, the majority of internal auditors that took part in this research believe that internal audit participation can add value to the M&A process and this value can be enhanced if their role is allowed to expand. Overall, it is management's responsibility and decision to expand the participation of the internal audit function at the various stages of M&A projects. One of the key prerequisites for a more expanded role is the change of management's perception about the ideal role of internal auditors during M&A projects. On the other hand, the internal audit function must possess the necessary skills and knowledge to provide quality and value added output.

The role of the 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 also need 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 jeopardize their "traditional" role as internal control experts and overcome major operational or compliance risks and controls in the organization. Management of the internal auditing department, audit committee, and the board of directors are in a position to define and use internal auditing as an important tool for the attainment of corporate objectives and their participation in specialized projects such as M&A. This

research highlighted the intention of internal auditors to have a greater level of involvement in this type of project, defining also the need for the expertise audit teams can bring, especially in large audit shops.

A best practices model was also developed in order to provide a basis and a benchmark for future participation of audit teams in M&A projects. This model was derived from the formulation and covering of three different models: the normative (formulated using the extensive literature review), the observed, and the preferred (based on the postal questionnaire). Their comparison and the validation of the practices are mentioned in the descriptive data analysis.

We must note that there is no evidence in this research that indicates a surely positive outcome for the bidder company if these best practices are followed. The use of these best practices must not be a panacea but only a useful guide derived from the rich organizational and internal auditing experience of the participants and the interviewees. Providing an objective and proper assessment and evaluation of business risks attached during an M&A project can challenge and find new opportunities for the expansion of the internal audit function to a more proactive and consulting role apart from its “internal control” based role.

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LIST OF FIGURES

