Defining Internal Audit’s Role in Mergers and Acquisitions

Adding Value for Successful Integration

22 March 2012
A FRAMEWORK FOR MEMBER CONVERSATIONS

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From the AUDIT DIRECTOR ROUNDTABLE of the CORPORATE INTEGRITY PRACTICE www.adr.executiveboard.com

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GUEST PANELIST

Gus Shea
Senior Audit Manager

Company Capsule
Industry: Semiconductor and Related Device Manufacturing
2011 Revenue: $54.00B
2011 Employees: 100,100

Intel holds about 80% of the market share for microprocessors that go into desktop and notebook computers, and also into computer servers, and is still #1 in semiconductors. Intel also makes embedded semiconductors for the industrial, medical, and in-vehicle infotainment markets. While most computer makers use Intel processors, Dell and Hewlett-Packard are the company’s largest customers. The Asia/Pacific region generates two-thirds of Intel’s revenues.

Petrie Terblanche
Senior Director of Internal Audit and Compliance

Company Capsule
Industry: Network Solutions
2011 Revenue: $2.15B
2011 Employees: 4,546

Brocade leads the industry in providing comprehensive network solutions that help the world’s leading organizations transition smoothly to a virtualized world where applications and information reside anywhere. As a result, Brocade facilitates strategic business objectives such as consolidation, network convergence, virtualization, and cloud computing. Today, Brocade solutions are used in over 90 percent of Global 1000 data centers as well as in enterprise LANs and the largest service provider networks. The company serves a wide range of industries and customers in more than 160 countries with a complete family of Ethernet, storage, and converged networking solutions as well as a full range of education, support, and professional services offerings to provide a comprehensive solution.

Princy Jain
Partner
Risk Assurance Practice

Company Capsule
Industry: Accounting Services
2011 Revenue: $9.88B
2011 Employees: 39,951

PricewaterhouseCoopers LLP is the US arm of Big Four accounting firm PricewaterhouseCoopers International (which formally rebranded itself PwC in 2010). The accountancy’s offerings include auditing and human resources, tax-related, and other advisory services. Focus industries include consumer products and services; industrial products and services; financial services; entertainment; utilities; and technology. PricewaterhouseCoopers also has a practice area geared specifically to private companies. It has about 80 offices in more than 30 states.
QUESTIONS?

Please use one of the handheld microphones

or

Text Chris at 281-615-1793
The 2007 global deal environment was characterized by record volumes despite evidence showing that most M&A deals fail to add value.

**A GOOD DEAL?**

Global Annual M&A Deal Volume

*Trillions of USD*

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Percentage of Deals Adding Shareholder Value

- **58%** Deals That Don’t Add Value
- **42%** Deals That Add Value
As economic markets tighten, organizations will reassess spend; however, deals done during periods of economic weakness provide greater value.

SILVER LINING

Cost-Cutting Trend by Company Size
Percentage of Companies Responding, 2008

Success Rates of Mergers

Cumulative Relative Total Shareholder Return Index

A RISK FOR AUDIT TO ADDRESS

Market Capitalization Decline Drivers from Strategic Risks
*Top 20% of Fortune 1000 (1988–2005)*

- **25%** Decline in Core Product Demand
- **23%** Poor Acquisition/Merger Integration
- **21%** Other Strategic Risk Factors
- **11%** Destructive Price War
- **20%** Competitor Infringement on Core Market

\[n = 99.\]

Commonly Cited Drivers of Deal Failure

1. Selecting an Integration Approach
2. Merging Cultures
3. Retaining Key Talent
4. Managing Workforce Uncertainty
5. Merging IT Systems

Source: CFO Executive Board research.
Internal Audit sees value in increasing their current involvement in M&A but are faced with several challenges.

FINDING A SEAT AT THE TABLE

Internal Audit Involvement in M&A

Challenges Impacting M&A Involvement By Internal Audit

- **Expertise**: Active participation on deal teams requires specialized financial and functional knowledge.
- **Resources**: Most Internal Audit teams are not staffed to accommodate short-notice, long-time commitment deal work.
- **Management Resistance**: Management is not aware of the value of Internal Audit skill set in M&A participation.
- **Budget**: Planning horizon for deal involvement is not long enough to properly plan for in budget.

Areas for greatest value-added involvement are in due diligence and integration phases.

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<th>Impact</th>
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Source: 2008 ADR M&A Survey Results.

n = 99.
INTERNAL AUDIT’S ROLES IN THE MERGER AND ACQUISITION PROCESS

Opportunities for Internal Audit Involvement in M&A

<table>
<thead>
<tr>
<th>1. Target Identification and Assessment</th>
<th>2. Due Diligence</th>
<th>3. Integration</th>
<th>4. Post-Acquisition Assessment</th>
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WEARING MULTIPLE HATS

Wells Fargo Selected Mergers and Acquisitions
Annual Revenue, 1997–2007

- **Acquisition: Greater Bay Bancorp**
  - Size: $7.4 Billion in Assets
  - Objective: Geographic Expansion and Market Share

- **Acquisition: Strong Capital Management**
  - Size: $41.0 Billion AUM
  - Objective: Product Expansion Distribution

- **Acquisition: First Security Corp**
  - Size: $3.2 Billion
  - Objective: Geographic Expansion

- **Acquisition: Norwest Aquires Wells Fargo**
  - Size: $31.4 Billion
  - Objective: Geographic Expansion

Audit Services Due Diligence Scope

Due Diligence Process Assurance

OBSERVATIONS SUMMARY

- **Audit Project Title:** Acquisition Beta 6
- **Date:** Sep '08
- **Business Area:** Mortgage
- **Business Unit:** Corporate Headquarters

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<th>Issue #1</th>
<th>Status</th>
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<td>Issue Statement</td>
<td>Corrective Actions</td>
<td>Responsible Individual</td>
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Risk and Controls Assessment

Wells Fargo Audit Services assesses the controls strength of the acquisition target including the Internal Audit department.
ASSURANCE AT EVERY STEP OF DUE DILIGENCE

Five Stages of Due Diligence

**Due Diligence Event**
- **Deal Notification**
- **Planning**
- **Fieldwork**
- **Reporting**
- **Wrap Up**

**Internal Audit Action**
- **Create “Risk Lists”**
  - Update existing information request checklists and due diligence programs
  - Work with business lines to develop list of possible risks
- **Review Team Composition**
  - Ensure appropriate parties are represented
  - Partner to train business units without M&A experience
- **Facilitate Team Communication**
  - Share findings between teams
  - Resolve issues between teams as necessary
- **Weigh Key Findings**
  - Review assumptions in financial models
  - Summarize all due diligence reports
  - Update and carry forward lessons learned documents
- **Validate Action Plan**
  - Review drafts of definitive agreements
  - Validate due diligence issues are addressed

**Goal**
- Improve risk coverage and efficiency
- Gather necessary expertise
- Bridge gaps between teams
- Build complete due diligence picture
- Track key issues to close
AVOIDING UNPLEASANT SURPRISES IN TRANSITION

Assessment Process Steps

Pre-Acquisition

1. Establish Triggers
WFAS will provide support if certain criteria is met.

2. Assess Control Environment
WFAS reviews the control environment of the target and the acquiring business line to assess the strength of controls in place.

3. Evaluate Business Environment
WFAS evaluates the risk environment and highlights any areas for concern.

4. Evaluate Internal Audit Function of Target
WFAS investigates the effectiveness of the target’s Internal Audit department, or appropriate governance function.

5. Report Findings
WFAS informs the deal team of risk and control issues for consideration in final deal documents.

6. Assign Risk Rating
WFAS team members working on the deal assign the new entity a risk rating based on the risks and controls discovered during due diligence.

7. Transition to Audit Team
WFAS due diligence team transitions new acquisitions to the applicable business line audit team.

8. Inform Audit Planning
Output from due diligence work informs future audit planning.

Post-Acquisition

Deal Decision
DOUBLE BANG FOR THE BUCK

Process Steps

Communicate
Internal Audit and M&A regularly check in to stay informed of potential deals

Decide
Internal Audit decides their level of involvement on a deal by deal basis

Update
Project management office gives IA periodic updates during due diligence

Access
Business provides IA with access to due diligence materials

Review
Internal Audit conducts acquisition review audit

Acquisition Review Audit Report

Acquisition Risk Review
Company Alpha

Assessment Date: May 2008
Assessment Controls: Not Rated

Report Date: July 2008
Location: Los Angeles, Calif.

Audit Scope

The objective of this review was to assess the operational and financial risk related to Company Alpha in order to plan future audits and discuss potential integration concerns and gaps in the design of control systems. This included high-level review of existing internal controls.

Our work was structured around the COSO elements:

- Control Environment
- Risk Assessment
- Control Activities
- Communication and Information
- Monitoring

Our assessment included reviews of the following processes:

- Market/Sell
- Manufacturing
- Procurement
- Human Resources and Payroll
- Finance
- Information Technology

Summary of Results

Control Environment: _____________________________________________

Risk Assessment: _______________________________________________

Control Activities: ______________________________________________

Information and Communication: _________________________________

Monitoring: ____________________________________________________

Detailed Observations:
1. ____________________________________________________________
2. ____________________________________________________________

Benefits

1. Comprehensive Integration Plan
   Internal Audit confirms risks have been identified and well addressed by the business team during integration.

2. Risk-Based Audit Planning
   Internal Audit identifies risks to review during comprehensive audits included in the annual plan.

“When our businesses are aware of the right risks, they nail integration.”

Doug Anderson
Corporate Auditor
The Dow Chemical Company

1 Pseudonym.
Internal Audit conducts post acquisition reviews and provides feedback for continuous improvement.

“Involving Internal Audit in integration planning and post acquisition effectiveness reviews has helped management learn from each deal to make wise M&A decisions, smoothly integrate the businesses and assess the level of transaction success.”

Bryan Reasons
Vice President, Risk Management
Cephalon, Inc.

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<tr>
<th>M&amp;A Stage</th>
<th>Internal Audit Involvement</th>
<th>Post-Close Timeline</th>
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<td>Target Identification</td>
<td>Internal Audit observes initial discussions from a financial and accounting perspective.</td>
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<td>Q2:</td>
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<tr>
<td>Due Diligence</td>
<td>Detailed financial audits focused on risks, systems and controls are conducted by Internal Audit.</td>
<td>Q3:</td>
</tr>
<tr>
<td>Integration</td>
<td>Hand off meetings between Internal Audit, finance, and IT to ensure control issue understanding.</td>
<td>Q4:</td>
</tr>
<tr>
<td>Post Acquisition Review</td>
<td>Internal Audit conducts a review of every M&amp;A deal to assess results and highlight lessons learned for future deals.</td>
<td>Q1:</td>
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<td>Q2:</td>
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1. **Post-Acquisition Audit**
   - Six months post-close, Internal Audit conducts controls testing for new entity and rolls report into SOX testing.

2. **Quarterly Financial Review**
   - Financial assumptions become part of the new entity budget and forecast versus actual analysis is reviewed quarterly.