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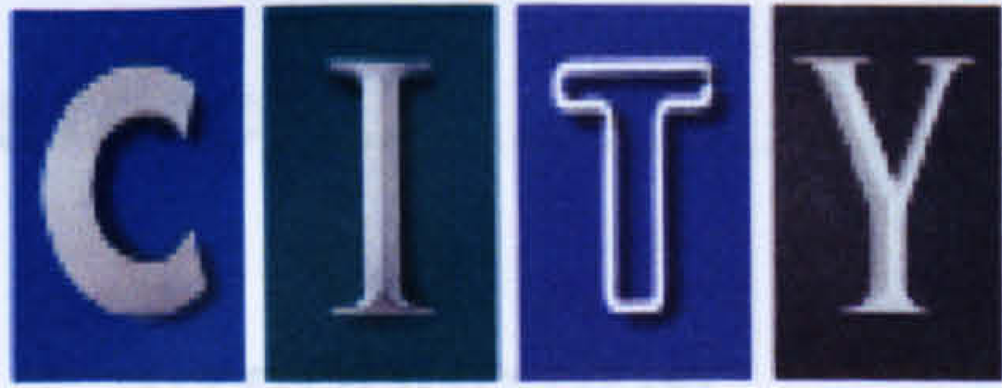

Cass Business School
City of London

"The Internal Audit Role During Mergers & Acquisitions: The European Union Experience"

This report is submitted as part of the requirements for the award of the degree of Doctor of Philosophy

NIKOLAOS DOUNIS

MARCH 2007

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ABSTRACT

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. On the other hand, internal audit has evolved dramatically during the last years from its traditional role of control orientation to a more proactive, risk based and consultancy role. But despite this evolution, empirical evidence showed that internal audit function has no effective contribution during the M&A activity. This study analyzes the present level of involvement of internal audit function during the M&A activity and compare it with the preferred and ideal (normative) level. This comparison leads to the identification of possible gaps between these three different models. This gap analysis identifies the possible reasons of this low level of involvement, as well as, possible means and actions in order to participate more actively to the specialized M&A projects. Finally, we formulated and validated a best practices model of a more expanded level of internal audit involvement at the different stages of M&A's, as well as, a list of potential prerequisites and actions for this expansion.

Chapter 1: Introduction

1. INTRODUCTION

1.1 Background information

When two companies come together through a merger or acquisition, they enter a new world: the world of M&A. Every year, thousands of companies large and small, public and private, join forces through merger or acquisition, hoping to accomplish together what they could not accomplish separately. Also, dramatic events in mergers, acquisitions, restructuring and corporate control fill the newspapers headlines almost daily and have become central public and corporate policy.

Mergers and acquisitions are transactions of great significance, not only to the companies themselves but also in many other constituencies such as workers, managers, competitors, communities and the economy. Their success or failure has enormous consequences for shareholders and lenders as well as the above constituencies. Also, shareholders may lose their investment because of the imprudent acquisitions made by their companies. Acquiring companies are often motivated by the need to make efficiency savings in production and other activities. These are often achieved in considerable cost to workers in the form of job losses and communities in the form of terminated economic activity that plants and factories being shut down represent (*Sudarsanam, 2003*).

Mergers and acquisitions rank among the topics most heavily researched by scholars in virtually all management fields. From strategy to corporate finance, from organizational behaviour and human resources management to operations management, marketing and accounting, all the way to antitrust studies, academic work looking at the merger phenomenon to all possible angles could suffice to fill a reasonably–sized library. A general guidance can be summarized in the statements that M&A are risky, there must be a strategic logic behind the purchasing impetus, it is important not to overpay and post–merger integration is hard to manage because of the sheer complexity of the process and the difficulty in handling people issues (*Zollo, 2003*).

1.2 Worldwide and European Union M&A activity

One of the striking aspects of mergers and acquisitions as a phenomenon is that they occur in bursts interspersed with relative inactivity. This pattern is called the wave pattern of mergers and has been observed worldwide. What triggers these waves and why they subside are not fully understood, although several possible contextual explanatory factors have been identified.

Merger activity continued at a fervor pitch in the first quarter of 2005, announced worldwide mergers and acquisitions exceeded $589bn in the opening quarter. Also global announced M&A volume with a value up to $500 million reached $684,8bn in the fourth quarter of 2005, a 15.8% increase from last year. In total 29,603 deals were announced in 2005 indicating an increase compared with 28,479 deals announced in 2004. That marks the strongest pace of merger volume during a six–month period since the second half of 2000. Also, United States M&A activity helped drive this growth with $226,8bn and a 15.1% increase from 2004 (*Thomson Financial, February 2006 report*).

On the other hand, European Union business environment is bewilderingly complex, a mosaic of national markets with different languages and commercial cultures each with its own set of company laws, commercial cultures, corporate tax structures, accounting standards and takeover regulations. It is also an environment undergoing rapid evolution, as for example the economic and political changes in the former Communist countries of Central and Eastern Europe. Some countries like Poland or the Czech Republic joined European Union in 2004 and Bulgaria and Romania will follow in 2007, transforming a large European Union and a single market with millions of customers.

For deals valued up to $500million, UK companies were the most targeted in Europe accounting for 2,291 deals valued at $78.9bn or 33.3% of the European market. Strong growth of 15.5% in Italy and 25.7% of Spain comparing with the volume of 2004 helped drive European M&A volume higher. In terms of industry, the greatest increase compared with the figures in 2004 was in the real estate, media & entertainment and in financial sector. The trend is showing that 2006 is likely to be a record year for M&A

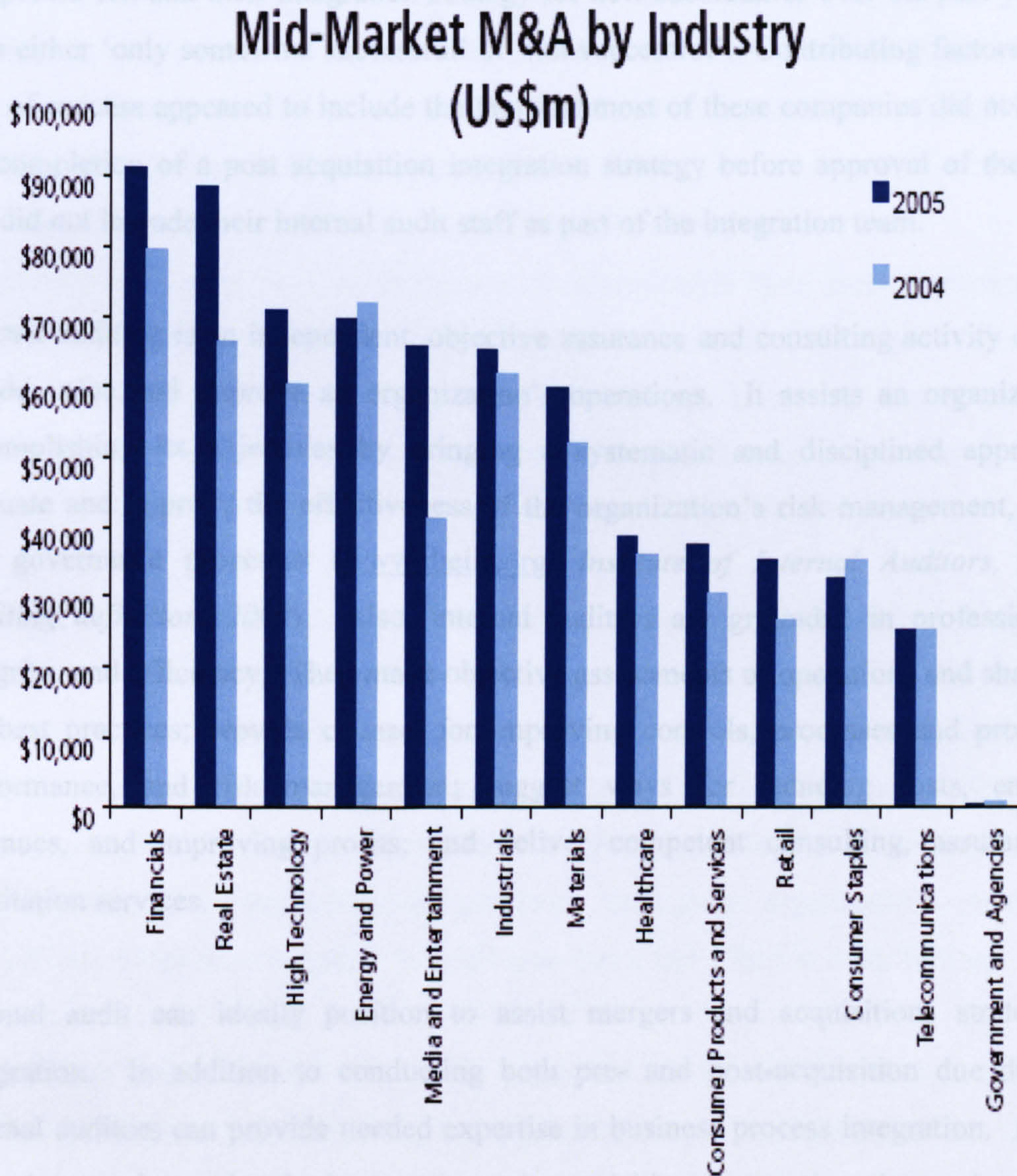
activity, despite the slowdown of takeover activity in the fourth quarter of 2005 (*CNNmoney.com, March 2006*). These figures are also illustrated at the following tables and figures:

Table 1.1: Announced M&A deals by selected target nation

Announced M&A by Selected Target Nation					
	01/01/2005 – 31/12/2005		01/01/2004 – 31/12/2004		
Region/Nation	**Rank Value (US$m)**	**No. Deals**	**Rank Value (US$m)**	**No. Deals**	**% Change in Rank Value**
Worldwide	*684,283.3*	*29,603*	*590,818.7*	*28,479*	*15.8*
United States	*226,771.5*	*8,502*	*197,086.5*	*7,995*	*15.1*
Europe	*237,286.0*	*8,961*	*210,486.2*	*8,757*	*12.7*
UK	*78,944.8*	*2,291*	*66,409.2*	*2,442*	*18.9*
Italy	*21,899.7*	*587*	*18,955.7*	*518*	*15.5*
Spain	*13,401.9*	*414*	*10,658.7*	*483*	*25.7*

Source: Thomson Financial [http://banker.thomson.com, February 2, 2006]

Figure 1.1: Mid–Market M&A (by industry)



Source: Thomson Financial [http://banker.thomson.com, February 2, 2006]

1.3 The internal audit role during M&A Activity

With the current high volume of mergers and acquisitions, companies need an effective integration strategy to ensure that mergers and acquisitions objectives are achieved. Not all mergers and acquisitions, however, are successful in achieving their initial objectives. A survey conducted by IBM of twenty *Fortune* 100 companies found that sixteen of these companies felt that their integration strategy for new subsidiaries over the past years had been either 'only somewhat successful' or 'not successful'. Contributing factors to their lack of success appeared to include the fact that most of these companies did not require the completion of a post acquisition integration strategy before approval of the merger and did not include their internal audit staff as part of the integration team.

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It assists an organization in accomplishing its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of the organization's risk management, control, and governance processes (www.theiia.org, *Institute of Internal Auditors, Internal Auditing definition, 2000*). Also, internal auditors are grounded in professionalism, integrity, and efficiency. They make objective assessments of operations and share ideas for best practices; provide counsel for improving controls, processes and procedures, performance, and risk management; suggest ways for reducing costs, enhancing revenues, and improving profits; and deliver competent consulting, assurance and facilitation services.

Internal audit can ideally position to assist mergers and acquisitions strategy and integration. In addition to conducting both pre- and post-acquisition due diligence, internal auditors can provide needed expertise in business process integration. Also, by assuming an integral role in merger and acquisition integration, internal audit can enhance its image as a value provider within the organization. We can also add that 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 affect the organization's profitability.

1.4 Purpose of the study

As mentioned, mergers and acquisitions represent a dynamic phenomenon with a large number of organisations that are joining forces in order to gain competitive advantage, new markets and customers and create possible synergies. This means that these organisations are planning to accomplish certain strategic objectives and add value to the merged organisation. But as such strategic move, M&A activity incorporates a number of risks for the bidder or target company and the shareholders. These risks are encountered during the various stages of an M&A (pre–acquisition or post–acquisition) and often fail to achieve planned objectives.

It is also a well-known fact that the internal audit profession faces many challenges as we march in this new millennium. Internal auditors have seen their role evolve from performing traditional internal audit functions (such as observing and counting and functioned as assistants to the independent accounting profession in order to attest to the accuracy of financial matters), to more of a risk based and consultancy role.

The topic of my research is concerned with the internal audit role during mergers and acquisitions with specific reference to the European Union companies. As evidenced by the new definition of internal auditing (as adopted by the Institute of Internal Auditors), the work performed by internal auditors is not limited to the area of assurance services but it can also include consulting activities. Unfortunately, even though internal audit has expanded its role in many business processes throughout organizations, merger and acquisition activity does not seem to be an area that it has effective contribution.

This trend is also evidenced in a survey published in 1998 by the Institute of Internal Auditors (*Davison, 2001*), indicating that a great number of auditors stated that they only performed due diligence testing in regard to new mergers and acquisitions activity and felt that more value could be added to the M&A process if their roles were allowed to expand. On the other hand, for those internal audit departments involved in the merger and acquisition activity, "specialized" auditors were usually taking the lead rather than a team of auditors from the internal auditing department and also participants noted that

they needed more training in mergers and acquisitions in order to sit at the same table with the planning and implementation team. Also, another international study (*Selim et al, 2002*) evidenced the low to moderate involvement of internal audit departments to the M&A process and especially at the pre–acquisition stages.

We can conclude that although internal audit profession has evolved during the years and internal auditors have the motivation for an evolution to a more pro–active and risk based role, top management often perceives they cannot participate effectively in specialised projects such as M&A's. This study will try to decipher this trend by selecting a number of organisations in the European Union area and analysing current and preferred situation in order to identify possible gaps and explore the reasons for this low level of involvement, especially at the pre–acquisition stages.

1.5 Research objectives

The main *objectives* of this research are to:

1. Describe and understand the role internal audit function currently plays in the European Union companies that pursue mergers and acquisitions.
2. Examine the relative contribution of internal audit function to the various stages of M&A's.
3. Describe and analyse 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 analyse 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 desired prerequisites that are essential for internal audit function in order to play a more active role in the M&A process.

1.6 Research methodology

Research methodology for collecting and analyze data in order to finally suggest a best practices model is described thoroughly in Chapter 3. Briefly, research was conducted as follows:

The *first stage* includes the literature review. From the literature review we have more easily explored and developed a normative model indicating best practices applied in different stages of the merger and acquisition process. The literature review included the following:

- Reference texts on mergers and acquisitions, internal auditing and risk management.
- A wide range of articles and papers published in a variety of journals (Journal of Finance, Strategic Management Journal, Journal of Auditing, etc.).

Also, useful data was derived 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.
- The Internet, in order to source other books and articles, official publications, current publications and books on related topics.

From the careful review we gained a 'rich' picture and composed a postal questionnaire, carefully formed and applied for internal auditors. Then we selected 120 European Union companies merged in the period 01/01/2000-31/12/2003 and sent it to the Chief Audit Executives of the bidder companies. This questionnaire was accompanied by an explanation letter and a follow up mail questionnaire was also sent after three weeks.

The *second stage* included the descriptive data analysis of the returned questionnaires. 34 out of 120 questionnaires were replied (28% response rate). This analysis helped us to explore current situation (level of involvement of internal auditors in various stages of

M&A projects) that was then linked and compared with the preferred (preferred level of internal audit involvement) and best practice (derived from the literature review) situation.

In the ***third*** stage this comparison leaded to a number of gaps and a preliminary analysis and formulation of conclusions and assumptions for the internal audit role in the European Union mergers and acquisitions.

In the ***fourth and final*** stage we conducted semi–structured interviews with ten internal audit managers and practitioners (with their organisations also experienced and participated in M&A projects) in order to validate previous preliminary results, gain understanding on the reasons for the gaps identified and useful conclusions derived at the previous stage. These key findings and analysis formulated the best practices model and the action plan and recommendations for a more effective internal audit contribution to M&A projects in the European Union area.

1.7 Limitations of the study

- The literature review has revealed that mergers and acquisitions are an area with enormous research potential. Unfortunately, mainly due to time constraints this research cannot be stretched over an infinite period of time.

- This research concentrates and the sample was selected from bidder organisations that pursued mergers and acquisitions and were based in the European Union area, apart from the ten new countries incorporated during the latest enlargement. Also, the researcher believes that this thesis can be a benchmark for academics as well as practitioners for future research in the area.

- A further limitation is that, because of the nature of the European Union merged companies from all countries could not be included to the sample of the companies being researched. Thus, the researcher will include the European Union deals

completed or unconditional on the period 01/01/2000-31/12/2003 and will not include the ten new members of the European Union.

- The issue of corporate divestments, although mentioned and analysed in the literature review, will not be included in this study.

1.8 Summary

This chapter tried to set the main issues and objectives that will be analyzed and explored in this research. Although M&A activity increases during the years and internal auditing has evolved from a "post-mortem" and "after the event" to a more consulting activity, evidence has showed that internal auditors are not quite involved through the M&A process.

This research will try to highlight and explore, through a quantitative and qualitative methodology, current, preferred and normative situation setting also important issues such as gap identification and analysis, possible prerequisites and best practices valid for internal audit departments and practitioners.

Apart from the limitations set at this chapter, this research has also as a primary objective valid and reliable descriptive and empirical data in order to improve generalisability of the main conclusions.

SUPPLEMENT OF CHAPTER 1

Merger and acquisition terminology

The term's mergers and acquisitions are frequently used but sometimes there are various types and distinctions between them. Below are the primary legal transactions utilized to bring two or more companies together (*Weston et al, 2001*):

Merger – In a merger, two separate companies combine and only one survives. In other words, the merged firm goes out of existence, leaving its assets and liabilities to the acquiring company. The firm that is being acquired is often times called "target" company.

Acquisition – Legal transactions by which all or part of the ownership or assets of a business are acquired through purchase or exchange. Acquisitions usually involve a transfer either of stock, assets, membership or other evidence of ownership. The term is used in a much broader sense in the bibliography but is broadly used to mean the purchase of assets or companies in the merger process.

Consolidation - A consolidation is a combination of two or more firms in which an entirely new corporation is formed and all merging companies ceased to exist. Two similarly sized firms usually consolidate than merge.

Leveraged Buyout (LBO) – A leveraged buyout is a type of acquisition that occurs when a group of investors, often led by the management of a company, borrows funds to purchase the company. The assets and future earnings of the company are used to secure the financing required to purchase the company.

Joint Ventures – An operating joint venture may be defined as a separate entity (partnership or corporation) that has two or more companies as owners. The partners contribute capital to the joint venture in the form of cash, inventory, distribution networks, manufacturing processes, fixed assets or intellectual property such as technology patents and trademarks.

Spin-Off Divestiture – A spin off is the opposite of an acquisition. Accomplished voluntarily, a spin off is the sale or exchange of a division, subsidiary or other provider for various tactical reasons. An involuntary spin-off, called a divestiture, is sometimes required by a federal antitrust enforcement as a condition to clearance of a merger.

Takeover – This term has been used almost synonymously with the terms merger and acquisition. It was used only when one company acquired control of another company, but its use has been broadened to include the acquisition of a company that will be operated as a subsidiary.

Equity carve-out – A transaction in which a parent firm offers some of a subsidiary's common stock to the general public to bring in a cash infusion to the parent without loss of control.

Tender Offers – A tender offer is a proposal by a corporation that is seeking controlling interest of another company to buy the stock of that company at a specified price from any stockholder who will submit, or "tender" shares.

Often, economists and managers group mergers based on whether they take place at the same level of economic activity-exploration, production or manufacturing, distribution. The element of relatedness is also important in defining economic categories of mergers. Thus, we can group mergers on horizontal, vertical and conglomerate.

Horizontal mergers

A horizontal merger involves two firms that operate and compete in the same kind of business activity. Forming a larger firm may have the benefit of economies of scale. The argument that horizontal mergers occur to realize economies of scale cannot be sufficient to be a theory of horizontal mergers.

Horizontal mergers are regulated by the government for possible negative effects on competition. They decrease the number of firms in an industry, possibly making it easier for the industry members to collude for monopoly profits.

Vertical mergers

Vertical mergers occur between firms in different stages of production operation. It is in the oil industry, for example, that distinctions are made between exploration and production, refining and marketing. There are many reasons why firms might want to be vertically integrated. There are technological economies, elimination of the transaction costs, planning for inventory and production may be improved due to more efficient information flow within a single firm.

The efficiency and affirmative rationale of vertical integration rests primarily on the costliness of market exchange and contracting. The argument, for instance, that uncertainty over input supply is avoided by backward integration reduces to the fact that long term contracts are difficult to write and execute.

Conglomerate mergers

Conglomerate mergers involve firms engaged in unrelated types of business activity. We can distinguish three types of conglomerate mergers, financial, managerial and concentric. This type of merger is not aim explicitly at shared resources, technologies or synergies but the focus is on how the acquired entity can enhance the overall stability and balance of the firm's total portfolio, in terms of better use and generation of resources.

Chapter 2: Literature Review

2. LITERATURE REVIEW

2.1 Introduction

This chapter will mainly focus on the theoretical aspects and empirical evidence surrounding the whole issue of mergers and acquisitions. It will explain and document the various types of mergers and acquisitions and the empirical evidence provided from the literature review.

The ***first part*** will focus on merger motives and prescriptions, providing a review on the various theories and the empirical evidence.

The ***second part*** will mainly focus in the various types of mergers and acquisitions (e.g. corporate divestments and sell-off's, equity carve-out's, cross-border acquisitions), and will try to provide evidence based on research and literature about issues like valuation, bid process, shareholder wealth and performance.

The ***third part*** will have an analysis of the different stages of a merger, like corporate and acquisition strategy, due diligence, post-acquisition integration and post-acquisition audit, providing also useful evidence about these stages and the linkages to the research.

Finally, the last two parts will contain the regulatory framework in Europe, U.S. and U.K. and the internal audit role during the various stages of mergers and acquisitions. This analysis and the literature review will lead to the research questions and research hypotheses presented at the next chapter.

2.2 Merger motives and prescriptions

The wave of mergers and reverse mergers during recent years has drawn widespread attention, but most of the academic and public discussion has been devoted to the mergers' consequences. The motives behind these mergers have received only modest attention although they ultimately decide whether a merger is attempted or not.

Most observers agree that mergers are driven by a complex pattern of motives, and that no single approach can render a full account (e.g. *Ravenscraft and Scherer, 1987; Steiner, 1975*). Merger motives have triggered far less theoretical efforts than merger consequences. At the most general level, those motive theories that regard merger consequences as the moving cause behind mergers can distinguish from those that do not. Mergers motives can be distinguished as follows (*Trautwein, 1990*):

Efficiency theory

This theory views mergers as being planned and executed to achieve synergies, in general three types of synergies can be distinguished.

1. *Financial synergies* result in lower costs of capital. One way to achieve this is by lowering the systematic risk of a company's investment portfolio by investing in unrelated businesses. Another way is increasing the company's size, which may give it access to cheaper capital and a third way is establishing an internal capital market.
2. *Operational synergies* can stem from combining operations, for example a joint sales force, or from knowledge transfers (*Porter, 1985*).
3. *Managerial synergies* are realised when the bidder's managers possess superior planning and monitoring abilities that benefit the target's performance. The positive motivation effects ascribed to leveraged buyouts (*Jensen and Murphy, 1988*).

Monopoly theory

This theory views mergers as being planned and executed to achieve market power. From this point of view the company could act as following:

1. The firm can cross-subsidise products. Profits from the position in one market are used, for example, to sustain a fight for market share in another market.
2. The firm can aim at simultaneously limiting competition in more than one market. *Edwards (1955)* developed this theory of mutual forbearance. A practical example is building a foothold in a competitor's main market who in turn posses such a foothold position in the firm's main market (*Porter, 1985*).
3. The firm can aim at deterring potential entrants from its markets.

These kinds of advantages have been referred to as collusive synergies (*Chatterjee, 1986*) or competitor interrelationships (*Porter, 1985*). Collusive synergies represent no efficiency gains but wealth transfers from the firm's customers. The efficiency gains sometimes accruing to monopolistic competition do not occur in non horizontal mergers (*Scherer, 1980*).

Valuation theory

This approach argues that mergers are planned and executed by managers who have better information about the target's value than the stock market (*Steiner, 1975; Holderness and Sheenan, 1985*). Bidders' managers may have unique information about possible advantages to be derived from combining the target's businesses with their own.

The difference between the valuation theory and other merger explanations is its recognition of the role which genuine uncertainty plays in strategic decisions such as mergers. Capital market participants cannot fully evaluate the information on which a bid is based.

Empire-building theory

According to this theory, mergers are planned and executed by managers who thereby maximise their own utility instead of their shareholders' value. This approach has its roots in the studies of separation of ownership and control in a corporation (*Berle and Means, 1933*). Its underlying idea was contained in various managerial theories of the

firm (*Baumol, 1959; Marris, 1964*) and recently *Rhoades (1983) and Black (1989)* have developed related merger explanations.

An empire-building argument is not necessarily confined to the motive of growth maximisation. This is shown by *Rhoades' (1983)* analysis of the merger wave of the 1960s. Another recent development in this field is *Black's (1989)* overpayment hypothesis. *Black* postulates that managers overpay for targets because they are overly optimistic and because their interests diverge from those of their stockholders. In sum, the empire-building theory has to be given the most credit of the theories, because is a common name for a variety of merger explanations and the evidence collected until today is relatively limited.

Process theory

A fifth developed theory of merger motives has its background on the strategic decision process. This research has produced a vast amount of models that describe strategic decision not as rational choices but as outcomes of processes governed by one ore more influences.

Duhaime and Schwenk (1985) discuss the influence of individuals' limited information processing capabilities on acquisition and divestment decisions. *Roll (1986)* works out the implications of managerial over optimism. In his hubris hypothesis managers' expectations are systematically erroneous with an upward bias since a stock's market price serves as a downside cut off point. Rational bidders would not make overly good expectations lead to bids that. *Jemison and Sitkin (1986)* take an explicit acquisition process perspective and present a framework of four organisational process impediments to successful acquisition integration.

Raider theory

This label can be applied to a sixth possible merger motive. Its basic hypothesis is implied in the term 'raider'. *Holderness and Sheehan (1985)* interpret the term as meaning a person who causes wealth transfers from the stockholders of the companies he

bids for. The problem with the raider theory is that the wealth transfer hypothesis is illogic. In a successful bid the 'raider' pays other stockholders a premium to become the controlling stockholder of the company. Any extortion scheme would hurt him disproportionately, while partially bought-out stockholders might still enjoy a net gain from his activities.

Merger motives can be defined in terms of the acquirer's corporate and business strategy objectives. Strategies are formulated and acquisitions decisions are made by the management of the firms. Empirical evidence showed that often mergers that are motivated by managerial self-interest are not yield positive results. The causes of this failure cannot be unambiguously attributed to each of the theories analysed. But the previous analysis could give a first picture of what shareholders and management could expect from this decision. For this reason these theories of merger motives can prove often dangerous guides for the assessment of the performance of a future merger but, on the other hand, they can provide an effective and efficient language for communicating between the merged firms. The empirical evidence provided below can give us also a picture of the research effort in this area.

Empirical evidence on acquisition motives

Whether managers act in shareholders' or in their own interest, as well as some of the merger motives has been tested in a few studies. *Meeks and Whittington (1975)* found that, for a U.K. sample, sales growth is positively related to directors pay increases although such pay increases are also due to higher profitability.

Firth (1991) also tests whether executive reward increases with acquisition for a sample of 254 U.K. takeover offers during 1974-1980. He finds that the acquisition process leads to an increase in managerial remuneration, and that this is predicated on the increased size of the acquirer. He concludes that the evidence is consistent with takeovers being motivated by managers wanting to maximise their own welfare.

A more recent study by *Conyon and Clegg (1994)* finds, for a sample of 170 U.K. firms between 1985 and 1990, that directors' pay is positively related to sales growth. Further expansion through takeovers increases such pay and the relationship between frequency of takeovers and pay is positive.

From the empirical evidence we can conclude that merger can be motivated by managerial self interest. This is known also as the "agency problem". This means that manager's interests and motives may be, in some circumstances, different from those of the shareholder's. A number of control mechanisms exist to minimise the incidence and cost of the agency conflict to shareholders. They include controls such as shareholder-manager alignment devices, policing of managerial conduct and managerial compensation contracts.

2.3 Different types of mergers and acquisitions

2.3.1 Corporate divestments

Although the field of mergers and acquisitions tends to focus on corporate expansion, companies often have to contract and downsize their operations. The restructuring of business firms stems from a number of forces. One of the most basic is the need to meet global competition; another is the agency problem of conflict of interest between managers and shareholders or to move assets to owners who can utilise them more effectively.

The most common methods of corporate restructuring include divestments, spin-offs and sell-off, equity carve-outs and management buyouts. This section describes the evolution of these new forms of corporate control transactions and is linked with the previous part of corporate diversification that is the opposite strategy for a company. It will describe the structure and characteristics of the different forms of corporate restructuring, discuss the rationale and motives and will provide evidence from the available literature on corporate restructuring and performance.

Forms of corporate divestments

Corporate divestments can be carried out in a variety of ways:

- *Sell-off*: that is sale to another company.
- *Spin-off* or de-merger, where the divested part is floated on a stock exchange and the shares in that newly listed company is distributed to the shareholders of the parent.
- *Equity carve-out*, in which a subsidiary is floated on a stock exchange, but the parent, retains the majority control.
- *Management buyout (MBO)*, where the parent company sells a division or subsidiary to the incumbent management, or a private company, is bought by incumbent management.

A major motivating factor for divestitures is the belief that reverse synergy may exist. Divestments, spin-offs, carve-outs and management buyouts are basically a downsizing of the parent firm. Several research studies have analysed the impact of divestments on the various aspects of a company. Empirical evidence on this impact for these different forms of corporate restructuring is as follows:

Divestments

Areas of research on the issue of corporate divestments can be mainly summarised in two categories, impact on shareholder wealth as well as company performance and managerial motives behind the divestment.

Afshar et al. (1992) examined the stock market reaction to corporate divestments by a large sample of UK companies and investigated some of the specific factors. They tested the hypothesis that divestment is means of avoiding bankruptcy. This paper summarises various theories of value creation through divestments and investigates the impact of the transactional details of divestment announcements on stock reaction.

John and Ofek (Jan 1995) found that asset sales lead to an improvement in the operating performance of the seller's remaining assets in each of the three years following the asset sale and that the improvement in operating performance is positively related to the seller's stock return at divestiture announcement.

Kaiser and Stouraitis (June 1995) presents preliminary evidence on stock market reaction to divestiture announcements by European firms from Germany, Sweden, France and the UK. The main results indicated that stock price reaction is positive and continues for 60 days, depends on whether domestic subsidiaries (positive effect) or foreign subsidiaries (neutral effect) are sold and relative size of the divested unit explains a considerable part of the variation in stock-price effects.

Weisbach (1995) examined the relation between management turnover and divestitures of recently acquired divisions. Results indicated that at the time of a management change, there is an increased probability of divesting an acquisition at a loss or considered unprofitable by the press and suggested that management changes are important events that reverse poor prior investment decisions.

Spin-offs and sell-offs

Habib et al. (1997) offer an information based explanation for spin-offs. They provide a theoretical rationale for spin-off decisions in terms of information leading to higher valuation. They explain that when the various divisions of a firm are spun off into several firms that have separate stock market listings, the number of traded securities increases.

Ravenscraft and Scherer (1991), for a sample of about 450 companies estimated a hazard function to determine the environmental and organisational factors precipitating the sell-off of divisional units. The results indicated that sell-off is more probable under some circumstances like change of Chief Executive Officer; acquisition of the unit in a conglomerate acquisition previously or lower profitability. Also, the buyers of the sold-off units tended to improve their profit performance but not enough to realise a normal return on their investments.

Daley et al. (Aug 1997), test a prediction from the corporate focus literature, mention that cross industry spin-offs create more value than own industry spin-offs. The results indicate significant value creation around announcements of cross industry spin-offs

only. Also, there is significant improvement in operating performance for cross industry spin-offs and none for own industry cases.

Cusatis et al. (June 1993) investigated the value created through spin-offs over the period 1965 - 1988 by measuring the stock returns of spin-offs, their parent firms and parent spin-off combinations for periods of up to three years following the event of spin-offs. Both the spin-offs and their parents experience unusually high incidence of takeovers and the abnormal performance are limited to firms involved in takeover activity. These findings suggest that spin-offs provide a low cost method of transferring control of corporate assets to bidders who will create greater value.

Equity carve-outs

Allen (1998) examined the innovative corporate structure of Thermo Electron Corporation that holds controlling interests in 11 units taken public in equity carve-outs. The results indicated that Thermo Electron, a rather poorly performing firm from its inception in the late 1950's to the first carve-out in 1983, has transformed into an organisation that is proficient in utilising capital markets and sustain growth over time. Also, provides interesting insights into the relation between equity carve-outs and value creation and into the organisational changes that establish or strengthen this link.

Klein et al. (Dec 1991) provide also evidence that an equity carve-out is usually the first stage of a two-stage process either to dispose of parent interest in a subsidiary or eventually re-acquire the subsidiary's publicly traded shares. The results indicate that both the initial carve out announcement and subsequent sell-off announcement yield, on average, significantly positive abnormal returns to parent shareholders.

Anslinger et al. (November 1997) examined, from a sample of 119 U.S. parents carrying out equity carve-outs, their performance as well as that of their subsidiaries and also four out of five sample firm executives were interviewed. Results suggested that equity carve-outs are an effective way for companies to exploit growth opportunities and increase shareholder value. This result appears to lie in the changed relationship between the

corporate centre and the business unit, and the effect this has in three important areas, corporate governance, human resources and finance.

Management buyouts (MBO)

Performance of MBO's may be assessed over the short and the long term. *Wright and Coyne (1985)* found from a study of 111 MBO's up to 1983 that they showed improvement in profitability, trading relations, and cash and credit control systems. Also, *Thompson et al. (1989)* studied 182 MBO's over 1983-1986 period and found support for the above results. Over the long term, a study by *Houlden (1990)* found that, in terms of return on capital and return on sales over the first three years after the MBO, company performance improved but over the following three years it declined.

Note that the first U.K. management buyout was a defensive measure. In 1985, Philip Ling led a £56m buyout of the engineering group Haden. The takeover code requires independent advisers to be appointed as soon as possible, independent directors and advisers be provided with all information available to the management's financial backers and also deems that a director with any envisaged post buyout role has a conflict of interest and should not express an opinion on the bid *(Financial Times, 9 May 2003).*

This part has provided an analysis of corporate divestments and their different forms such as spin-offs, sell-offs, equity carve-outs etc. Divestments are an increasingly international phenomenon and are also a rebound to the poor performance of conglomeration which happened on a large scale on the 1960s and 1970s. As analysed in the literature review, in general, restructuring and divestment announcements have a positive effect on the stock market and overall performance of the divested parts often improves.

The role of internal auditors can prove quite important in the different forms of divestment in evaluation and assessment of the business risk and the perspective of the divestiture decisions. *Selim et al. (2002)*, in an international study, pointed out that divestitures present different and overlapping challenges. While divestments do not

provide solution to integration problem, they need to be evaluated from the firm's strategic perspective and valued carefully. In this research it was also indicated that internal audit has no role during strategic and specific divestiture planning and the nature of involvement is limited to the deal structuring and negotiation.

Also, and because of the low level of divestiture activities and involvement during the stages of a divestment, we cannot have a 'rich' picture about the preferred role of internal auditors during divestment activity. Internal audit function can prove quite helpful in evaluating the merits of the divestiture alternatives such as equity carve-out; spin-off etc. and can also provide assurance the systems and procedures during the sale of a business unit and the conduction of deal negotiations.

2.3.2 Cross-border acquisitions

In recent years the number of acquisitions made by companies in foreign countries has increased substantially. Such trans-national or cross-border acquisitions have been motivated by a variety of strategic considerations. The approach to cross-border acquisitions is not a straightforward extension of the approach to domestic acquisitions.

Cross-border acquisitions are much more complex due to differences in political and economic environment, corporate organisation, culture, tradition, regulatory framework and accounting rules between the countries of the acquirer and the target company. This part provides the motivation and barriers to cross-border acquisitions and also evidence on the success or failure of such transactions.

There have been some cross-border mergers in the European Union on a regional basis. This has created groups such as Nordea in Scandinavia, Fortis in the Benelux countries and HVB in central Europe. Also, several large banks have snapped up much smaller ones in other European Union countries - as with Barclays / Zaragozano and HSBC's purchase of France's CCF.

Motivations behind cross-border acquisitions

Companies undertake international acquisitions for a number of strategic or tactical reasons such as:

- Growth orientation, to escape small home market.
- Access to inputs or raw materials or access to cheap productive labour.
- Diversify across products and markets and reduce earnings volatility.
- Provide home country clients with service for their overseas subsidiaries.
- Exploit temporary advantages like, for example, favourable exchange rate making foreign acquisition cheap.

Barriers to cross-border acquisitions

Cross-border acquisitions face a variety of obstacles in different countries (*Sudarsanam, 2003*). Some of these barriers are:

(a) Structural barriers

- Statutory: strong power for supervisory boards to block mergers, discriminatory tax laws against foreign acquirers.
- Regulatory: antitrust regulation, foreign investment review, and rules of professional bodies.
- Infrastructure: absence of acquisitions services, e.g. legal, accounting, investment banks, audit services.

(b) Technical barriers

- Management: A two-tier board which cannot be removed or changed quickly, family-owned companies, powers to limit maximum voting rights and override shareholder's in company's interest.

(c) Information barriers

- Accounting: financial statements not available, poor quality of information, low compliance with international accounting rules.
- Shareholders: due to issue of bearer shares, shareholder structure not known.
- Regulation: regulatory procedures not known or unpredictable.

(d) Culture and tradition

- Attitude: possible dislike of hostile bids, xenophobia, unwillingness to disclose information, 'to sell is to admit failure' syndrome.
- Value system: high premium on trust and confidence in negotiations rather than formal controls.

Cross-border acquisitions face a variety of obstacles in different countries. For example, in Continental Europe, family control of companies can prove a quite difficult barrier for effective deals. Also, the importance of recognising issues such as the role of trade unions, different regulatory frameworks is great. These obstacles must be analyzed at the first stages of an M&A in order to avoid future problems during the integration process. Integrating a cross-border acquisition is generally more complex and often presents different forms of problems.

Kang (Dec 1993) examined a sample of 119 Japanese bidders and 102 targets during 1975-1988 and a control sample of 119 U.S. bidders and 102 U.S. targets involved in domestic U.S. mergers during the same period. He also provided useful insights into the motivations for the wealth consequences of cross-border mergers. Results were consistent with the literature on foreign direct investment and the market for corporate control. Japanese mergers and acquisitions in the U.S. create statistically significant wealth gains for both Japanese bidders and U.S. targets.

Datta and Pulia (1995) examined shareholder value creation in 112 large cross-border acquisitions undertaken by U.S. firms between 1978 and 1990. They empirically tested the impact of relatedness and cultural distance on such wealth effects. Findings suggest that cross-border acquisitions do not create value for acquiring firm shareholders and results also indicate that cultural fit has an important impact.

Derwenter (March 1995) examined shareholder wealth gains from domestic and foreign takeover announcements in the U.S. chemical and retail industries. These data indicated that there is no significant difference in within industry mean takeover premia levels.

The results also indicated that the market's reaction to buyer nationality is closely tied to the transaction characteristics.

Especially for European companies, *KPMG Management Consulting* (1999) conducted a survey about cross-border acquisitions and suggested that '*this decade has seen a rapid increase in mergers and acquisitions transactions and a view, gaining in strength, that they do not always deliver their promised deals*' and '*the findings show that corporate and management cultures should be considered right at the outset*'.

Also *Norburn and Scoenberg (1994)*, based on a sample of 70 U.K. companies acquiring in Continental Europe, discussed the types of cross-border acquisitions British companies make, the acquisition processes they adopt and the major areas of unforeseen difficulties. The key lessons are the need for specialised integration skills and the need to facilitate the transition from family to professional management.

Finally McKinsey Consulting have examined the success of cross border acquisitions (*Bleeke et al. 1993*). They report from a sample of 28 foreign acquisition programmes by 8 U.S, 9 Japanese and 11 European corporations that the overall success rate was 57 per cent which is much better than for purely domestic acquisitions.

Cross-border mergers are subject to many of the same influences and motivations as domestic mergers. However, they also present unique threats and opportunities. When firms choose to merge internationally, it implies that they have concluded that this will result in lower costs or higher productivity than alternative contractual means of achieving international goals. Although the risks of operating in a foreign environment are greater, they can be reduced through carefully planning or by an incremental approach to entering the foreign market. Evidence provided above showed that cross-border mergers and acquisitions, unless they possess unique threats, have a positive effect on performance and on shareholder wealth.

This research is concentrated in the issue of cross-border acquisitions, limited its scope on the European Union area. Cross-border and international M&A projects possess further risks and set of difficulties. These are not only financial conventions and legal requirements but also differences on management style and corporate culture of the acquired firms. These risks and difficulties require a greater level of consideration and analysis.

The researcher believes that cross-border M&A projects possess unique threats and thus need further consideration, although evidence proved that outcome and shareholder wealth is positive.

2.4 Different stages in mergers and acquisitions

2.4.1 Performance of mergers and acquisitions

The rhetorical question 'Do mergers really work?' and similar proclamations reflect the widespread perception that mergers are not successful and are often driven by irrational impulses. The outcome of acquisitions and mergers is of considerable interest to all the stakeholders in the merging firms. These include shareholders, managers, employees, the consumers and the wider community.

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 shareholders of acquiring firms. *Table 2.1* for the United States and *Table 2.2* for the United Kingdom summarise the results of previous research and evidence, assessing the performance of acquirers in terms of shareholder value enhancement.

Table 2.1: Post-acquisition shareholder returns (%) in U.S. takeovers: Summary of empirical studies

Study (year)	Type of offer	Returns to target shareholders during takeover bid (%)	Returns to bidder shareholders during takeover bid (%)	Returns to acquirer shareholders in (years) after acquisition (%)
Jensen & Ruback (1983)	Merger	20	0	
	Tender	30	4	
Magenheim & Mueller (1988)	Merger		- 0,4	- 28
	Tender		1, 4	9
Jarell & Poulsen (1989)	Tender	29	1,0	
Franks, Harris & Titman (1991)	Full sample	28	-1,0	0,1
	Contested	39	-1,4	0,0
	Uncontested	25	-0,9	0,3
Loderer & Martin (1992)	Merger			0,0
	Tender			0,0
Agrawal, Jaffe & Mandelker (1992)	Merger			-10,3
Loughran & Vijh (1997)	Merger			-16,0
	Tender			43,0
Rao & Vermaelen	Merger			-4,0
	Tender			8,6

Source: Selim et al, 2002

Table 2.2: Post-acquisition shareholder returns (%) in U.K. takeovers: Summary of empirical studies

Study (year)	Returns to target shareholders during takeover bid (%)	Returns to bidder shareholders during takeover bid (%)	Returns to acquirer shareholders in (years) after acquisition (%)
Firth (1980)	28	-6,3	0,0
Franks & Harris (1989)	22	0,0	-12,6
Limmack (1991)	31	-0,2	-4,5
Sudarsanam et al. (1996)	29	-4,0	
Gregory (1997)		-0,5	-8,2
Higson & Elliott (1998)	38	0,4	-1,1

Source: Selim et al, 2002

We must note that wealth gains are measured by abnormal returns, i.e., returns in excess of an appropriate benchmark return. These tables provide clear evidence that shareholders of acquirers experience wealth losses on average, or at best, break even. On the other hand, shareholders of target companies are better off with abnormal returns in the order of 20% to over 43%. The poor wealth experience of acquirers is common to both the U.S. and the U.K. and is also fairly consistent across a range of models. Overall, mergers and acquisitions more often destroy, rather than enhance, value for the acquirer shareholders.

However, one aspect of the post-acquisition performance is that there is some variation in acquirer and target shareholder wealth performance across merger types. Evidence presented above paints a rather unflattering picture of M&A's and raises important questions about the reasons for acquisition failure. This failure can arise at any stage of the acquisition process, which it will be divided for the purpose of this research in four stages.

These stages are:

- Corporate and acquisition strategy development
- Deal structuring, due diligence and negotiation
- Post-acquisition integration
- Post-acquisition audit

The following sections will cover these four stages and will summarize and present the empirical studies and the risks related to this process.

2.4.2 Corporate and acquisition strategy development

An acquisition is a means to an end, the end being the achievement of certain strategic objectives of the acquirer. These strategic objectives may be varied, including growth of the firm, gaining competitive advantage in existing product markets, market or product extension, or risk reduction. Like all other strategic decisions, acquisitions should satisfy the criterion of added value.

Acquisitions need to be placed in the context of the firm's broader corporate and business strategy framework. Corporate strategy analysis has evolved in recent years through several paradigms-industries, structure driven strategy, and competition among strategic groups, competence or resource-based competition (*Thomas and Pollock, 1999*). The evolution of business strategy has been driven more by the practical needs of business than by the development of theory. The emergence of corporate planning was associated with the problems faced by managers during the 1950's and 1960's in co-ordinating decisions and maintaining control in increasingly large and complex enterprises.

Also, the primary emphasis of corporate planning during the 1960's and 1970's was on the diversification strategies through which large corporations pursued growth and security. Also, during the 1980's and 1990's, interest on the role of strategy in building competitive advantage resulted in a shift of interest toward the internal aspects of the firm. The main result of this evolution in business and corporate strategy is a bulk of

theories analysed. Under the industrial organisation model, companies choose cost leadership or product differentiation with narrow or broad segments (*Porter, 1985*). Under this model companies choose mergers and acquisitions strategy in order to gain market power, save cost, gain economies of scale and scope and finally gaining competitive advantage.

On the other hand, in recent years, the resource-based view of competition has gained ground. During the 1990's, ideas concerning the role of a firm's resources and capabilities as the principal basis for its strategy and the primary source of profitability. Central to this resource-based view is the idea that the firm is essentially a pool of resources and capabilities, and that these resources and capabilities are the primary determinants of its strategy (*Barney, 1991; Madhoney and Pandian, 1992; Peterlaf, 1993; Collis and Montgomery, 1995*). Using this view, mergers and acquisitions may be interpreted within the resource-based model as a search for partners with complementary resources and capabilities and also can explain different types of acquisitions such as related and unrelated.

Evidence also showed that internal audit involvement in the strategy and strategic and acquisition planning is low. *Selim et al (2002)*, in an international study, provide evidence that the actual participation of internal auditing during the strategic planning stage is quite low. Internal audit function appears to be quite uninvolved due to the fact that while internal auditors prefer to have a greater level of involvement during strategy development, management has the perception that it has the sole responsibility to develop and execute business strategic initiatives.

But internal auditors can play a greater role in the strategic planning stage by making sure that there is a well defined and organised strategic planning process, advising on systems and processes that can mitigate acquisition risk and addressing the risk assessment process within the strategic planning process. One of the objectives of this research is to highlight the current and preferred level of involvement of the internal audit function in

the strategic planning stage in the European Union mergers and acquisitions and also provide useful evidence about the gaps between the current and the preferred situation.

2.4.3 Valuation and due diligence process

Valuation of the target and due diligence in an M&A project are an important part of the process of determining the consideration to be offered to the target shareholders. The value that the bidder places on the target sets the maximum price that the bidder can afford to offer the target shareholders, as well as valuation of the totality of the incremental cash flows and earnings.

Valuation of a target is based on expectations of both the magnitude and the timing of realization of the anticipated benefits. Where these benefits are difficult to forecast this process is not precise and exposes the bidder to valuation risk. The degree of this type of risk depends on the quality of information available to the bidder which also depends on the nature of the bid (friendly or hostile) and the time spent in preparing it.

Companies, like people, are individuals. Each has a unique history, its own purpose and a place in the current economic picture. Companies and information differ and due diligence process can be one of the most useful stage of the merger process because the unique history of each company cannot establish a standard guideline. During due diligence stage, a general guideline can be comprised with the objective of compatibility with acquisition objectives, relevant facts and useful feedback about the company and the industry it represents can be summarized, financial data and a detailed review of the financial statements and human resource or cultural fit of the target company.

Gates (1988) presents due diligence as one of the most important stages to get the most value from an acquisition and insists that due diligence can greatly reduce the risk of the deal and need to cover important aspects like marketing, financial information, business outlook etc. Also, *Kaplan and Ruback (1995)* compared different valuation models in a sample of 51 highly leveraged transactions completed between 1983 and 1989. This

study provides evidence that discounted cash flow methods gives reliable estimates of market value.

Young and Sutcliffe (Aug 1990) suggest also that current high bid activity indicates that target companies may be undervalued. They examined the existence of value gaps by researching survey of stockbrokers' valuation and study of market values. They also found evidence that on average bidders overpay but many acquirers are expected by the stock market to create value. Also, negotiations and due diligence are conducted in an atmosphere where the bidder and the target may have private information that the other party does not have. Effective techniques developed for negotiations under such circumstances must be followed to avoid buying a "lemon" (*Dierickx and Koza, 1991*).

It is also essential to suggest the role of advisers in the due diligence and deal structuring stage. A merger may involve the use of one or more advisers like merchant banks, lawyers, accountants, strategy consultants etc. The need for any of these advisers depends upon the extent of in-house expertise available to the company and the level of the complexity of the deal (*Servaes et al, 1996*). Also the large scope and complexity of current deals have made companies highly dependent on professional advice from investment banks further diminishing the clients' ability to judge or even question the investment banks performance (*Kosnik and Shapiro, 1997*).

A very important question for choosing an adviser to this stage would be what difference can make the choice of one adviser on the outcome or cost of a bid. Empirical evidence showed that bid period returns are highest when both bidder and target retain first tier banks and lowest when they both hire second tier banks (*Sudarsanam and Salami, 1999*).

The internal auditor's role during mergers and acquisitions usually is associated with due diligence process *(Trampe, 1998)*. Internal auditors can provide management with vital information about the value of the company being acquired, its financial condition, any weaknesses in its financing or internal controls as well as its history, customer base, property conditions and management practices.

An interesting case study of effective contribution of internal audit function during the due diligence stage is the case of Ameritech that was acquired by SBC Communications in October 1999 (*Burke, 2000*). The results of this involvement of internal auditing function during due diligence stage were as follows:

- They got managements' attention in order to demonstrate that internal auditors had the necessary skills and competencies to add value to all M&A deals at Ameritech.
- They identified several best practices and benchmarks used by world-class companies.
- They performed due diligence internally and the result was to take advantage of the internal auditors' in depth knowledge of company operations and overall strategy.
- Internal auditors' skill sets in areas such as interviewing, analysis and communications were also tapped.
- Internal auditors' contributions resulted in reduced consulting fees, improved response time and knowledge retention throughout the company.

Due diligence and internal auditing teams must therefore draw upon a wide range of competencies both from within the acquirer and from external sources. Internal audit function can contribute to the setting up of the due diligence team and to its functioning by identifying the areas that need focusing and by keeping the team to a more rounded and holistic, rather than a functional, view of the acquisition.

2.4.4 Post-acquisition integration

Even though merger and acquisition activity is carefully designed to ensure a tight strategic fit between two companies, the task of integrating them remains difficult and may be getting even harder than in the past. A way of meeting the challenge is to treat the integration process as nothing less than a far-reaching change management initiative.

The objectives of the merger integration process should be to uncover potential problems that could keep the combined organisation from running smoothly and to take actions that prevent these problems from even arising. An effective integration program requires the merging firms to identify the obvious trouble spots at the beginning and then surface and attack the 'hidden' problems that could touch off surprise disruptions after the deal is completed (*Altier, 1997*). Integration has the characteristics of a change management program and some concepts could prove useful and should be applied to merger integration (*Galpin and Robinson, 1997*). The ability of the organisation to change fast and adjust to the new situation, a clear and well defined leadership alongside with clear and excessive communication channels and focused initiatives can prove important for the success of a post–acquisition integration stage.

One of the major problem areas during this stage is the integration of the merging firm's information systems and it has to be considered at the specific acquisition stage itself (*Buck-Lew et al, 1992*). Evidence has suggested that poor post acquisition performance was due to the failure of organisations to consider fully the implications of merging together the harder information systems and technologies (*McKierman and Merali, 1995*). Organisational culture compatibility must also be considered alongside information systems synergies (*Weber and Pliskin, 1996*). *Hoffman (1997)* also discusses the turbulence faced by Boeing after its acquisition with McDonnell Douglas in carrying out information systems integration.

The level and extent of involvement of the internal audit function during the post-acquisition integration stage according to an international study (*Selim et al, 2002*) is high. Internal audit function can serve the organisation by loaning out staff to assist with

the integration, provide consulting services to aid the business functions integrate smoothly, review and monitor high, medium and tactical integration plans. Also one of the most useful things that internal audit can do in an acquisition situation is to conduct a 'current-state assessment' of the business processes of both the acquired and the acquiring company (*Davison, 2001*). Finally, in addition to all of the financial and physical integration plans, a separate human resources and cultural plan should also be developed.

The merger of Nations Bank and Boatmen in 1997 provides a good example of how internal auditors can help operations running smoothly during a merger and minimise the acquirer's financial loss due to customer defection or employee turnover (*Trampe, 1998*). Nations Bank's internal auditors' contribution had as a result:

- Reduced consulting fees because Nations Bank's internal auditors had many of the same skills as consultants.
- Reduced external audit fees because with proper communication, coordination and planning internal auditors were able to do much of the external auditors work.
- Reduced internal and external fraud by monitor exceptions and trends to identify potential fraud.
- Enhanced customer retention as a result of their knowledge of the bank's transactions flow and their affection to the customers.
- Assist transition teams and line of businesses managers in implementing internal controls and the internal control aspects of major changes resulting from the merger.

From the above analysis and evidence it is obvious that internal auditors can play an important role and contribute effectively at the post-acquisition stage. This research will try to highlight internal audit's contribution to the European Union mergers and acquisitions and discover the gaps between current and preferred situation. Effective post-acquisition integration can help the company to overcome smoothly this stage and proceed to the final, post-acquisition audit, stage.

2.4.5 Post-acquisition audit

Post-acquisition management 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. At the post-acquisition stages, the climate for achieving change can be difficult. It is vital that the new parent company moves quickly to control and monitor the activities of its subsidiary.

An initial diagnosis of the subsidiary should address key areas of control and the internal audit team should be responsible and have the authority to require post acquisition audit on controls through systems (e.g. authorisation of payments, management information), controls through structures and controls through people (e.g. create loyalty to the parent company, motivate for maximum performance (*Cook, 1993*):

But the stage of post-acquisition audit may often be neglected for several reasons (*Selim et al, 2002*), including:

- Lack of organisational emphasis on learning.
- Each deal considered so unique that past experience of mergers is deemed irrelevant.
- Lack of a centralised and ongoing function that is responsible for achieving the past and diffusion of learning.
- Past learning not codified but resides in individuals' experience with those individuals being co-opted into deal making teams when necessary.
- Individuals' past experience is not systematically communicated but spread haphazardly through anecdotes and folklore within the organisation.
- 'The trail gone cold' – difficult to trace the acquired or merged firm since it is now part of a larger strategic business unit or subsidiary so lessons cannot be learned.

Post-merger audit by internal auditors can be acquisition specific as well as being part of an annual internal audit plan that has a major role in ensuring organisational learning and its dissemination. The need for post-acquisition audit is primarily bounded by its objectives. It is expected to provide evidence on the possible synergistic benefits that could be in the form of operating efficiencies and economies of scale. Possible problems

could be the assessment of different management styles, the over-reliance to investment bankers or inadequate planning.

The role of post-merger audit is essential in order to follow-up, identify problems at the integration stage and suggest solutions for post merger integration. These solutions can include effective change management, learning of how organisations respond to change and adjust the program of post-integration, maximise the return on effort by changing the procedures and processes that will produce the greatest results and finally certify that the M&A process operates in a controlled environment.

2.5 Regulatory framework of mergers and acquisitions

The antitrust laws protect competition as a means to promote efficiency and thereby enhance consumer welfare. They condemn mergers that will enable the merged firm to restrict output and raise prices, because such mergers reduce efficiency, making life easier for the merged firm and its rivals. In this part, we will describe the institutional arrangements behind the regulatory frameworks in the United States, United Kingdom and the European Union, in order to present and compare regulations and laws in the countries that represent major M&A volume (in terms of deal value and size) and we will also provide the criteria and procedures for mergers and acquisitions in these areas.

2.5.1 Antitrust regulation in the United States

Among other countries, U.S.A. has the longest tradition of antitrust regulation, starting the Sherman Act of 1890. This Act declared contracts and combinations which restricted interstate trade or trade with other countries illegal, and any attempt at monopolizing this trade a criminal offence. The Sherman Act was not particularly suitable for the prevention of prospective mergers and acquisitions, especially in the form of acquisition of stock to gain control of companies.

The Clayton Act 1914 was passed to overcome the shortcomings of the Sherman Act, and was subject to later amendments to make it a more effective mechanism for dealing with mergers. More specifically, Section 7 of the Clayton Act prohibits full or partial

acquisition by a commercial corporation of the stock or assets of another engaged in commerce in the country, if the effect of such an acquisition may be substantially to lessen competition or tend to create a monopoly.

The Federal Department of Justice (DOJ) enforces the various statutory rules as well as the Federal Trade Commission (FTC). Both agencies investigate and, if necessary, initiate proceedings in federal courts. The FTC also has various appeal procedures involving the administrative law courts and the independent FTC commissioners.

We must also notice that, in addition to the above federal regulation, individual states have their own antitrust laws applying to mergers that would not affect interstate trade. Affected parties can bring or join proceedings under both federal and state laws. This contrasts with the European Union and the United Kingdom position, which we will analyse subsequently, where affected parties cannot bring a legal action to force the European Commission or the Office of Fair Trading (OFT) to investigate a merger.

2.5.2 Merger control in the U.K.

In the United Kingdom mergers have been the subject of antitrust regulation since 1965, during which period the U.K. government's policy has gone through distinct phases. While the main thrust of the antitrust regulation has been the maintenance of effective competition, many other issues of public interest have been from time to time considered relevant in determining whether a merger should be allowed. In this part, we describe the functioning and record of the U.K. antitrust regulatory framework.

In the United Kingdom, there is no obligation to notify a proposed or completed merger to the authorities. The general law of the UK regulating mergers is contained in the Fair Trading Act 1973 (FTA). Also, the Office of Fair Trading (OFT) carries out a preliminary investigation and then recommends to the Secretary of State whether or not the transaction should be referred to the Competition Commission for in depth review and monitors merger activity in the United Kingdom.

The Fair Trading Act merger provisions were replaced when the relevant provisions of the Enterprise Act 2002 entered into force during 2003. The Act is designed to update the UK merger control regime and the two main changes had as a target to:

- Minimise political involvement in merger decisions by transferring decision making power from the Secretary of State for Trade and Industry to the independent competition authorities (the OFT and the Competition Commission).
- Focus the criteria for decision making on competition, by assessing most mergers against a substantial lessening of competition test rather than a public interest test.

There are three principal authorities involved with the enforcement of the UK merger control rules (*Enterprise Act, 2002*): the Office of Fair Trading (OFT) headed by the Director General of Fair Trading; the Competition Commission; and the Secretary of State for Trade and Industry. The main tasks of these authorities are as follows:

- ***The OFT*** - it is a first stage filter for mergers that meet the jurisdictional 'qualifies for investigation' thresholds. Acting on the Director General's advice, the Secretary of States, decides whether or not a transaction raises sufficient competition concerns as to merit fuller investigation by the Competition Commission. The OFT is under a duty to keep itself informed of actual or prospective mergers that qualify for investigation. It does this, by reviewing press reports and monitoring announcements made to the Stock Exchange. Also, the other major role of the OFT is to negotiate undertakings either to avoid a reference to the Competition Commission or following a Competition Commission investigation and adverse report, negotiating undertakings to remedy the adverse effects.

- ***Competition Commission*** - it is an independent body consisting of members drawn from industry, commerce and academic life. The Commission does not instigate the inquiries that it conducts. Cases are referred it for in depth review by the Secretary of State. These usually last 3-4 months following which a detailed report is presented to the Secretary of State.

- *The Secretary of State* - the Secretary of State plays the role of the decision-maker deciding whether or not to refer a merger to the Competition Commission and following investigation on whether to block or clear the deal. However, decisions on merger cases will be taken by the independent authorities: i.e. the OFT at stage one and the Competition Commission following in depth review.

Evidence attained from the stock market reaction to regulatory bodies' references, suggests that the average gain for target shareholders when the bids for their companies are cleared by the Monopolies and Mergers Commission is 38 per cent, over the period from twelve months before to one month after the report (*Franks and Harris, 1993*). Thus, most of the gains on bid announcements which are subsequently lost might have arisen from increased market power of the merging firms. *Forbes (1994)* also found non-significant gains over the same periods for bidder shareholders, whose bids are stopped by the Monopolies and Merger Commission. Thus, Forbes' results are broadly in line with those of Franks and Harris (1993).

2.5.3 European Union merger regulations

Mergers of enterprises operating within the European Union are, since 1990, subject to European Union - level merger regulation. This regulation was promulgated with the aim of achieving the 'one-stop shop' clearance of mergers. This means that the merged companies deal with just one authority instead of review by various national authorities, which can lead to confusion and uncertainty. The result is that there is now a hierarchy of merger regulation in the European Union, with very large mergers having European Union-wide impact being examined within the European Commission (EC). Smaller mergers with their impact within a single member state are investigated by that state's own antitrust regulator.

The Merger Regulation is the first Europe-wide merger control law and has been in force for more than 12 years and gave the European Commission the exclusive jurisdiction to examine large, cross-border mergers in Europe, within tight deadlines and to assess their impact on competition. The Merger Regulation plays an important role in guaranteeing

efficiency in production, in retaining the incentive for enterprises to innovate and in ensuring the optimal allocation of resources.

The European Union competition rules are consisted from the *Articles 81-88* at the new Treaty of the European Community. The basis for these anti-cartel rules is the *Article 81* and *82*. According to *Article 81*, 'the following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which (a) directly or indirectly fix purchase or selling prices or any other trading conditions, (b) limit or control production, markets, technical development or investment, (c) share markets or sources of supply, (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive advantage and (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts'.

Article 82 concerns with anti-dominance rule. According to this article 'any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of, it shall be prohibited as incompatible with the common market insofar as it may affect trade between Member States. Such abuse may consist in directly or indirectly imposing unfair purchase or selling prices, limiting production or applying dissimilar conditions to equivalent transactions with other trading parties and thereby placing them at a competitive advantage.

On the other side there was much criticism summarized and presented thoroughly in the economic media (such as journals or magazines) about the regulatory framework from both European and U.S. companies *(Financial Times, November 27th 2002)*. The opponents of the new rules insisted that though merger regulation would result in chaos for companies and headaches for their lawyers and some even warn that the new regime will make cartels harder to detect and punish. Critics also argued that this regime will

fragment antitrust enforcement, increasing costs and risks for companies. Also, as quoted by many American businessmen, Europe's commissioner for competition would provoke a trade war over merger policy and complained that the Commission sees markets in static and not dynamic terms (*The Economist, October 26th 2002*).

But on the other hand, after decades of failed attempts, the European Commission remains committed to the idea of a pan-European takeover directive. The Commission argues that more takeovers will lead to more restructuring and Europe will need more restructuring if it wants to catch up with, and overtake, the United States as set out in the Lisbon declaration (*Berglof and Burkart, 2003*).

European merger control has played a key role in maintaining competitive structures in Europe and in fostering the creation of a single market. Despite the criticism, this is the long-term benefit of a vigorous competition policy, which is achieved not only through merger control, but also through the control of subsidies and the fight against cartels and monopolised sectors.

2.5.4 Best practices on co-operation in merger investigations between European Union and United States

In today's global economy, many sizeable transactions involving international businesses are subject to review by the European Union and United States. Where the United States and European Union are reviewing the same transaction, both jurisdictions have an interest in reaching, insofar as possible, consistent, or at least non-conflicting, outcomes. Possible divergent approaches to assessment of the likely impact on competition of the same transaction can undermine public confidence in the merger review process and may frustrate the agencies' objectives. This review can enhance the co-operation in merger review between the U.S. Department of Justice and the European Commission.

Given legal constraints existing in both jurisdictions, effective inter-agency co-ordination between United States and the European Union depends to a considerable extent on the

co-operation and goodwill of the merging parties. In particular, co-operation is more complete and effective when (*US- EU Merger Working Group, 2002*):

- The merging parties allow the agencies to share information the disclosure of which is subject to confidentiality restrictions.
- The investigation timetables of the U.S. and E.U. run more or less in parallel so that the investigative staffs of each agency can engage with one another and with the parties on substantive issues at similar points in their investigations.
- At the start of any investigation, each agency should designate a contact person who will be responsible for setting up a schedule for conferences between the relevant investigative staff of each agency, discussing with the merging parties and co-ordinate information gathering or discovery efforts.

Also, the U.S. competition authorities and the European Commission are in the process to introduce a series of co-operation procedures to smooth the process of merger investigations on both sides of the Atlantic. This cooperation will formalize several practices that already employed and will offer on merging companies the possibility of a meeting early on with both agencies to discuss timing and will allow the agencies to exchange information.

Over the last several years, the European Commission have been making increasing use of the terms 'portfolio power', 'conglomerate effects' as theories of competitive harm in markets in which there is no direct overlap between the merging parties. These terms are used interchangeably to encompass a variety of different means by which a merger may allegedly create or strengthen a dominant position in non-overlap markets (*United States Department of Justice, 2001*). They used these theories to examine certain cases concerning American companies. These are:

- *Coca Cola / Carlsberg* – the Commission argued that 'the inclusion of strong beer and packaged water brands, such as those of Carlsberg, in the beverage portfolio gives each of the brands in the portfolio grater market power than if they were sold on

a 'stand-alone' basis. The Commission also worried that economies of scale and scope were 'key competitive factors' in the carbonated soft drinks market and the newly merged firm would take advantage of these efficiencies.

- ***General Electric / Honeywell-*** the case that has brought the most attention to portfolio effects is the Commission's recent decision blocking the merger of General Electric and Honeywell. In that decision the European Commission focused on the creation of opportunities for the merged firm to offer low price bundles of aircraft engines and systems. Also, the leverage from General Electric of its existing dominance in aircraft engines into avionics and finally General Electric's aircraft leasing arm (GECAS) would buy only (or at least heavily favor) Honeywell products, which would help create a dominant position for the merged firm. The European Commission concluded that as a result of these actions, revenue streams for General electric and Honeywell competitors in engines and avionics / non-avionics systems markets would shrink in the event of a merger leading to a reduction in their future investment.

However, on closer examination it is difficult to say so clearly that United States really has a significantly better regime. In the first place, despite rare cases such as General Electric / Honeywell analysed above, the European Union and United States have been converging on substantive merger issues over the last few years. Hence it is increasingly difficult to sustain the argument that the U.S. model on substance is better than the European Union model. On procedure, although the U.S. model formally gives greater protection to firms, it is far from clear that in reality it offers much more than the European Union system. Ideally, each system should learn off the other, so the European Union will strengthen judicial review, and United States speed up its administrative systems (*Acquisitions Monthly, May 2003*).

2.5.5 Relationship of the U.K. and E.U. regulators

In principle, mergers that fall within the scope of the European Commission Merger Regulation will not be subject to control under United Kingdom rules (or indeed, the

national rules of any other European Union Member State). Briefly, a merger will fall to be reviewed under the European Commission Merger regulation when it satisfies one of two alternative sets of jurisdictional thresholds (*OFT, Enterprise Act 2002*):

- **Either** the combined world-wide turnover of the merging parties exceeds 5 billion Euros **and** the combined European Union - wide turnover of each of at least two of the parties to the merger exceeds 250 million Euros **unless** each of the merging parties achieves more than two thirds of its aggregate Community-wide turnover within one and the same Member State

- **or** the combined world-wide turnover of the merging parties exceeds 2, 5 billion Euros **and in each of at least three Member States** the combined turnover of the merging parties is 100 million Euro and at least two parties to the merger each has a turnover of more than 25 million Euro **and within the E.U. as a whole** at least two parties to the merger each has a combined turnover of more than 100 million Euro.

According to the latest *Enterprise Act 2002 (Office of Fair Trade, Enterprise Act 2002)*, where a merger satisfies on of these two sets of jurisdictional thresholds, the merger must be notified to the European Commission. National merger control laws are expressly excluded from applying to mergers falling under the European Commission Merger Regulation.

Finally, the Office of Fair Trading (OFT) is most likely to request that a case be referred back from the European Commission in when: (a) it concerns entirely or largely the United Kingdom or a market within the United Kingdom; (b) the OFT have the experience in reviewing the market or markets in question; and (c) where the assets concerned by the transaction are located in the United Kingdom so that if, ultimately, a remedy is required, it would be possible for the U.K. authorities to secure that remedy.

Summary

Regulatory framework plays a key role in maintaining competitive structures and in fostering the creation of consumers' welfare. This is the long-term benefit of a vigorous

competition policy and that is the objective of the regulatory and antitrust frameworks in United States, United Kingdom and the European Union. Apart from that, merging companies often cannot understand the legal risks and very often face regulatory obstacles to start the merger process.

Internal audit role in this process could be useful and can help merged companies to manage better these legal risks. Research (*McNamee and Selim, 1998*) uncovered a significant and rapid change in internal auditing from a passive and reactive control-'based role to an active and anticipative risk-based role. This means that the role of internal auditors could be more active in this legal process.

This brief description of the antitrust and merger control in United States and United Kingdom has been provided to illustrate the diversity of approaches to antitrust regulation. *Table 2.3* provides a horizontal comparison of these three different regulatory frameworks.

This part has provided an introduction to the rules and regulations governing mergers and acquisitions in United States, United Kingdom and the European Union, from the antitrust perspective. It has described the different regulatory frameworks in these three different areas and tries to provide evidence on the effect of these regulations to the merging companies.

Many see merger activity as an expression of strong change forces. Through mergers and restructuring firms want to become more efficient and gain possible synergies and cost reductions. The role of antitrust regulation should not restrict these competitive forces. On the other hand a regulatory framework is essential in order to gain consumer welfare and control possible competition violation and cartel creation.

Table 2.3: Horizontal comparison of the regulatory frameworks on European Union, United States and United Kingdom

	UNITED STATES	EUROPEAN UNION	UNITED KINGDOM
Differences	*Individual states have their own antitrust laws*	*Affected parties cannot bring a legal action to force the European Commission to cancel the decision made*	*Affected parties cannot bring a legal action to force the Office of Fair Trading to cancel the decision made*
	Dual regime – Federal and State laws	*One – stop shop clearance of mergers: Very large mergers having E.U. wide impact are examined by the European Commission and smaller mergers within a single member state are investigated by that state's antitrust regulator*	*There is no obligation to notify a proposed or completed merger to the authorities. The Office of Fair Trading carries out the preliminary investigation and then recommends to the Secretary of State whether or not the transaction should be referred to the Competition Commission*
	Formal guidelines for the assessment of mergers	*No formal guidelines for the assessment of mergers*	*No formal guidelines for the assessment of mergers*
Regulatory body	*Federal Department of Justice and Federal Trade Commission*	*European Commission*	*Office of Fair Trading, Competition Commission and Secretary of State for Trade and Industry*
Historical evolution	- *Sherman Act 1890* - *Clayton Act 1914* - *Dept of Justice statutory rules*	- *Merger control regulation (1990)*	*- Fair Trading Act (1973)* *- Enterprise Act (2002)*

2.6 The internal audit role during mergers and acquisitions

2.6.1 The evolution of internal auditing profession

Internal auditing profession has changed dramatically during the last six decades. During that period the profession's narrow scope of measuring and evaluating the effectiveness was expanded to a much broader spectrum of activities. Internal auditing has evolved from an essentially accounting oriented craft to a management oriented profession. At one time, internal auditing functioned as an assistant to the independent accounting profession and attesting to the accuracy of financial matters. Now, internal auditing has established itself as a distinctive discipline with a far broader focus. This can be obvious from the evolution of definitions of the internal auditing profession.

According to the definition that was introduced in the *Standards for the Professional Practice of Internal Auditing (1978)* "Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization". Thus, the main objective of internal auditing function was to assist members of the organization in the effective discharge of their responsibilities and provided useful feedback such as appraisals, recommendations, counsel, and information concerning the activities reviewed.

In 1999, the Institute of Internal Auditors Board of Directors approved the new definition that determined "Internal auditing as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes (*Institute of Internal Auditors, 1999*).

Traditional internal auditing has focused on control and operations. However, integrated management control frameworks such as COSO and CoCo have more closely aligned an organization's control activities with broad organizational objectives and the risk of not achieving these objectives. More specifically, COSO framework was introduced by *The Committee of Sponsoring Organizations of the Treadway Commission.* Its focus was on

the achievement of certain objectives (effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations) and five inter-related components of control:control environment, risk assessment, control activities, information & communication and monitoring (*Committee of Sponsoring Organizations of the Treadway Commission, 1994*).

On the other hand, the Canadian Criteria of Control Committee sponsored by the Canadian Institute of Chartered Accountants include twenty criteria of control (in terms of purpose, commitment, capability, monitoring and learning) and defines internal controls as the elements of an organization that support people in the achievement of the organization's objectives. These objectives can fall in one or more of the following categories: effectiveness and efficiency of operations, reliability of internal and external reporting and compliance with applicable laws, regulations and internal policies (*Sawyer's, 2003*).

Accordingly, the new definition recognizes that controls exist to assist the organization in managing its risk and to promote effective governance processes. The risk framework drives the determination of assurance and consultative projects that should be performed to add value to the organization (*Krogstad et al, 1999*). Modern internal auditing provides services that include the examination and appraisal of controls, performance, risk and governance. Once perceived as the client's adversary, internal auditors now pursue cooperative, productive working relationships with clients through value-added activities.

Internal auditing profession began to evolve in 1941 when the Institute of Internal Auditors was formed. It has passed through two dominant paradigms and is poised on the edge of a third. The first internal auditing paradigm focused on observing and counting. Then, Victor Brink introduced the concept of a system of internal controls and changed the paradigm from a focus on re-performance to a focus on controls. The third paradigm is based on viewing the business process through a focus on risk (*McNamee and Selim, 1999*).

Also, *Page and Spira (2004)* discuss that the perception of internal auditors as mindless box–tickers checking compliance with centrally imposed systems is long out of date but, on the other hand, they suggest that not all internal auditors become risk management professionals whose role is to identify, assess and mitigate the business risks faced by their organisations. The following table illustrates the differences between the two paradigms:

Table 2.4: Comparison of old and new paradigms of internal auditing profession

CHARACTERISTIC	***OLD PARADIGMS***	***NEW PARADIGM***
Internal Audit Focus	Internal Control	Business Risk
Internal Audit Response	Reactive, after-the-fact	Coactive, Continuous monitoring
Internal Audit Tests	Important Controls	Important Risks
Internal Audit Methods	Emphasis on the completeness of detailed control testing	Emphasis on the significance of broad business risks covered
Internal Audit Role in the Organization	Independent Appraisal Function	Integrated Risk Management and Corporate Governance

Two major regulatory frameworks had also "boost" the integrated role of internal audit function. Combined Code (*Financial Services Authority, July 2003*), introduced in the UK by Financial Services Authority and replaced the Combined Code issued by the Hampel Committee on Corporate Governance in June 1998. In 2006, Combined Code has been updated, applied for reporting years beginning on or after July 2006. The Code contains main and supporting principles and provisions concerning companies and institutional shareholders as well as guidance on internal controls (Turnbull Guidance) and on audit committees (Smith Guidance).

On the other hand, in the United States, Securities and Exchange Commission (SEC) introduced Sarbanes-Oxley Act in July 2002 largely in response to major corporate and accounting scandals involving several prominent companies. Section 404 of the Act requires management assessment of internal controls requires most publicly registered companies and their external auditors to report on the effectiveness of the company's internal control over financial reporting.

Internal auditing is a dynamic profession that has evolved in response to changes occurring within it and in the organizations it serves. The new definition was one more important step in this process. However, as the pace of change accelerates, internal auditing must visualize and seize new opportunities to meet organizational needs. On the other hand, mergers and acquisitions are a very complex process that includes risks and opportunities and the new roles for internal auditors could broaden the profession's self image and encourage its full participation in the process.

2.6.2 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 & Vijh, 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 (*Dierícx 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 2.5: 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 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, 1999*) 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).

The management of a company has operational responsibility for the management of risk, whilst the role of the Board is to ensure that risk management processes are in place, as well as obtaining assurances from management, internal audit and others 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.

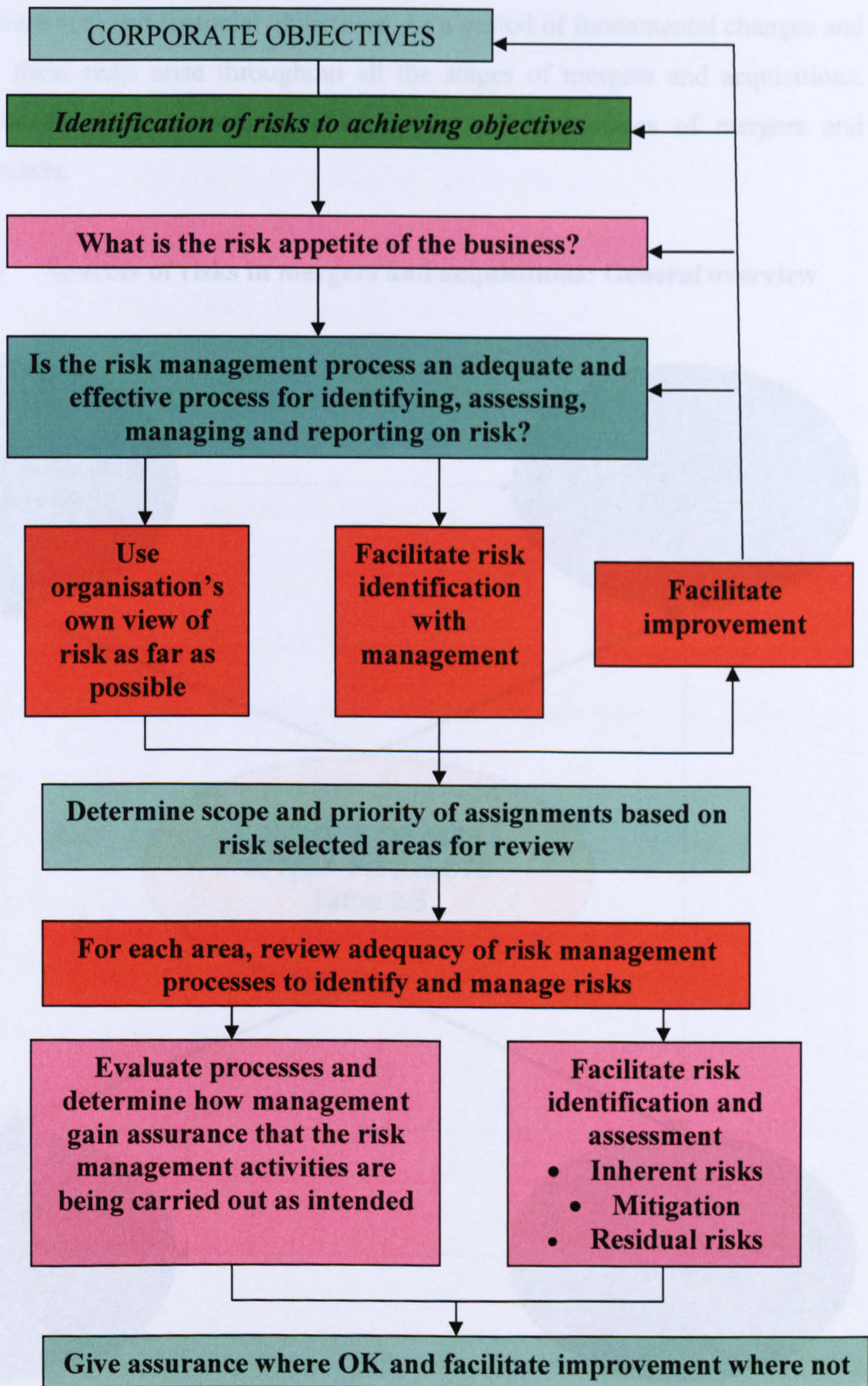
Another important issue of risk–based philosophy is the new *Enterprise Risk Management Framework* initiated by the *Committee of Sponsoring Organizations*

(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 strives 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. This approach is presented in the following diagram:

Figure 2.1: Risk-based internal auditing



Mergers and acquisitions encompass a number of risks causing the firm to miss its strategic, organisational and financial objectives. As a period of fundamental changes and destabilisation, these risks arise throughout all the stages of mergers and acquisitions. *Figure 2.2* illustrate these sources of risks at the different stages of mergers and acquisitions projects.

Figure 2.2: Sources of risks in mergers and acquisitions: General overview

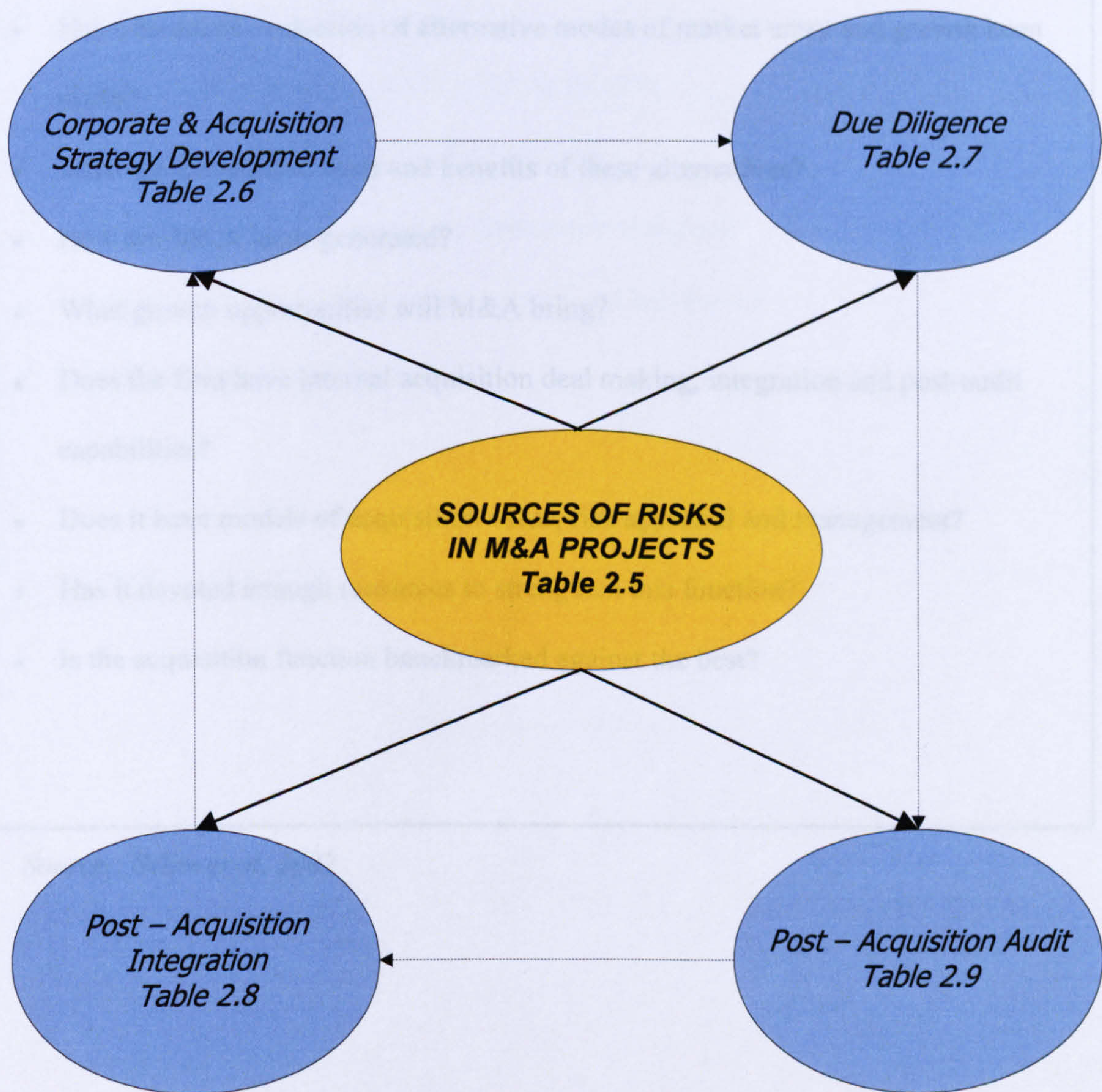


Table 2.6 Examples of possible risks in corporate and strategy planning

- Are the sources of the firm's current and future competitive strengths clearly identified?
- Can they be developed internally or do they need to be sourced externally?
- What are the alternative ways of assessing the resources/capabilities?
- What is the place of M&A in the firm's competitive strategy?
- Has a balanced evaluation of alternative modes of market entry and growth been made?
- What are the relative costs and benefits of these alternatives?
- How are M&A ideas generated?
- What growth opportunities will M&A bring?
- Does the firm have internal acquisition deal making, integration and post-audit capabilities?
- Does it have models of acquisition value, risk appraisal and management?
- Has it devoted enough resources to strengthen this function?
- Is the acquisition function benchmarked against the best?

Source : Selim et al, 2002

Table 2.7 Examples of possible risks in valuation and due diligence process

- Selection of inappropriate acquisition team and advisers
- Inappropriate and costly bid strategies and tactics
- Risk of conflicting interests with advisers
- Does due diligence cover commercial, HR and environmental risks?
- Availability of financing
- Selection of the appropriate valuation technique
- Selection of appropriate accounting method
- Are antitrust rules and regulatory framework observed?
- Setting unrealistic negotiation parameters and benchmarks
- Inadequate due diligence process

Source : Selim et al, 2002

Table 2.8 Example of possible risks in post - acquisition integration

- Lack of integration strategy or plan to achieve the strategic and financial goals
- Lack of project management approach
- Absence of performance benchmarks and milestones for evaluating integration process
- Does the integration experience contribute to organisational learning and developing a core competence?
- Does the integration plan cover all relevant aspects of the two firms?
  - Organisational restructuring
  - Cultural integration
  - IT systems
  - Human Resource issues
  - Processes
  - Operations and production
- Does the integration process include effective communication strategies for internal and external shareholders?
- Do project management teams include managers from both firms?

Source : Selim et al, 2002

Table 2.9 Example of possible risks in post-acquisition audit

- Absence of acquisition specific and thorough audit
- Inadequate assessment of performance due to poor performance metrics or time scale for delivery of performance
- Absence of clear identification of reasons for success or failure
- Lack of effective communication strategies to communicate the lessons from acquisitions
- Have the deals been audited for delivering their promises?
- Do performance benchmarks represent a balanced scorecard covering?
- Does the audit create a well-calibrated feedback mechanism for organisational learning?
- Are both successes and failures in acquisitions communicated effectively so they become embedded in organisational procedures, systems, cultures and routines?
- Does post audit lead to more effective acquisition process and organisational capability that confers a competitive advantage?

Source: Selim et al, 2002

2.6.3 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 be 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 must 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. The following table lists a potential checklist during pre–acquisition stage:

Table 2.10: Pre–acquisition stage – Checklist for review

I. Screening of potential candidates		II. Confirm readiness of acquiring company for diversification	
A. Business Position	Market trends and market share	***A. Business expertise***	Define distinctive competence
	Political, economic, social and technical environment		Source of competitive advantage
	Analysis of competition		Ascertain how to add value
B. Current and forecast results	Profit measures	***B. Financial discipline***	Preparation and presentation of management information
	Asset values		Efficiency of treasury function
	Liquidity		Resource planning
C. Potential fit between companies	Business fit	***C. Organisational effectiveness***	Organizational structure
	Financial fit		Personnel procedures
	Organisational fit		Quality of planning function

Source: Cook, 1993

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:

1. Forming a business resources team and generating cooperation among M&A stakeholders.
2. Conducting pre-acquisition due diligence.
3. Developing the post acquisition integration strategy.
4. 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 auditing 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 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. But we must take into consideration that during post–acquisition stage, merged organization 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 must 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. This potential checklist for post-acquisition review is presented on the following table (*Cook, 1993*):

Table 2.11: Post–acquisition stage – Checklist for review

PHASE I	*Reporting systems*	Cash and Bank
		Authorisation of payments
		Management of information
	Structures	Remedial restructuring
		Shorter communication lines
		Create separate accountable units
	People	Identify talented middle managers
		Create loyalty to parent
		Motivate through target and bonuses
PHASE II	*Use of assets*	Safeguards against misuse
		Identify 'jewels in the crown' meriting investment
		Rationalize surplus capacity
	Economy and efficiency	Identify opportunities to integrate facilities, finance, data processing etc.
		Co – ordinate group arrangements for purchasing , pensions, insurance etc.
	Accomplishment of goals	Compare outcomes with original strategy and review effects on integration on products, markets, prices
		Compare outcomes with original strategy and review effects on integration on communication and distribution

Source: Cook, 1993

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 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.

2.6.4 Internal auditing as a value added tool in the M&A process

The definition of "value added" can vary considerably from one audit department to the next. For many practitioners, this phrase describes audit work that helps management to improve the business, rather than assignments that simply verify compliance with policies and procedures. The type of work or services that constitute value-added practice is situation specific. What adds the most value for one organization or even one area might be a waste of resources somewhere else (*Roth, 2003*).

Value added auditing can be described as a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. Another similar term is value for money auditing. Value for money auditing takes into account the 3 E's (Economy, Efficiency, and Effectiveness). It frequently makes extensive use of performance indicators in the form of ratios and other statistics to give an indication of value for money (*Chambers, 1997*).

A survey conducted by the *Institute of Internal Auditors Research Foundation* in the study *"Adding value: Seven Roads to Success" (2003)*, solicited information regarding best practices and value added auditing. Survey questionnaires were sent to approximately 4,500 North American audit directors and managers. Participants were asked to identify their current best practices in value added auditing, as well as practices they believe will become increasingly important to them.

The ten most frequently named practices in each category are presented in the following table:

Table 2.12: Current Vs Preferred Value Added Practices

CURRENT BEST PRACTICES	*BECOMING MORE IMPORTANT*
• *Risk assessment to develop the annual audit plan*	• *Control self-assessment*
• *Control self-assessment (CSA)*	• *Consulting*
• *Consulting*	• *Risk management*
• *Risk-based audit projects*	• *Computer assisted audit techniques*
• *Partnering with line management*	• *Risk assessment to develop the annual audit plan*
• *Participation of teams*	• *Participation on teams*
• *Systems implementation reviews*	• *Internal control training*
• *Computer assisted audit techniques*	• *Continuous monitoring*
• *Internal control training*	• *E-commerce / cyber security*
• *Automated work papers*	• *Systems implementation reviews.*

Although what constitutes value-added activity will vary based on many factors, there are some general rules that apply across the board. Four factors that determine some prerequisites for internal auditors in order to add value to their organisation can be summarised as follows (*Roth, 2003*):

- A deep knowledge of the organisation, including its culture, key players, and competitive environment.

- The courage to innovate in ways stakeholders don't expect and may not think they want.
- A broad knowledge of those practices the profession, in general, considers value added.
- The creativity to adapt innovations to the organisation in ways that yield surprising results and exceed stakeholders' expectations.

Three of these factors – organisational knowledge, courage, and creativity – represent competencies and personal qualities that, for the most part, are self-explanatory. "Practices the profession considers value added", however, leaves much room for interpretation, and thus merits further attention.

Gary Stern (1994) also provides a "best practices" list for internal audit departments in order to possibly add value to their organization. Thus, internal auditors can help and become a catalyst for change and help business units to operate more effectively. Internal auditors can also use self–assessments in order to encourage auditees' involvement and participation for a problem solving approach. Also, bringing business staff into the philosophy of internal audit enables them to receive broader experience and perceive the scope and objective of internal audit department. Finally, other best practices in this article indicate to share technology with the business units, align with customers, conduct preventive auditing and place internal auditors in special assignments.

Value added practices indicated in the literature were conrol self assessment, consulting skills and the use of computer assisted audit techniques. Control self assessment is a process which allows and encourages line management, staff, and internal auditors to participate in the review and evaluation of systems of internal control. It requires free and open discussion and can reduce the perception of audit as negative and bureaucratic procedure. On the other hand, the new definition (*Institute of Internal Auditors, 1999)* introduced consulting as another possible internal audit role based on the background and experience of internal auditors (*Sawyer's, 2003*).

Mergers and acquisitions tend to represent the ambition of adding value to the new company. Internal auditing can prove that is a value added activity during the process and the various stages of a merger. Value-added auditing is based on the premise that the results of all audits should be quantified in order to show the value added to the process. This process of quantifying the contribution of internal auditing recommendations is the difference between an audit department viewed traditionally as a cost center versus an audit department with the potential for being viewed as a profit center (*Seaman, 1995*).

Motivated by the universal mandate to curtail expenses and boost profits internal auditing departments must seek ways to add value in the merger process. But very few internal audit functions are asked to measure or demonstrate the value they deliver. On the other hand, board directors and heads of internal audit agree that the most important ways in which internal audit adds value are providing assurance that the main business risks are being managed and providing assurance that the general internal control framework is operating effectively.

Chapter 3: Research Questions

3. RESEARCH QUESTIONS

3.1 Introduction

The extensive literature review in the previous chapter surrounded the whole merger and acquisition phenomena. It provided also empirical evidence assembled by several studies in the United States, United Kingdom and other countries that support the hypothesis of high rate of failure in the merger and acquisition process. As analyzed, this failure can occur at any of the stages mentioned: corporate and acquisition strategy, valuation and due diligence, post-acquisition integration, post-acquisition audit.

Mergers and acquisitions are a very complex process that requires a deep understanding of the sources of value creation and the possible synergies. The risk of failure needs careful planning and evaluation. As mentioned, internal auditing has been involved in due diligence stage, with its role being limited to accounting issues. Also, in leading edge organizations, internal auditing has taken part in deal structuring, post-acquisition integration and post-acquisition audit (*Selim et al, 2002; Davison, 2001*).

The increasing importance of merger and acquisition activity to corporate strategy and the record of failure of such strategies in creating value, both in the United States and the European Union adding also the great evolution of internal audit profession during the last years gave us the motivation to research the role internal audit function possibly can play in the process. This research will highlight especially 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 the minimization of the various risks in the process.

3.2 Research questions

The research questions will be as follows:

Q1: What is the role internal audit currently plays in leading edge organizations in the European Union that pursue mergers and acquisitions?

One of the objectives of this research is to identify and analyze the role internal auditors currently plays during the stages of M&A projects. As evidenced in the previous parts internal auditors are not included in the M&A process and, in the cases that were involved, they performed due diligence and testing. Also, internal audit directors seemed to be involved in the preliminary discussions (*Davison, 2001; Selim et al, 2002*). Analysis of the curent role will form the first "pillar" of our research in order to decipher the present role of internal audit practioners and professionals.

Q2: What is the contribution of internal auditing to the various stages of a merger and what role does it play in complementing and enhancing other functions involved?

Internal auditing is not the only function taken part in the M&A process. It is obvious that various departments are taken part to the process. These are, for example, finance, Information Technology, marketing, human resource etc. It is obvious that some functions or processes can overlap rising the cost and the time horizon of the merger or acquisition. It will be useful to analyze the level of contribution of internal auditing to the different stages of the M&A process as well as the level of co-operation with other functions.

Q3: What are the preferred roles internal auditors would like to play in the merger and acquisition process?

Internal auditing is now a mature profession whose practitioners are specialized in internal control, fraud detection and prevention and other areas of the corporate governance structure. The internal audit objective includes promoting effective control at a reasonable cost. We are moving from the traditional audit work such as planning, verification and compliance to a more risk based auditing that its scope of work is based on risk assessment, consultancy and a more proactive role.

Thus it is not surprising that in recent surveys and research, internal auditors and audit directors wanted to contribute more effectively to the M&A process at all the stages. Many of them believe that more value could be added by the internal auditing department if their roles were allowed to expand. Also, internal auditors suggested that they needed more training in mergers and acquisitions in order to overcome the difficulties and the 'mistrust' of the other member of the merger team.

This research will try also to highlight and summarize the preferred roles that internal auditors would like to play at all stages of the European mergers and acquisitions. We must also notice that researcher's objective is to effectively contribute the deep knowledge of the audit directors and the internal auditors of these European organizations as a result of their knowledge and organizational experience. It will try also to highlight the interaction between internal auditing department and other functions involved in the merger process such as finance and IT.

Q4: What is the 'ideal' situation of internal auditing involvement in the mergers and acquisitions process according to empirical evidence and literature review (Normative model)?

From the empirical evidence provided in chapter 2 we can develop and present the 'ideal' situation that various textbooks and articles present. This normative model would be very helpful in the analysis of the gaps between these three different models, the observed, preferred and the normative providing useful results in order to develop the best practices 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

When comparing the normative model, derived from the extensive literature review, to the observed current and ideal situation in the merger and acquisition process, a number of gaps will be identify. One of the objectives of this research is to highlight the reasons for the gaps in this process. These gaps could be management related; internal auditing related or related to some other general factors outside of the process and the companies.

Q6: What are the prerequisites that are essential for internal audit function in order to play a more expanded role and how they will interact with the best practice model suggested for European companies?

Selim et al (2002) suggests a list of prerequisites for a more effective internal audit role. This list includes actions such as:

- Knowledge of the firm's corporate and business strategies

- Good understanding of the various sources of risks to which business units are exposed
- Experience of operating businesses
- Good interpersonal skills
- Strong support from the board
- Awareness of the resources and capabilities of internal auditing to act as an adviser and internal consultant

In order to get the best possible results from the best practices model some prerequisites must be achieved. This research will try to identify and highlight these prerequisites in the European companies and could identify a large number of issues in order to provide useful recommendations to chief audit executives and internal auditing departments. The desired prerequisites could split in different sets such as those deals with internal audit strategy, knowledge, the level of proficiency, individual skills and capabilities etc.

Q7: Can we develop a model(s) of best practices of the internal audit function which would enhance the effectiveness of the merger process of the European companies and helping the firm achieve its strategic objectives?

Using the findings in the previous research questions we can present a variety of opportunities and actions for the internal auditing function in order to respond more actively to its proactive role in the M&A process. Internal auditors can actively be involved and play a greater role in all the stages (pro–active and post–active) of the M&A process.

Mergers and acquisitions are undertaken by companies to achieve certain strategic and financial objectives. Success of mergers depends on how well the organizations are integrated. The objective of a merger could be the value added by bringing together two companies. The issue of value added auditing is analyzed on the previous chapters. Empirical evidence (*Stern, 1994; Roth, 2003; Seaman, 1995*) and surveys (*Value agenda,*

Deloitte & Touche, 2003) analyzed this issue and tried to 'decipher' the ways an internal auditing department can add value to a company.

3.3 Summary of research questions

Based on the main points identified in the literature review, the above seven research questions have been formulated. By analyzing these questions, summarized also in the following table, in the forthcoming chapters the researcher hopes that he will decipher some useful findings which will make a significant contribution to the issue of internal auditing role during M&A projects in the European Union area and get some useful results and feedback in order to validate and update his best practice model.

Table 3.1: Summary table of research questions

Q1: What is the role internal audit currently plays in leading edge organizations in the European Union that pursue mergers and acquisitions?
Q2: What is the contribution of internal auditing to the various stages of a merger and what role can play in complementing and enhancing with the other functions involved?
Q3: What are the preferred roles internal auditors would like to play in the merger and acquisition process?
Q4: What is the 'ideal' situation of internal auditing 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: What are the prerequisites that are essential for internal audit function in order to play a more expanded role and how they will interact with the best practice model suggested for European companies?
Q7: Can we develop a model(s) of best practices of the internal audit function which would enhance the effectiveness of the merger process of the European companies and helping the firm achieve its strategic objectives?

Chapter 4: Research Methodology

4. RESEARCH METHODOLOGY

4.1 Introduction

The purpose of this chapter is to explain the research methodology used and also analyze important issues such as sampling, design of the questionnaires and specific methodology in order to find the most appropriate ways to have *valid*, *reliable* and *generalisable* results.

Reliability refers to the consistency of a measure of a concept. It can be assessed by posing the following three questions (*Easterby-Smith et al, 2002*):

1. Will the measures yield the same results on other occasions?
2. Will similar observation be reached by other observers?
3. Is there transparency in how sense was made from the raw data?

Possible threats to the reliability of a research could be the participant error, participant bias, and observer error and bias.

On the other hand, *validity* refers to the issue of whether an indicator (or set of indicators) that is devised to gauge a concept really measures that concept. *Robson (2002)* has charted the threats to validity, which provides a useful way of thinking about this important topic. These are:

- History
- Testing
- Instrumentation
- Mortality
- Maturation
- Ambiguity about causal direction

Finally, in quantitative and qualitative research, the researcher is usually concerned to be able to assert that findings can be *generalized* beyond the confines of the particular context. Thus, if a study is carried out by a questionnaire with a number of people who answer the questions we can often say that the results can apply to individuals other than

those responded to the questionnaire. In order to overcome the issue of generalization the researcher has to choose a representative sample (*Bryman, 2001; Saunders et al, 2003*). Another useful point when analyzing a research methodology is the need for a clear research strategy. This strategy will be a general plan of how the research questions will be answered. It must contain clear objectives, derived from the research questions and also specify the sources from which the researcher intends to collect data. We must also notice that these strategies are not mutually exclusive and that we can use a multi-method strategy. The main research strategies are (*Bryman, 2001; Saunders et al, 2003*):

- Experiment
- Survey
- Case study
- Grounded theory
- Longitudinal studies

Below we will provide a briefly analysis of these different strategies.

Experiment

Experiment is a classical form of research that owes much to the natural sciences, although it features strongly in much social science research. Typically, it involves different stages such as definition of a theoretical hypothesis, selection and allocation of samples, measurement of the variables and also control of other variables. Its strengths are that a small number of variables are subjected to testing and it can extend into real life, which creates a greater relationship to reality. On the other hand, its main weaknesses are that experiments can only examine a limited number of variables from the real world and also it is difficult to find willing organizations to participate in this type of research (*Saunders et al, 2003*).

Surveys

Surveys have become a very common method of research in our time and probably most, if all of us have had some experience with them either by playing the part of the researcher or as part of a sample requested to participate in a survey. Using a survey

strategy can give more control over the research process but much time will be spent in designing and piloting the questionnaire. Also, the data collected by the survey strategy may not be as wide ranging as those collected by other research strategies. But its main advantages are that they allow a greater number of variables to be studied than in other approaches and also they cover real situations and are more appropriate to making generalizations (*De Vaus, 2002*).

Case study

Robson (2002) defines case study as 'a strategy for doing research which involves an empirical investigation of a particular contemporary phenomenon within its real life context using multiple sources of evidence'. The data collection methods employed may be various such as questionnaires, interviews, observation and documentary. The design of a case study could include: conceptual framework, set of research questions, defining the case, sampling, data collection, pilot studies and finally data analysis. Case studies can be useful in developing and understanding reality in great detail but on the other hand there are restrictions to gain access to organizations, which in turn limits the generalizability of results.

Grounded theory

Grounded theory is often thought of as the best example of the inductive approach, although this conclusion would be too simplistic. In grounded theory, data collection starts without the formation of an initial framework and theory is developed from data generated by a series of observations. These data lead to the predictions that are then tested in further observations which may confirm or not the predictions (*Saunders et al, 2003*).

Longitudinal studies

The longitudinal study represents a distinct form of research design. Because on the time and cost involved, it is a relatively little-used design. With a longitudinal design a sample is surveyed and is surveyed again on at least one further occasion. It is more typically found in social sciences in fields such as sociology, social policy. However, a

longitudinal study can allow some insight into the time order of variables and therefore may be more able to allow causal inferences to be made.

This research will be carried out using both quantitative and qualitative approach. At first, a survey using a standardized questionnaire will be carried out in order to collect a large amount of data rather than being based on data already available. The collected data will be standardized allowing easy comparison and descriptive data analysis. Although a questionnaire design, pilot test and analysis can be time consuming this approach can provide us the basis to further analyze data collected at this stage.

In order to validate these preliminary results, semi–structured interviews will be carried out with a sample of population selected in order to gain understanding and have their opinion on the views and trends presented through the questionnaire analysis. This qualitative approach is more flexible and less structured than the standardized questionnaire; it will allow the validation and will increase the reliability of the preliminary quantitative results. A more thorough analysis of the different stages of this research is presented in the next parts of this chapter.

4.2 Deciding on the Sample

When a researcher embarks on his or her mission to carry out a survey, what he or she would like to accomplish most of the times is to establish the broadest possible generalization, applicable to infinitely large classes of events. If we could collect and analyze data from every possible case or group member this is termed *census*. For obvious reasons it is virtually impossible to observe all relevant events. Thus, *sampling* techniques provide a range of methods that enable to reduce the amount of data we need to collect by considering only data from a subgroup rather than all possible cases or elements.

Jankowich (1991) defines *sampling* as the deliberate choice of a number of people, known as the sample. The main task in sampling is to select a *representative sample* of the population of interest, also known as the target population that is the population to

which the researcher would like to obtain a sample that will be representative of the target population. However, it is extremely unlikely that one will be able to draw a perfectly representative sample. Because the populations studied are not known in all respects, there is no way of knowing just how representative a given sample is.

For the purpose of this research, a sample comprised of 120 bidder companies that pursued mergers and acquisitions and are based in the European Union was drawn. The list of participated companies is provided at the *Appendix A: Table of sampling organizations*. This list includes the mergers and acquisitions between European Union companies in the period 01/01/2000-31/12/2003 and was derived from *Thomson Financial Database*. The selection criterion was based on M&A projects held in the European Union this period, in order to collect data based on latest and updated trends and also allow sufficient time after the merger for a more valid and unbiased opinion of the participants. The other important selection criterion was based on the deal value of these transactions, in order to present results based on the analysis of the biggest deals in the European Union area during this period.

Also, this survey included companies from all the countries of the European Union as well as different business sectors and industries such as telecommunications, media, oil & gas etc. We must note, as indicated on the limitations of this research, that we derived the sample companies from the 15 countries of the European Union and have not included the ten new countries entered at the enlargement of the Union in 2004.

A postal questionnaire was sent in May 2004 accompanied with a letter explaining the scope and objectives of the research and also a glossary of terms (see *Appendix B-Questionnaire*). A follow up postal questionnaire was sent in July 2004, accompanied with a letter explaining the reasons for this follow up. From a total of 120 questionnaires, 34 (28% response rate) was returned by October 2004. Next step was the analysis of the data provided on the returned questionnaires. In order to analyze the data, statistical package ***SPSS 11.0 for Windows*** and ***Microsoft Excel*** spreadsheets were used.

This analysis leaded to a descriptive data analysis stage, presented in the next chapter, and was the basis in order to design the stage of the validation of the preliminary survey results.

4.3 Questionnaire Design

A questionnaire is an important instrument of research, a tool for data collection. The use of a questionnaire is a fully-structured technique. In this research we used postal self-completion questionnaires at the first stage in order to collect data, gain understanding on the research questions and form the basis for the validation of descriptive data through semi–structured interviews. The questionnaire was pilot tested during April 2004 and was sent to a number of practitioners and academics, in order to make comments and gain useful feedback on format, design and content issues. The results of the pilot test were quite satisfactory and minor changes were made to the format and the content of this questionnaire.

In many ways, the self-completion questionnaire and the structured interview are very similar methods of research. However because there is no interviewer in the administration of the self-completion questionnaire, the research instrument has to be especially easy to follow and its questions have to be particularly easy to answer. As a result, self completion questionnaires as compared to structured interviews tend to have fewer open questions, since closed ones tend to be easier to answer, have easy-to-follow designs to minimize the risk that the respondent will fail to follow filter questions or omit a question, and also are shorter in order to reduce the risk of 'respondent fatigue'.

The following table provides a useful comparison between the advantages and disadvantages of self-completion questionnaire over the structured interview:

Table 4.1: Advantages Vs disadvantages between self-completion questionnaire and structured interview

Advantages	Disadvantages
Cheaper to administer	Cannot ask many questions that are not salient to respondents
Quicker to administer	Difficulty of asking other kinds of question
Absence of interviewer effects	Cannot collect additional data
No interviewer variability	Difficulty to ask a lot of questions
Convenience for respondents	Lower response rates

Source: Bryman, 2001

As mentioned earlier, the postal questionnaire was sent to a selection of 120 European Union organizations that pursued mergers and acquisitions during the period 01/01/2000-31/12/2003 and was based on the representativeness criterion in terms of country and industry, as well as the deal value of these M&A transactions. The set of questions was designed with primarily two aims, appearance and easiness to complete. It is true that no matter how good the covering letter is, the first impression the prospective respondent will get from the appearance of the questionnaire will determine to a large extend whether he or she will complete it.

Because of the tendency for mail questionnaires and surveys to generate lower response rates than structured interviews, a great deal of research has gone into ways of improving response rate. The following steps and strategies are frequently suggested (*Bryman, 2001; Saunders et al, 2003*):

- Write a good covering letter explaining the reasons for the research, why it is important, and why the recipient has been selected.
- Mail questionnaires can be accompanied by a stamped addressed envelope or return postage.
- Follow up individuals who do not reply at first, possibly with two or three further mailings.
- Shorter questionnaires tend to achieve better response rates than longer ones.
- Clear instructions and an attractive layout improve mail questionnaire response rates.
- It is useful to begin with questions which are more likely to be of interest to the respondent.
- There is also the view that in general mail questionnaires should comprise as few open questions as possible, since people are often deterred by the prospect of having to write a lot.

Taking into consideration suggested strategies provided in the previous paragraph, our postal questionnaire was accompanied by a covering letter explaining the reasons and the main objectives of this research, the sampling criteria for the selection of their organizations in this survey, a stamped addressed envelope and a glossary of terms explaining some definitions in the questionnaire. The length of the questionnaire was as short as possible (8 pages) contained a balance of open and close–end questions and there was an effort to provide an attractive layout. This questionnaire was also followed up to individuals who didn't reply at first two months after the first mailing.

The findings in this postal questionnaire and also the extensive literature review leaded to the selection of a sample of internal audit managers and practitioners that experienced M&A projects in their organizations and conduct semi–structured interviews. The ability to collect data at this stage of the research depends on gaining access. *Saunders et al (2003)* provide some useful strategies in order to gain access. These are:

- Allow sufficient time
- Using existing contacts and developing new ones

- Provide a clear account of purpose and type of access required
- Overcome organizational concerns about the granting of access
- Identify possible benefits to the organization in granting access to the researcher
- Using suitable language
- Facilitate ease of reply when requesting access
- Establish the credibility with intended participants

In this research, upon completion of data collection from the returned questionnaires and descriptive analysis, a number of preliminary results, conclusions and gaps had identified. Using this primary data we selected a number of internal audit managers and practitioners, different of those participated at the first stage, that their organizations experienced M&A projects. Details were derived from existing contacts on the local affiliates of the Institute of Internal Auditors in the countries included in this research and the development of new ones. A selection criterion was based on the participants' professional experience and their organization's involvement during M&A projects. An agenda contained main results and conclusions derived from descriptive data analysis, was sent through e-mail in order to prepare more effectively for the interview. In total ten internal audit practitioners and managers from four different countries (United Kingdom, Netherlands, Italy and Greece) and different sectors (such as banking, financial services, telecommunications, manufacturing) were participated at this stage.

4.4 Research Methodology

As analyzed above there are various methods and strategies in order to answer the research questions. The purpose of this part is to explain the methodology and specific methods used in this research. It will split in four stages (see *Figure 3.1*):

Stage 1: Literature review, development of the postal questionnaires and preliminary data analysis

The first stage comprises a comprehensive literature review of relevant published texts and papers in the various aspects and forms of mergers and acquisitions. This literature review forms the foundation on which this research and research questions are built.

Also, it has proved quite helpful to sample current opinions in newspapers, professional journals and thereby gain insight into the aspects of the research objectives.

The extensive literature review and the research questions are analyzed thoroughly in Chapter 2. At the conclusion of this stage we had a 'rich' picture in order to develop the first postal questionnaire sent to 120 chief audit executives of organizations in the European Union that actively pursued mergers and acquisitions during the period 01/01/2000-31/12/2003 and are representative in terms of deal value, size, country and sector.

Stage 2: Development of the three different models, observed, preferred and normative

Using the data provided from the analysis of the returned questionnaires and also from the literature review we will formulate the three different models. These are:

- *Observed model* – this model will describe the role internal auditing currently plays during the M&A process at the European Union companies.

- *Preferred model* – this model describes the role internal auditors prefer to play during the M&A process. Given that many chief audit executives will probably have rich organizational experience and knowledge, the information of their preferred roles could be a very useful contribution to the research.

- *Normative model* – this model describes the 'ideal' situation according to the various textbooks and empirical evidence and its interface with functions such as corporate strategy, finance, human resources etc.

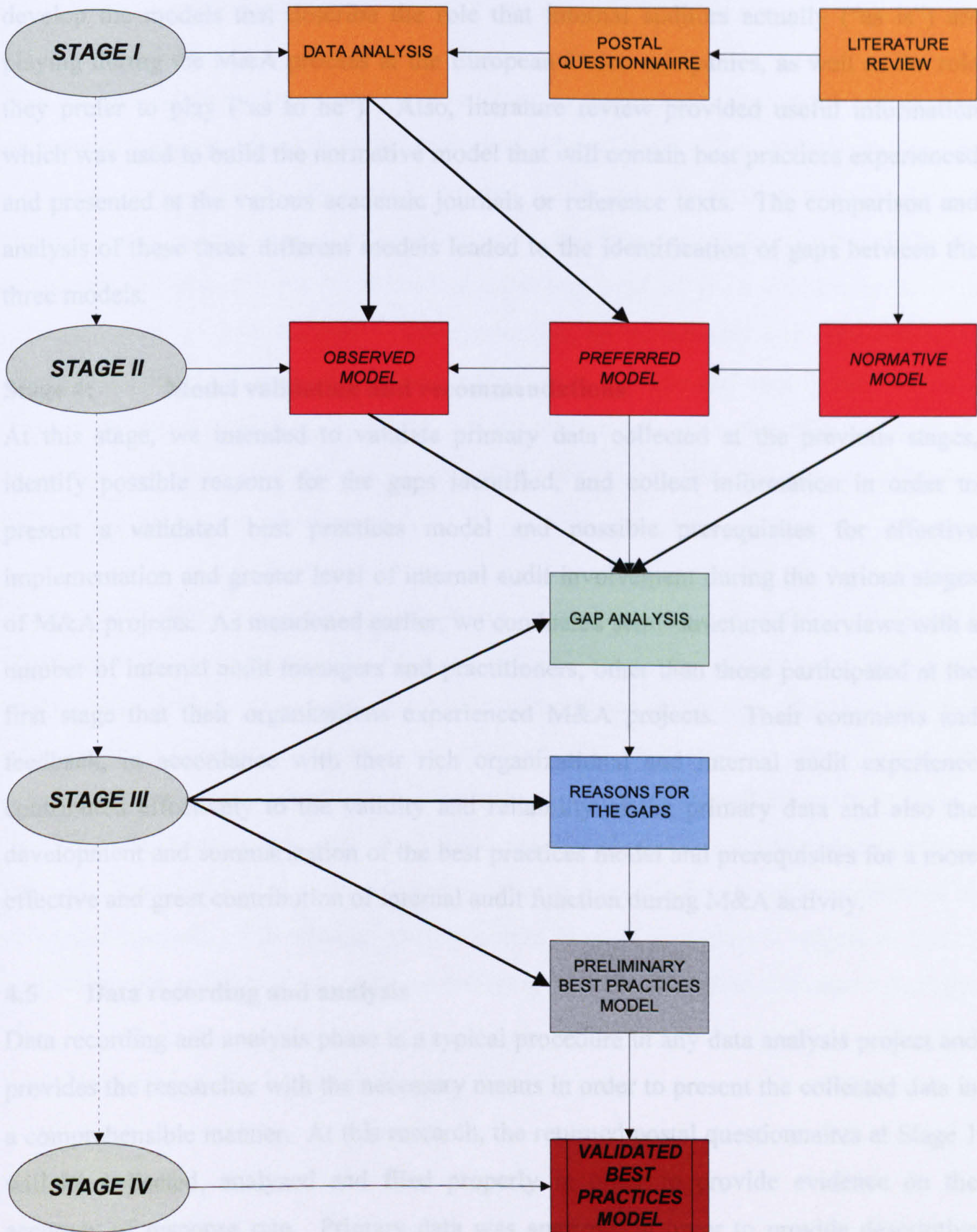


Figure 4.1 – Research methodology

Stage 3: Gap analysis and development of the suggested best practices model

Data collected through returned questionnaires at Stage 1 was used at Stage 2 in order to develop the models that describe the role that internal auditors actually ("as is") are playing during the M&A process at the European Union companies, as well as the role they prefer to play ("as to be"). Also, literature review provided useful information which was used to build the normative model that will contain best practices experienced and presented at the various academic journals or reference texts. The comparison and analysis of these three different models leaded to the identification of gaps between the three models.

Stage 4: Model validation and recommendations

At this stage, we intended to validate primary data collected at the previous stages, identify possible reasons for the gaps identified, and collect information in order to present a validated best practices model and possible prerequisites for effective implementation and greater level of internal audit involvement during the various stages of M&A projects. As mentioned earlier, we conducted semi-structured interviews with a number of internal audit managers and practitioners, other than those participated at the first stage that their organizations experienced M&A projects. Their comments and feedback, in accordance with their rich organizational and internal audit experience contributed effectively to the validity and reliability of the primary data and also the development and summarization of the best practices model and prerequisites for a more effective and great contribution of internal audit function during M&A activity.

4.5 Data recording and analysis

Data recording and analysis phase is a typical procedure in any data analysis project and provides the researcher with the necessary means in order to present the collected data in a comprehensible manner. At this research, the returned postal questionnaires at Stage 1 will be collected, analyzed and filed properly in order to provide evidence on the accuracy of response rate. Primary data was analyzed in order to provide descriptive analysis presented in the next chapter. At the final stage semi-structured interviews

conducted with the use of an agenda sent to the interviewees and data collected stored in soft copy format with the use of *Microsoft Word* files.

4.6 Summary

This chapter described the research methodology as well as other important factors such as sampling, design of the questionnaires and data analysis. The primary aim of the researcher is to provide both quantitative and qualitative approach in order to answer research questions and give more reliability and validity to the results. Both quantitative and qualitative research can be viewed as exhibiting a set of distinctive but contrasting preoccupations of a researcher. Each one has its advantages and disadvantages. Quantitative data are based on meanings derived from numbers and usually they analyzed through the use of diagrams and tables. On the other hand, qualitative data are based on meanings expressed through words and observation and data analysis is conducted through the use of conceptualization.

Thus, this research has quantitative approach at Stage 1 and 2 in order to design and analyze the postal questionnaire. At Stage 4, semi-structured interviews will have more qualitative approach because the researcher will collect and analyze the interviewees' views and experiences. However, we must say that multi-strategy research must be competently designed and conducted because a poorly conducted research will yield suspect findings no matter how many methods are employed. Finally, multi-strategy approach that combines quantitative and qualitative research should not be considered as a panacea because, while offering great potential in many instances is subject to similar constraints and considerations as research relying on a single method or research strategy.

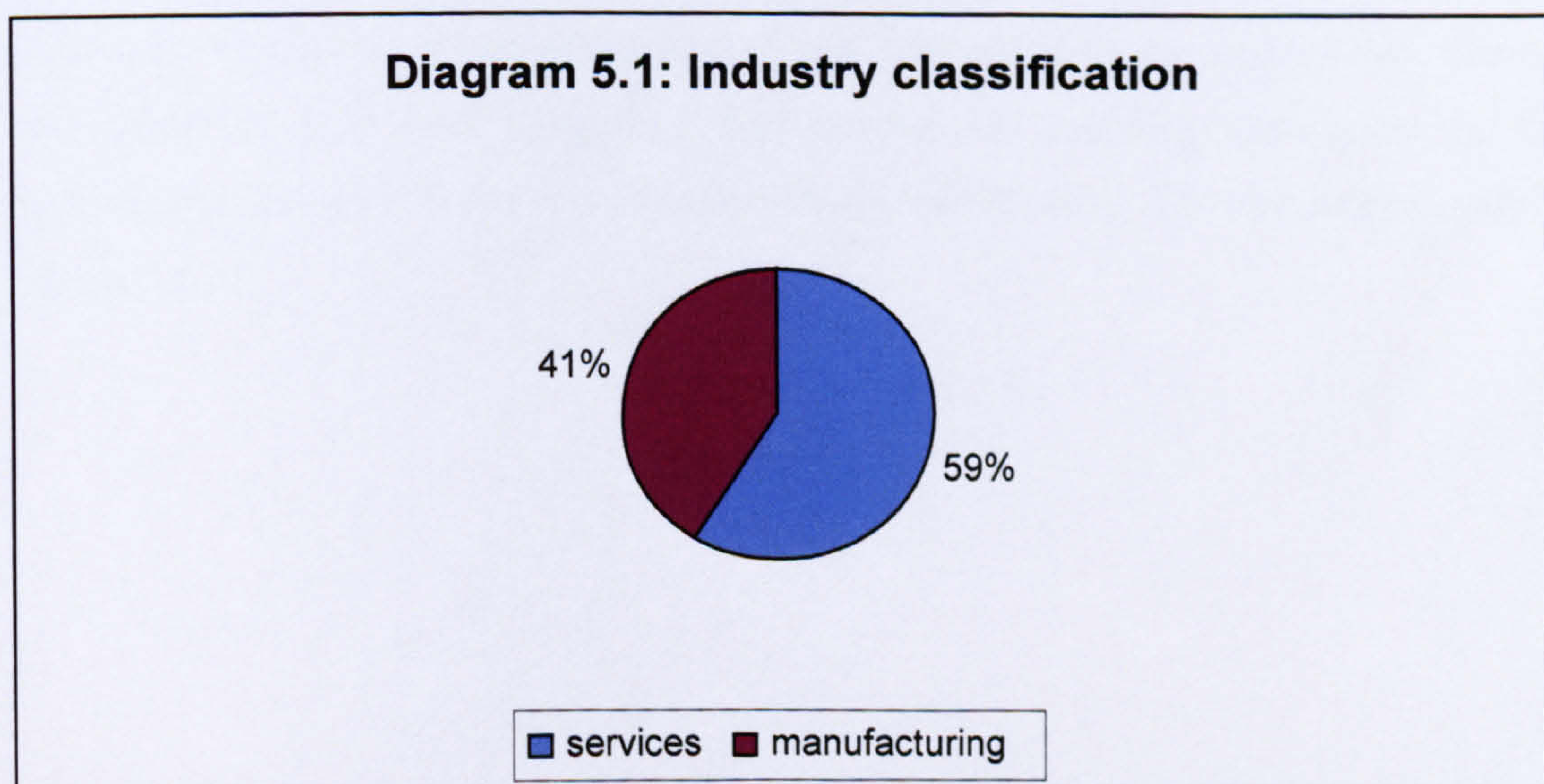
Chapter 5: Descriptive Data Analysis

5. DESCRIPTIVE DATA ANALYSIS

5.1 Sample Size

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 a very 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. Also, and rather on relying solely on frequency tables to describe the data collected, we choose to use also pie charts and other forms of graphical representation.

In total, 120 sampling organizations (see *Appendix A-Table of sampling organizations*) took part in this survey. Each chief audit executive received a questionnaire, an accompanying letter explaining the purpose and the objectives of the study and a "glossary of terms", which explained some key words on the questionnaire. Out of 120 questionnaires that were mailed, 34 (28%) were eventually completed and returned by 1st of September 2004. Data analysis revealed representativeness of industrial sectors included in the sample. *Table 5.1* reveals the proportion of industries included in the sample in two general categories such as manufacturing and services and *Diagram 5.1* mentions the primary industry of the organizations that took part in this survey:



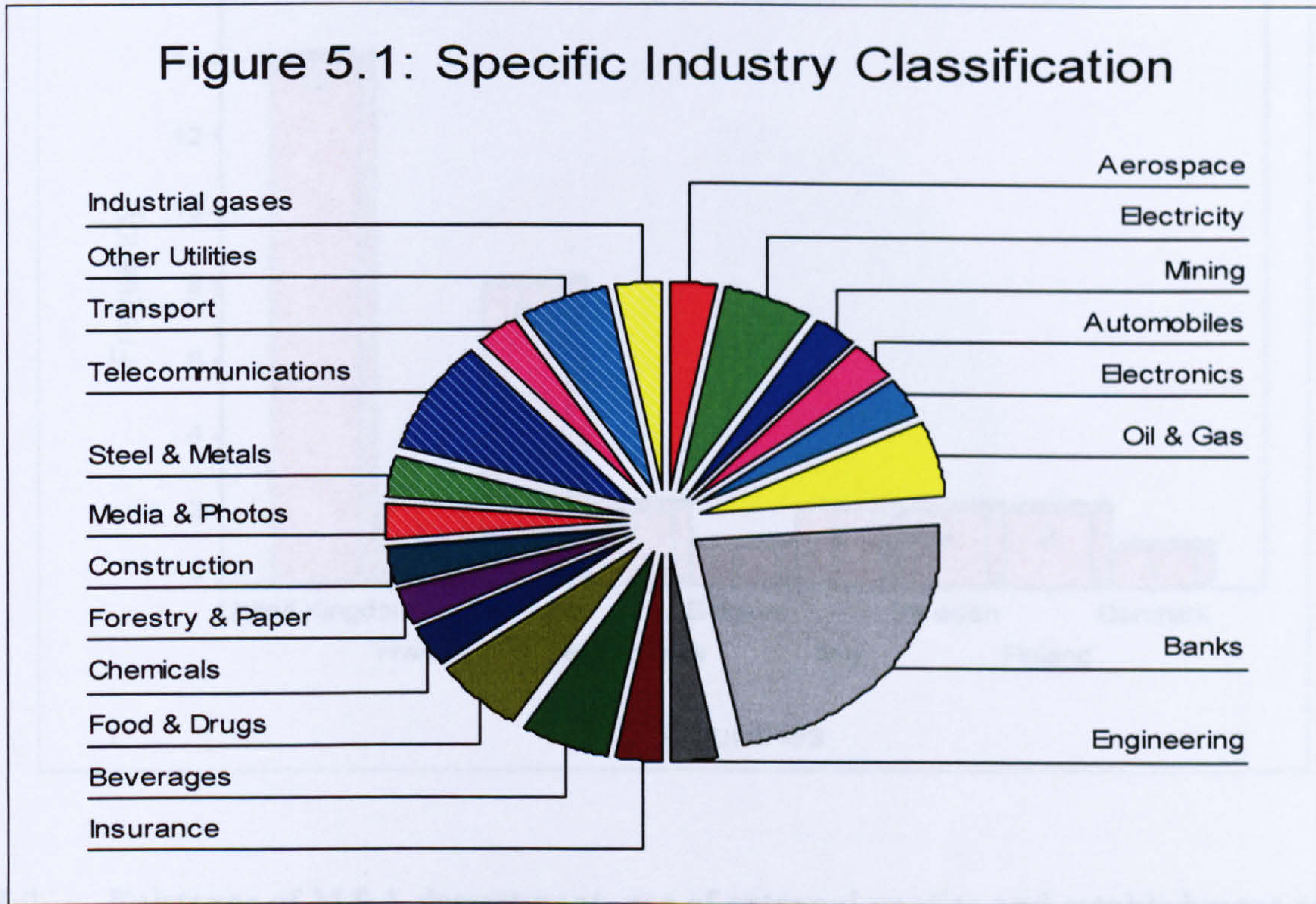
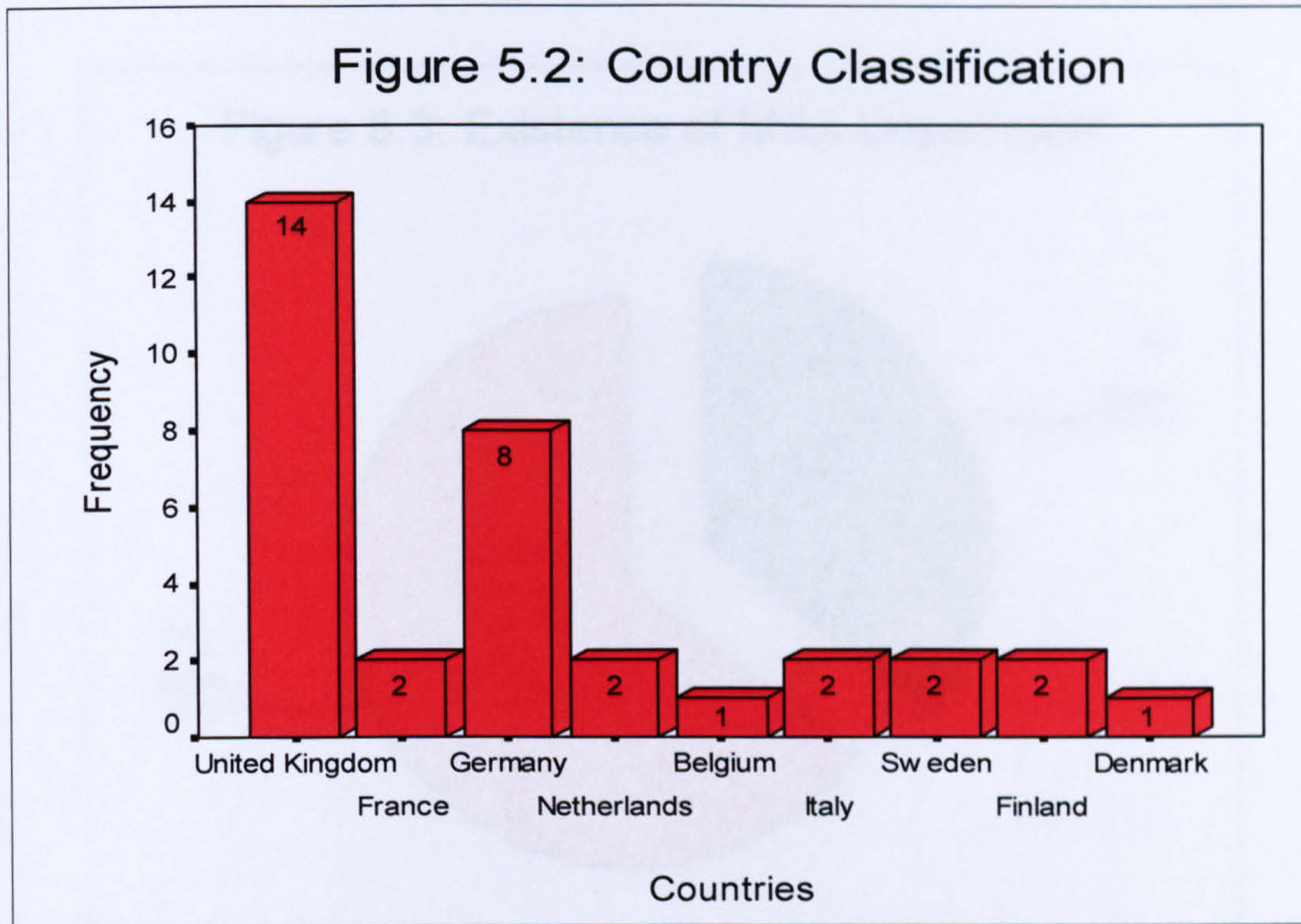


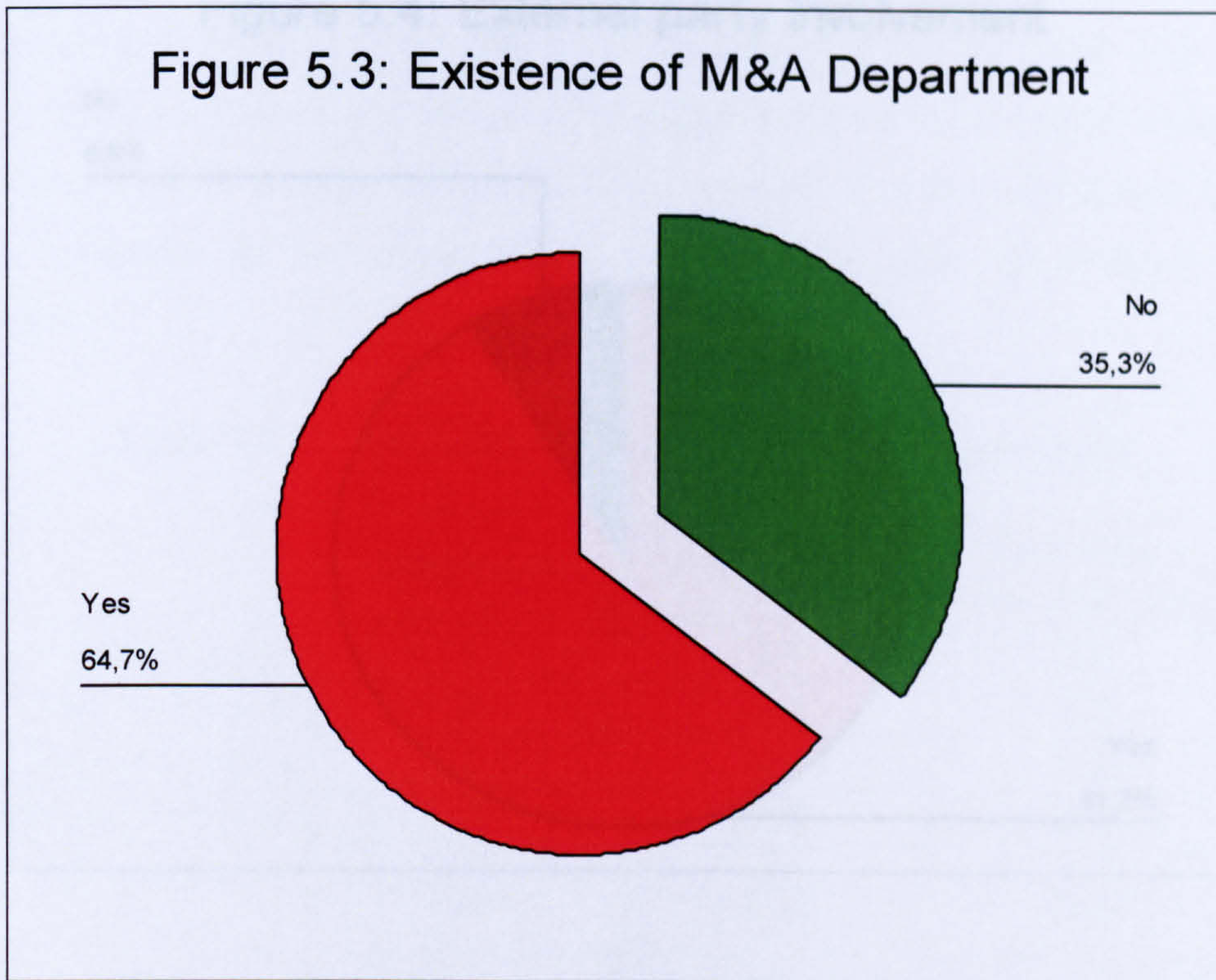
Figure 5.1: Specific Industry Classification

On the other hand, and because of the European's Union nature, we have included in the sample companies from all 15 countries of the Union. *Figure 5.2* represents the distribution of returned questionnaires by country:



5.2 Existence of M&A department, use of external parties and establishment and size of an internal audit department in the organization

Participants at this survey were asked if they had an M&A department in their organizations and also if they used external parties for the deal. If they did it so, we requested the type of the external party (e.g. investment bank, audit firm etc.). Finally, and in order to have a picture of the size of their internal auditing departments, directors were asked to state how long they had an internal auditing department in their organizations and what is the size of each of their departments. The results are exhibited in *Figure 5.3*:



It is clear from the responses that were given that a great percentage (64.7%) of respondents has an M&A department in their organizations. From the tables and figures below we can also state that almost all of the organizations have used an external party for the deal (91.2%). Also, a great percentage used investment banks and audit firms as external party (82.3%) for the deal. The results are exhibited in detail in *Figures 5.4 & 5.5:*

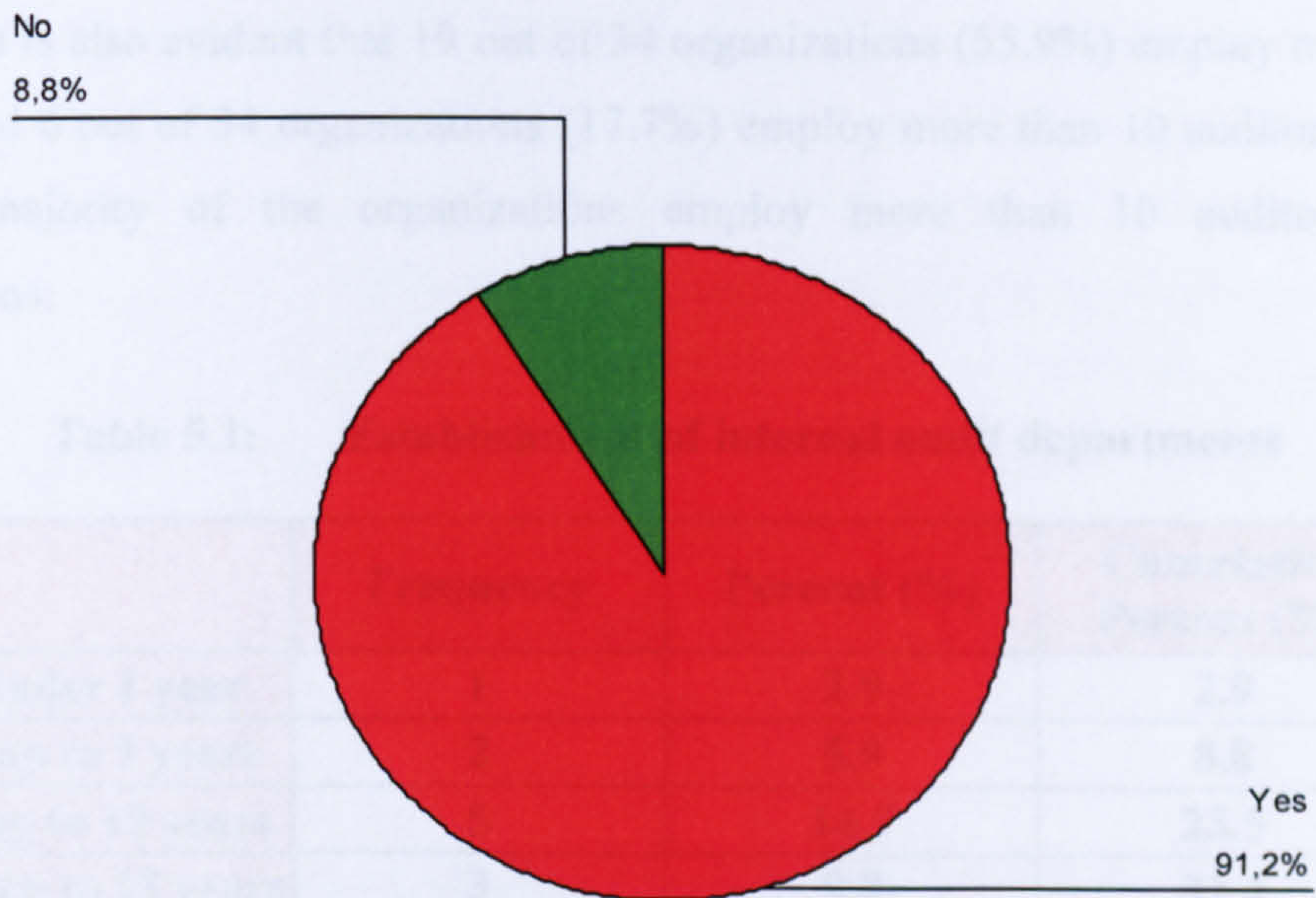


Figure 5.4: External party involvement

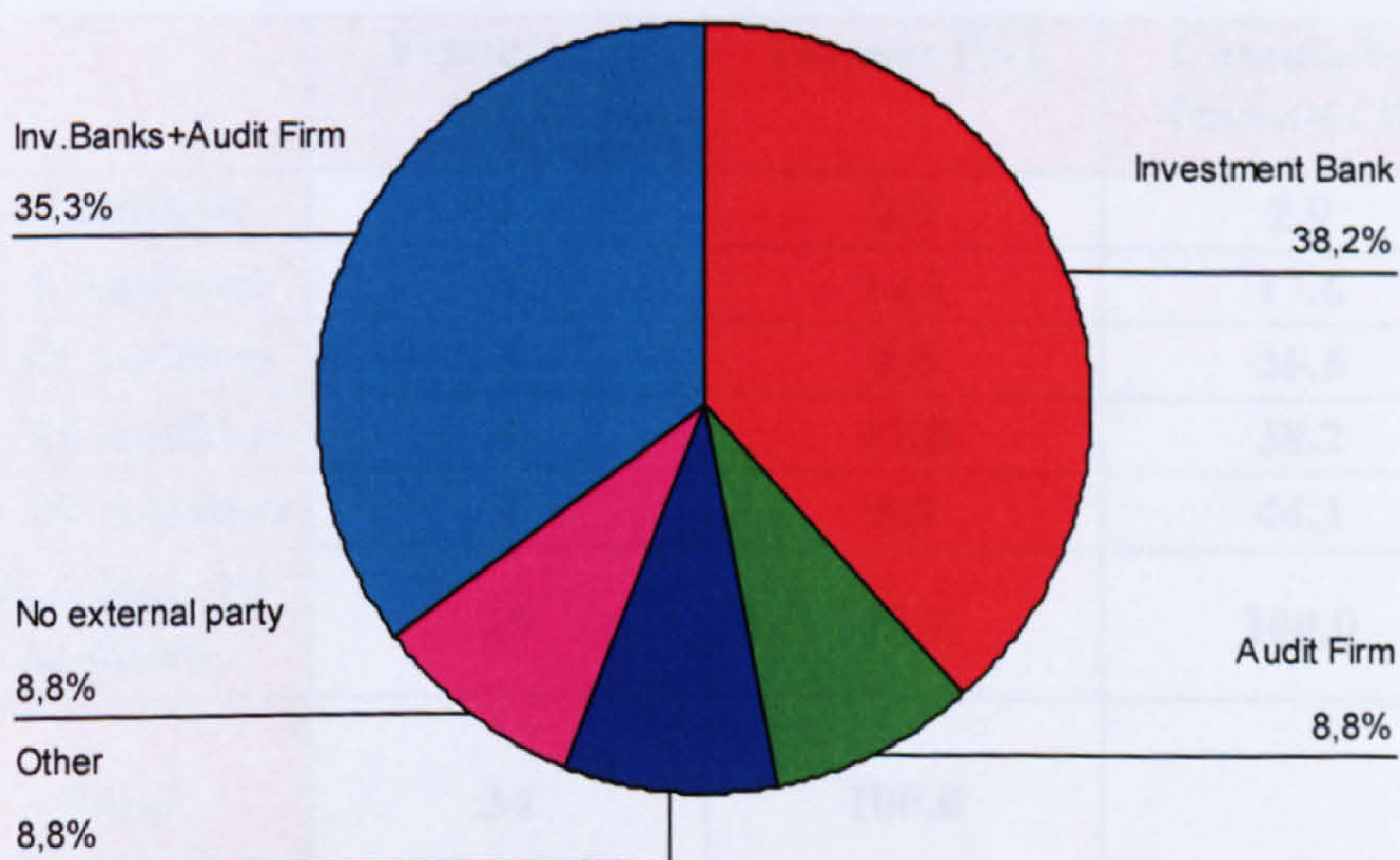


Figure 5.5: Type of external party involvement

The results exhibited in the following *Tables 5.1 and 5.2* states that a majority of internal audit departments have been established in the organizations for more than 20 years (67.6%). It is also evident 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.

Table 5.1: Establishment of internal audit departments

	Frequency	Percent (%)	Cumulative Percent (%)
Under 1 year	1	2.9	2.9
1 up to 5 years	2	5.9	8.8
5 up to 10 years	5	14.7	23.5
10 up to 15 years	3	8.8	32.4
More than 20 years	23	67.6	100.0
Total	34	100.0	

Table 5.2: Size of internal audit departments

	Frequency	Percent (%)	Cumulative Percent (%)
0 - 1 Auditor	1	2.9	2.9
2 - 5 Auditors	5	14.7	17.6
6 - 10 Auditors	3	8.8	26.5
11 - 15 Auditors	4	11.8	38.2
16 - 20 Auditors	2	5.9	44.1
More than 20 Auditors	19	55.9	100.0
Total	34	100.0	

5.3 Internal audit role during mergers and acquisitions in the European Union companies

One of the main objectives of this study is to analyze the role internal audit currently plays in recently merged companies in the European Union area. Thus, the postal questionnaire contained a number of questions concerning the roles internal auditors currently plays during the M&A process as well as the preferred roles believe that they can play. Previous research (*Selim et al, 2002; Davison, 2001*) has shown that even though internal audit has expanded its role in many business processes throughout organizations, M&A activity does not seem to be an area that internal audit has effective contribution, apart from due diligence stage and in some leading edge organizations in post acquisition audit stage.

Also, many practitioners suggested that internal audit could add more value to the M&A process if its role was allowed to expand. In our study the majority of audit executives responded that internal audit 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%) answering this question. *Table 5.3 and Figure 5.6* illustrate these results:

Table 5.3: Internal audit has a role to play during M&A's

	Frequency	Percent (%)	Cumulative Percent (%)
Strongly Agree	7	20.6	20.6
Agree	17	50.0	70.6
Uncertain	4	11.8	82.4
Disagree	6	17.6	100.0
Total	34	100.0	

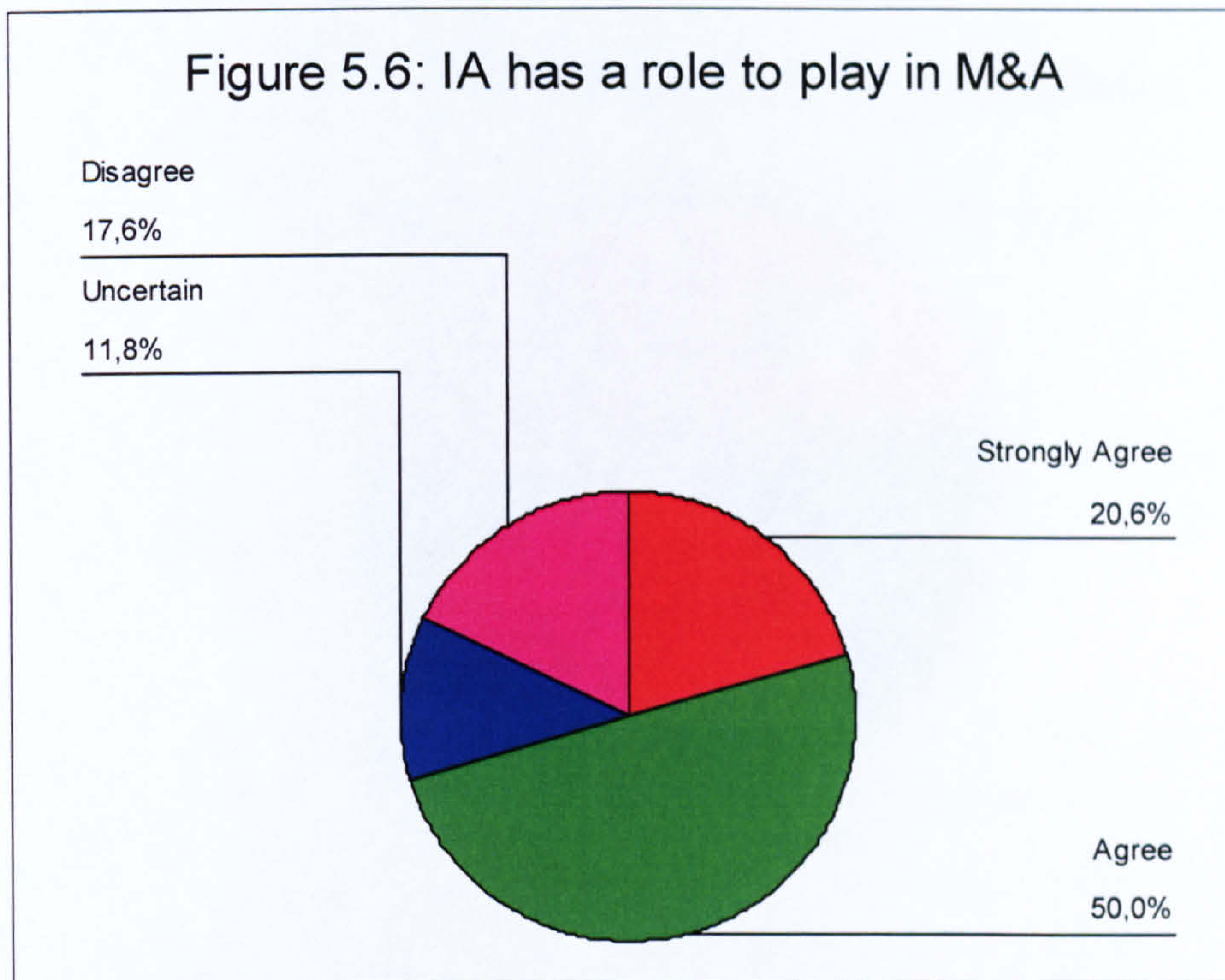
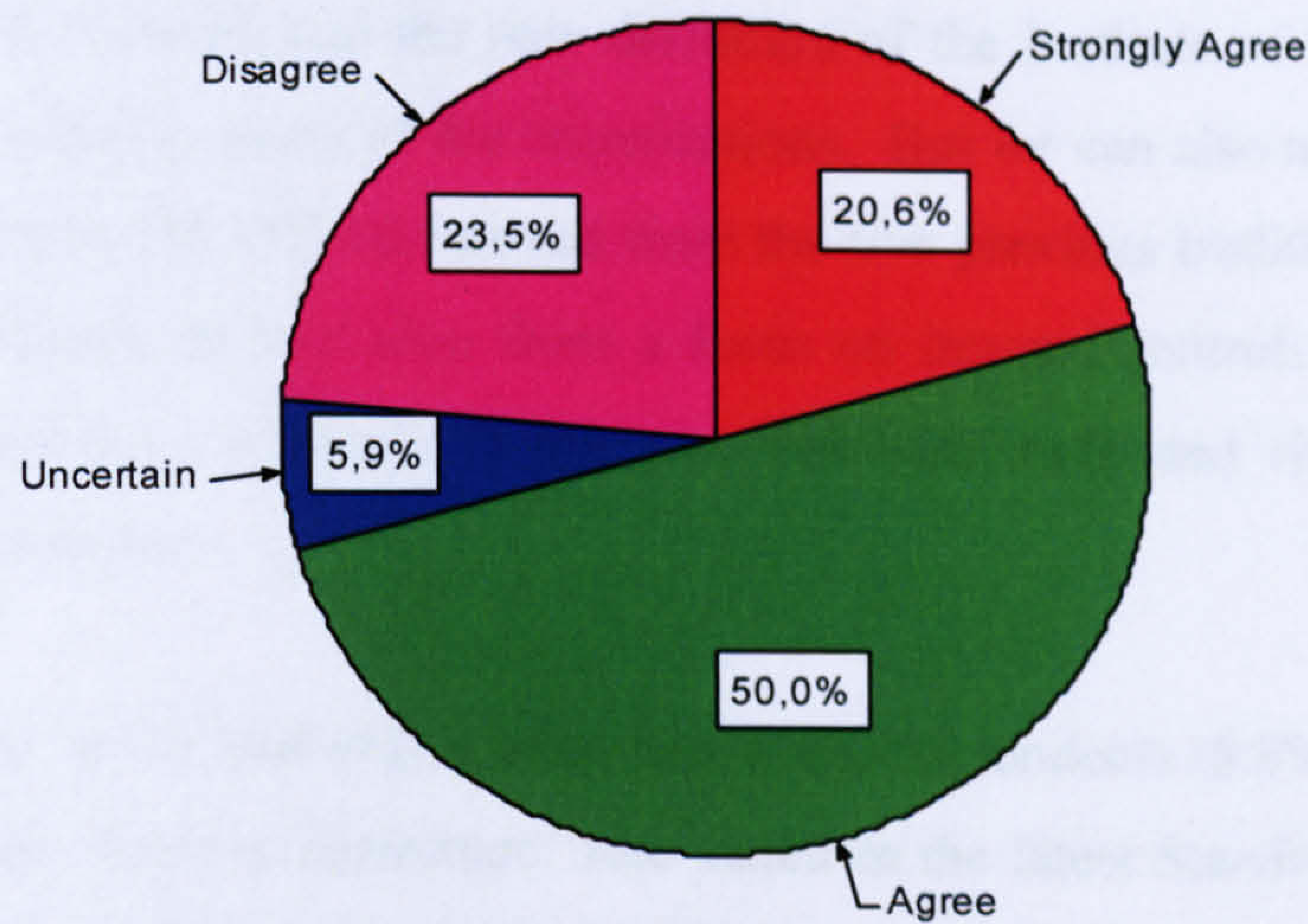


Table 5.4 and Figure 5.7 exhibits another interesting point that forms the basis in which we will analyze the current and preferred roles of internal auditing function during an M&A. Most respondents felt that the preferred role of internal audit in their organization should be more proactive than post-mortem. A total of 24 out of 34 directors (70.6%) agreed that they prefer their roles expanded at all the stages of the merger.

Table 5.4: Possible positive outcomes if internal audit act more proactive than post-mortem

	Frequency	Percent (%)	Cumulative Percent (%)
Strongly Agree	7	20.6	20.6
Agree	17	50.0	70.6
Uncertain	2	5.9	76.5
Disagree	8	23.5	100.0
Total	34	100.0	



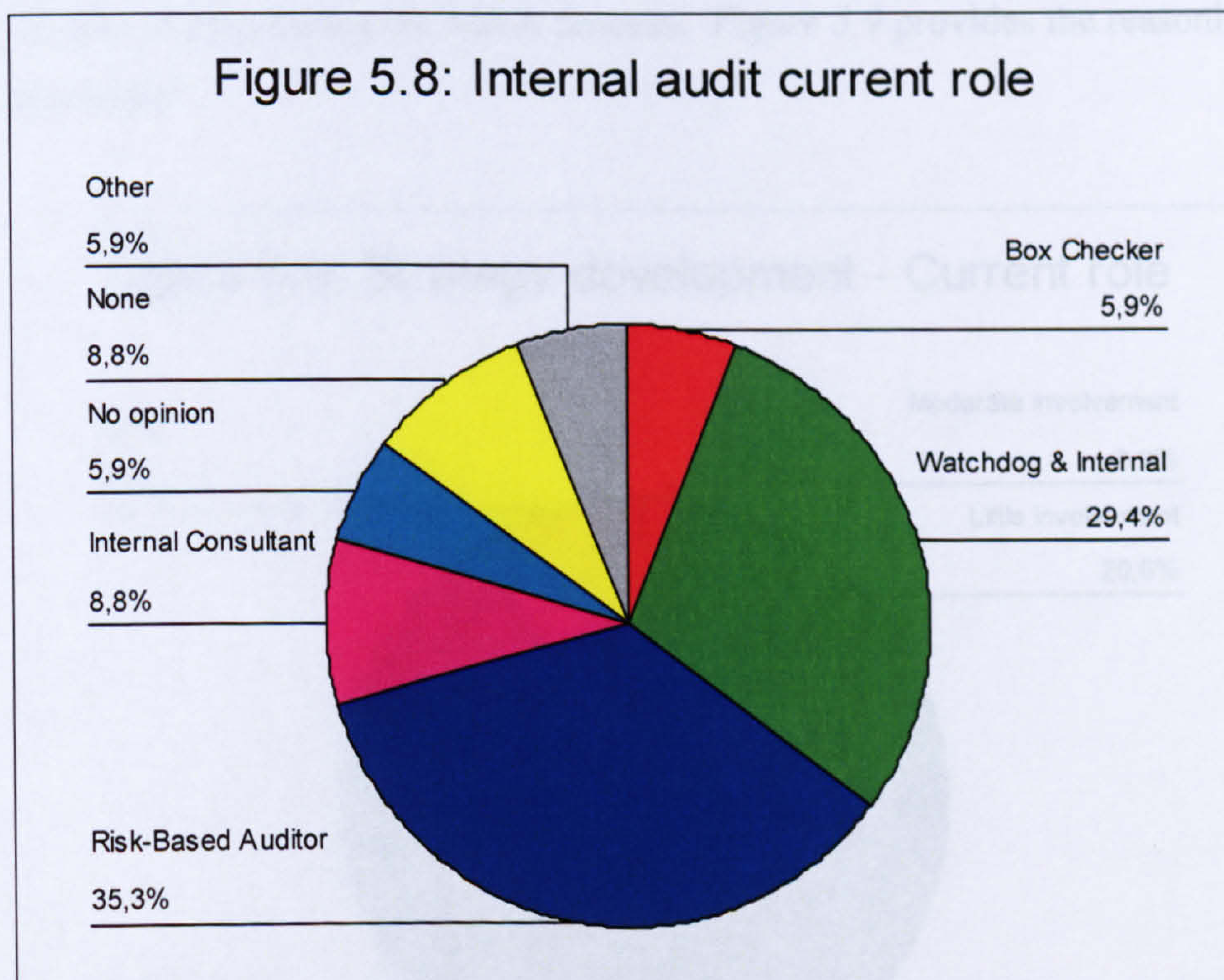
5.3.1 Internal audit current role during mergers and acquisitions in the European Union companies

As noted previously at the literature review stage, internal auditing profession has evolved during the years. At one time, internal auditing functioned as an assistant to the independent accounting profession and attesting to the accuracy of financial matters. Now, internal auditing has established itself as a distinctive discipline with a far broader focus. Traditional internal auditing has focused on control and operations. Modern internal auditing provides services that include the examination and appraisal of controls, performance, risk and governance.

In our study we tried to get a picture of internal auditing current role during the M&A process. Thus, we split the possible roles into four different categories that represent also the evolution and the different stages and approaches of the internal auditing profession. From the responses we can conclude that only a small proportion of the respondents have the traditional 'box-checker' role (5.9%). It also stated from professionals that the traditional role of internal auditors as mindless box checkers checking compliance with centrally imposed systems is out of date (*Page and Spira, November 2004*).

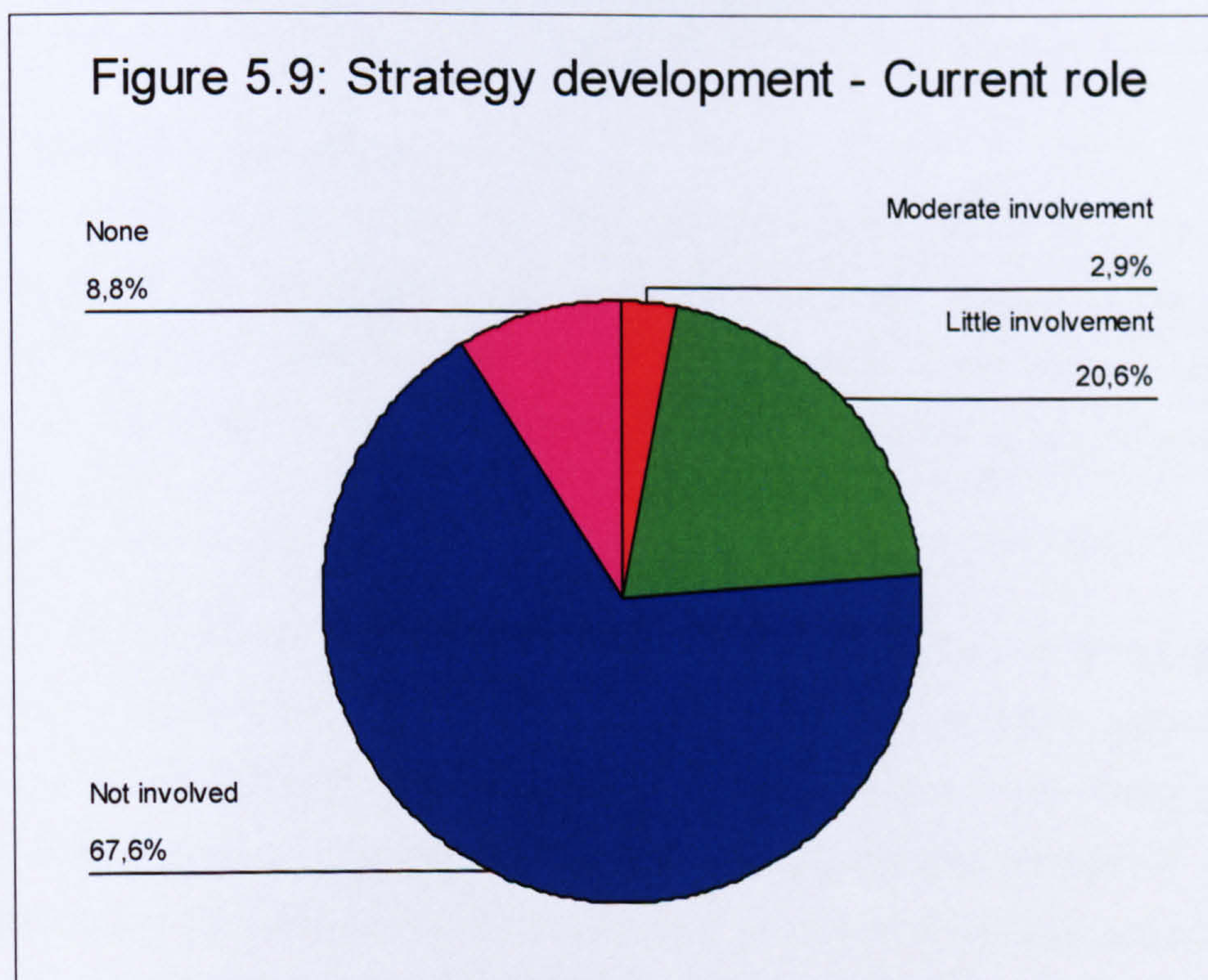
On the other hand, we can state that almost one third of the respondents (29.4%) described their role as 'watchdog & internal control expert'. This means that the new COSO ERM framework and the new definition of the Institute of Internal Auditors are not fully embedded to many of the organizations. But we can also note that another third of the respondents (35.3%) has moved from the two previous traditional roles and act as risk based auditors, an evolution from a focus on internal controls and an independent appraisal function to a focus on business risk and integrated risk management and corporate governance.

Finally, we can notice that only a small part of the respondents (8.8%) has tried to evolve and practice the 'internal consultant' role stated in the latest Standards published by the Institute of Internal Auditors. *Figure 5.8* illustrates clearly the distribution of respondents on internal auditors' current role during M&A's:



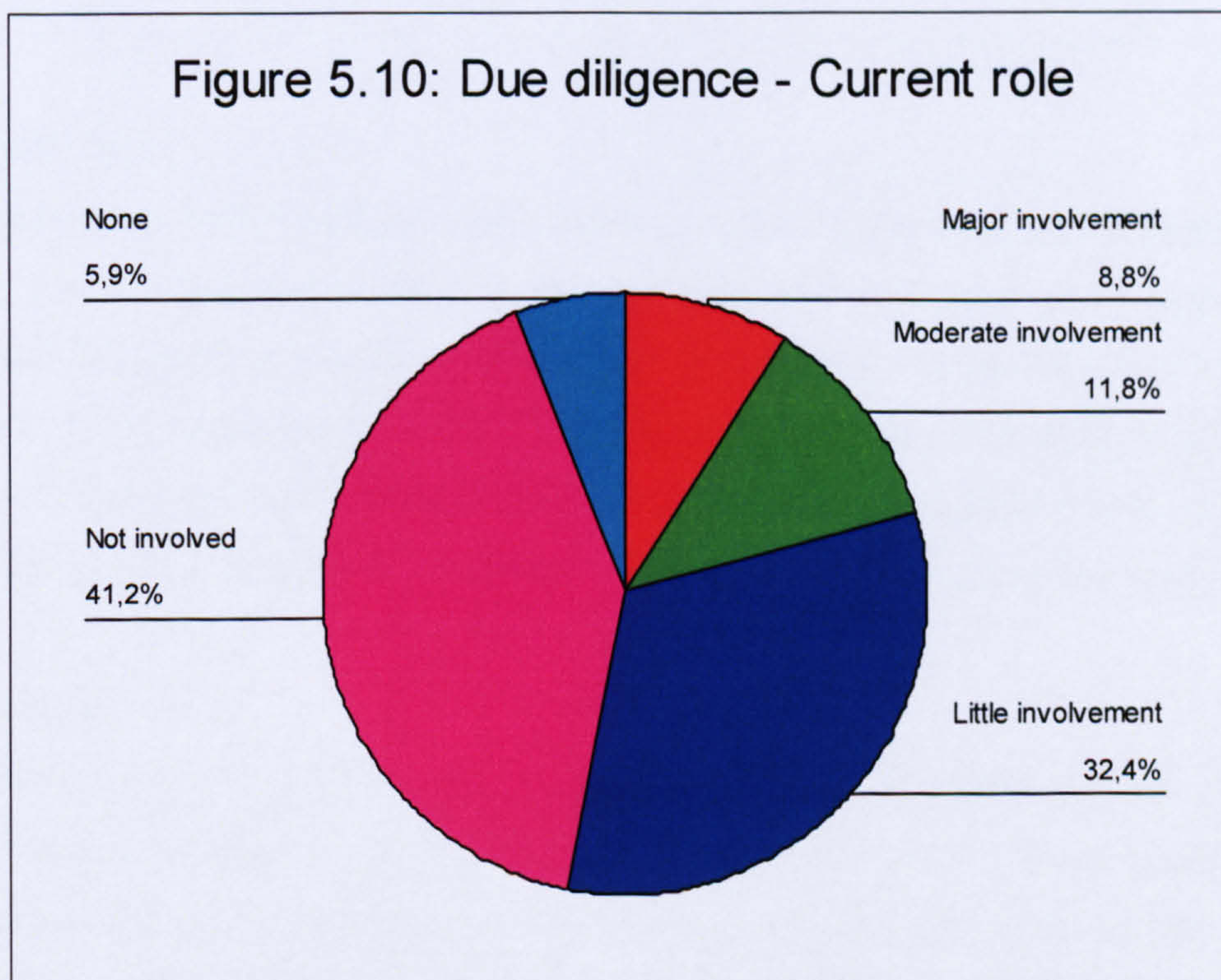
M&A process consists of four main stages. These are M&A strategy development, due diligence, post-acquisition integration and post acquisition audit. At the literature stage on chapter two we made a thorough analysis of the various risks for the M&A process during these stages. Previous studies (*Selim et al, 2002*) showed that internal audit has been involved in the due diligence and post-acquisition integration stage with no or small contribution to the other stages. In our postal questionnaire we included a question about the present level of internal audit's involvement in these stages in the sampling organizations.

First of all it is not surprising to state that internal audit function has not involved at all (67.6%) during the strategy development or it had a small involvement and contribution (20.6%). This can happen for various reasons such as that the organizations focus solely on making the M&A deal happen and then at a later stage worrying about integration and control issues. But this practice is contrary with the new 'risk–based' role internal auditors prefer to play during the M&A process. *Figure 5.9* provides the reasoning of the above statements:



On the other hand and on contrary to previous research, respondents stated that internal audit function has not involved (41.2%) or has little involvement (32.4%) during the due diligence stage (*Figure 5.10*), which 'traditionally' internal auditors contributed. We can state also that in the European Union companies a great proportion of internal auditing departments has no or small contribution to 'proactive' stages of an M&A, although they stated that the preferred role of internal audit in the M&A process should be more proactive.

This means that it can be the management's failure to recognize the importance of internal auditing during the first stages of an M&A. Although many directors responded that their current role in the organization was the 'risk-based' auditor or the 'internal consultant' we can state that this small contribution and involvement in the first stages weakens also their role as 'risk based' auditor.



The analysis of the questionnaires on the last two stages was not revealed surprisingly results. Internal auditing function had moderate (35.3%) or major (11.8%) involvement

at the post acquisition integration stage. Also 20.6% are not involved or have little involvement (26.5%). Finally a small percentage (5.9%) has no involvement during this stage. *Figure 5.11* verify the above conclusions:

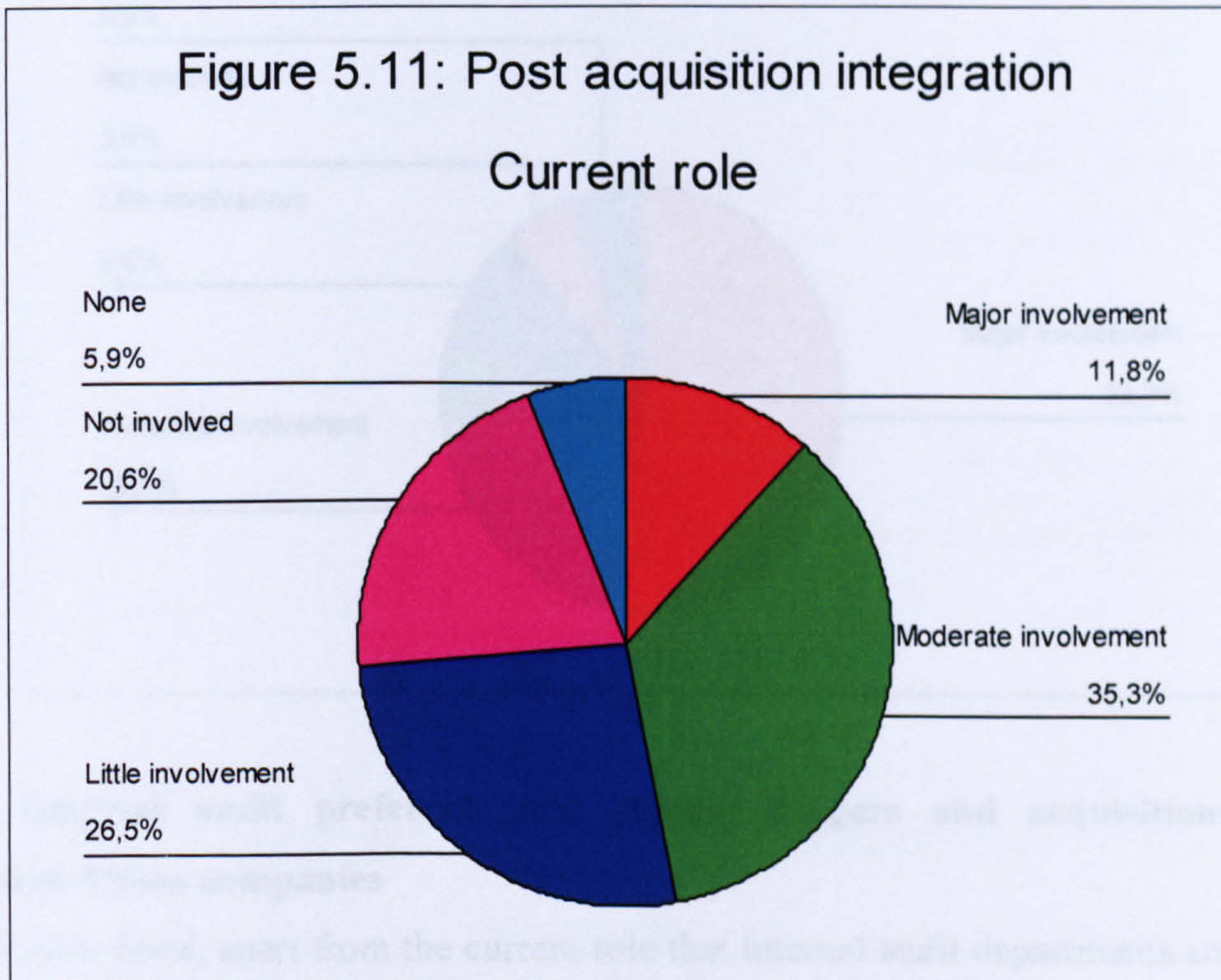
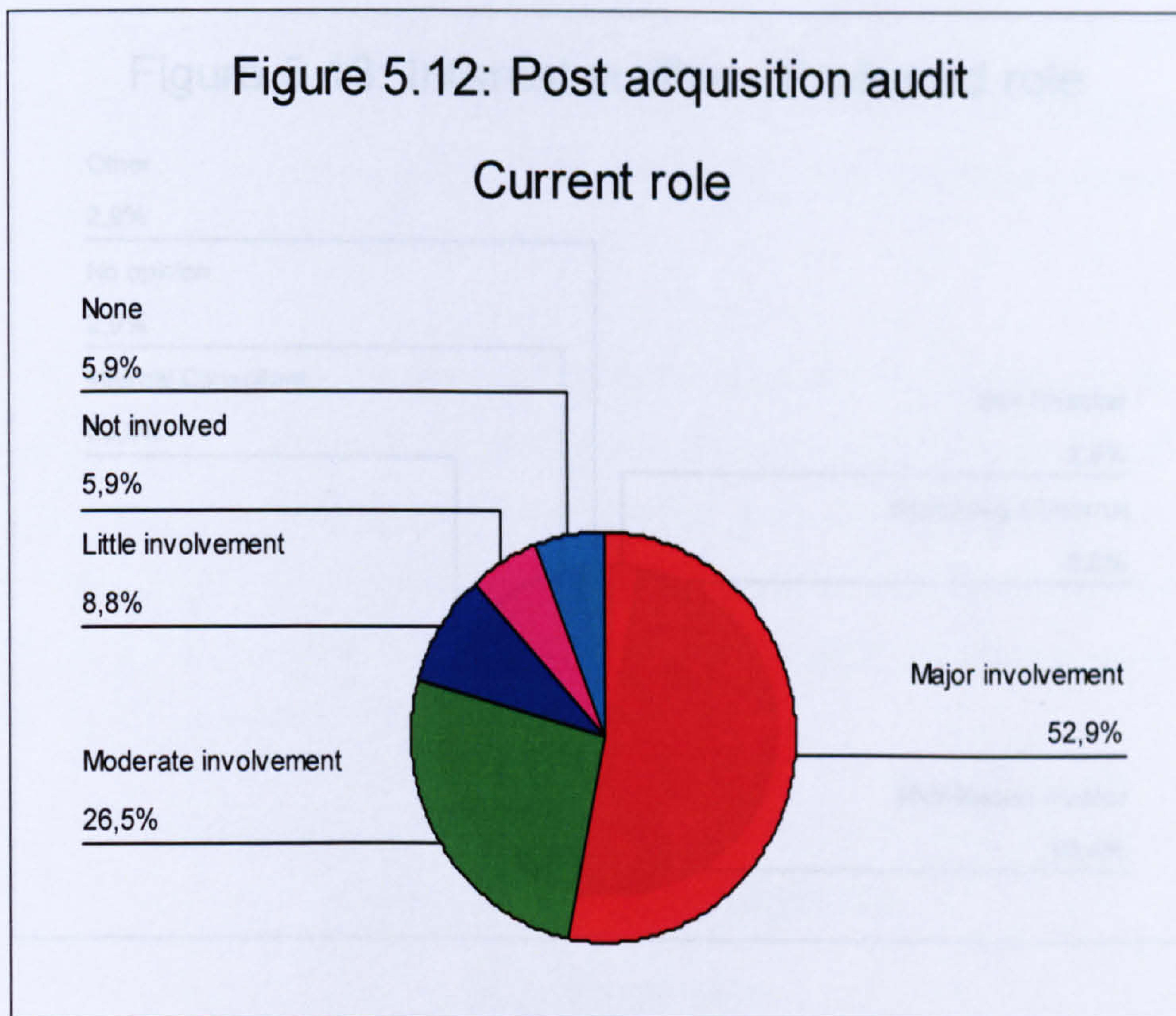


Figure 5.12 indicates that internal auditors also had major (52.9%) or moderate (26.5%) involvement during the post acquisition audit stage. Another 26.5% have moderate involvement and 8.8% little involvement. Finally, only 5.9% are not involved during this final stage. These results indicate that internal auditing is acting, in the European Union companies, in an 'after the fact' role on contrary to the international best practices that indicate the new 'coactive' and 'risk-based and consultancy' role.



5.3.2 Internal audit preferred role during mergers and acquisitions in the European Union companies

On the other hand, apart from the current role that internal audit departments and internal auditors pursue at the different stages of an M&A, we included in the questionnaire a part containing the same questions as those of current role but we added a separate column and giving the directors the possibility to express their opinions on their preferred roles, in order to analyze and state the possible differences and gaps between current and preferred situation.

We can conclude from *Figure 5.13* presented below that a great percentage of respondents prefer to act as 'risk-based' auditors (58.8%) as well as 'internal consultants' (23.5%). This means that a great portion of directors wants to move forward and prefer to provide risk based and consultancy services to the organization. But for many reasons, external or internal, this cannot be practiced among the organizations.

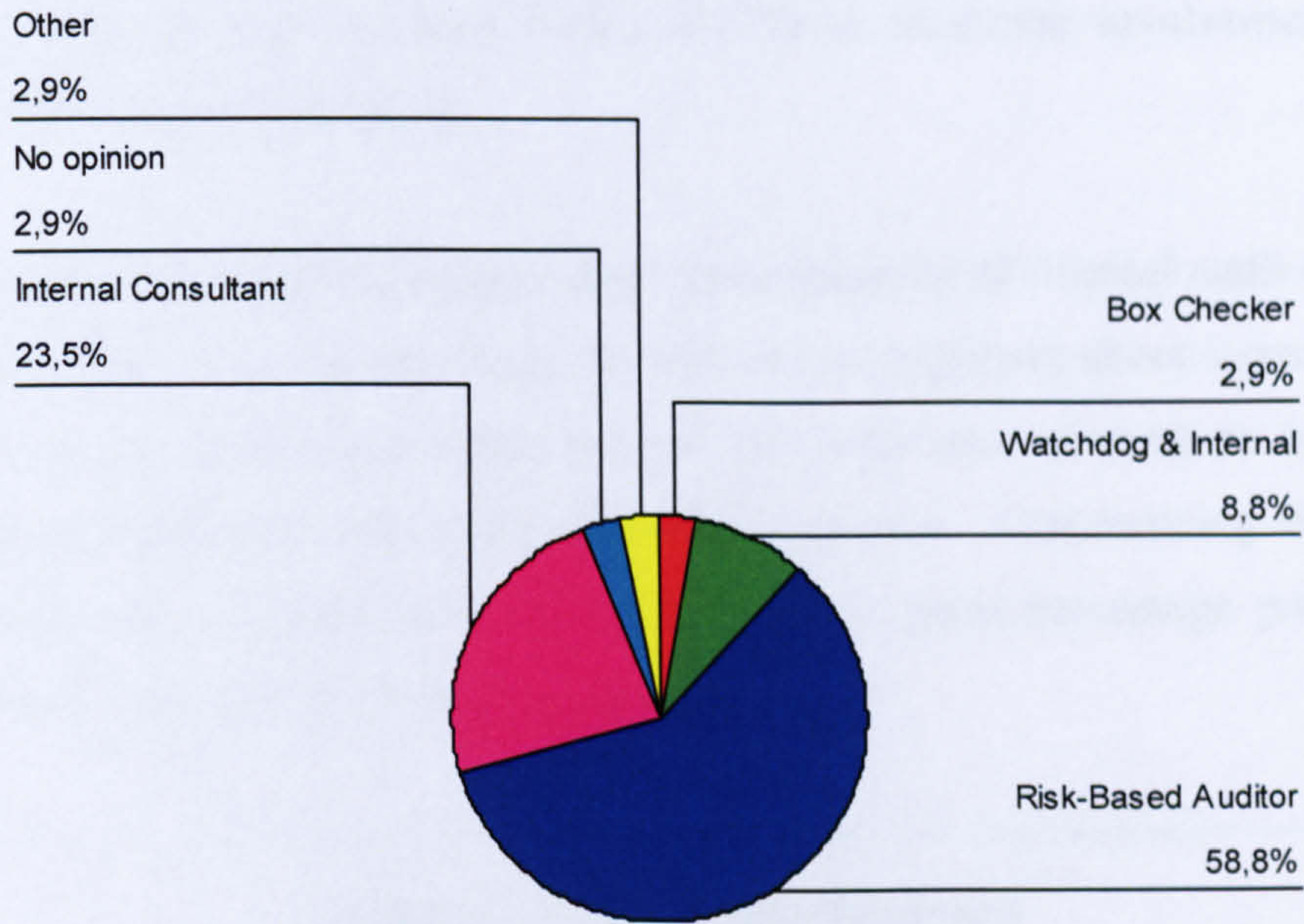


Figure 5.13: Internal auditor - Preferred role
Other
2,9%
No opinion
2,9%
Internal Consultant
23,5%
Box Checker
2,9%
Watchdog & Internal
8,8%
Risk-Based Auditor
58,8%

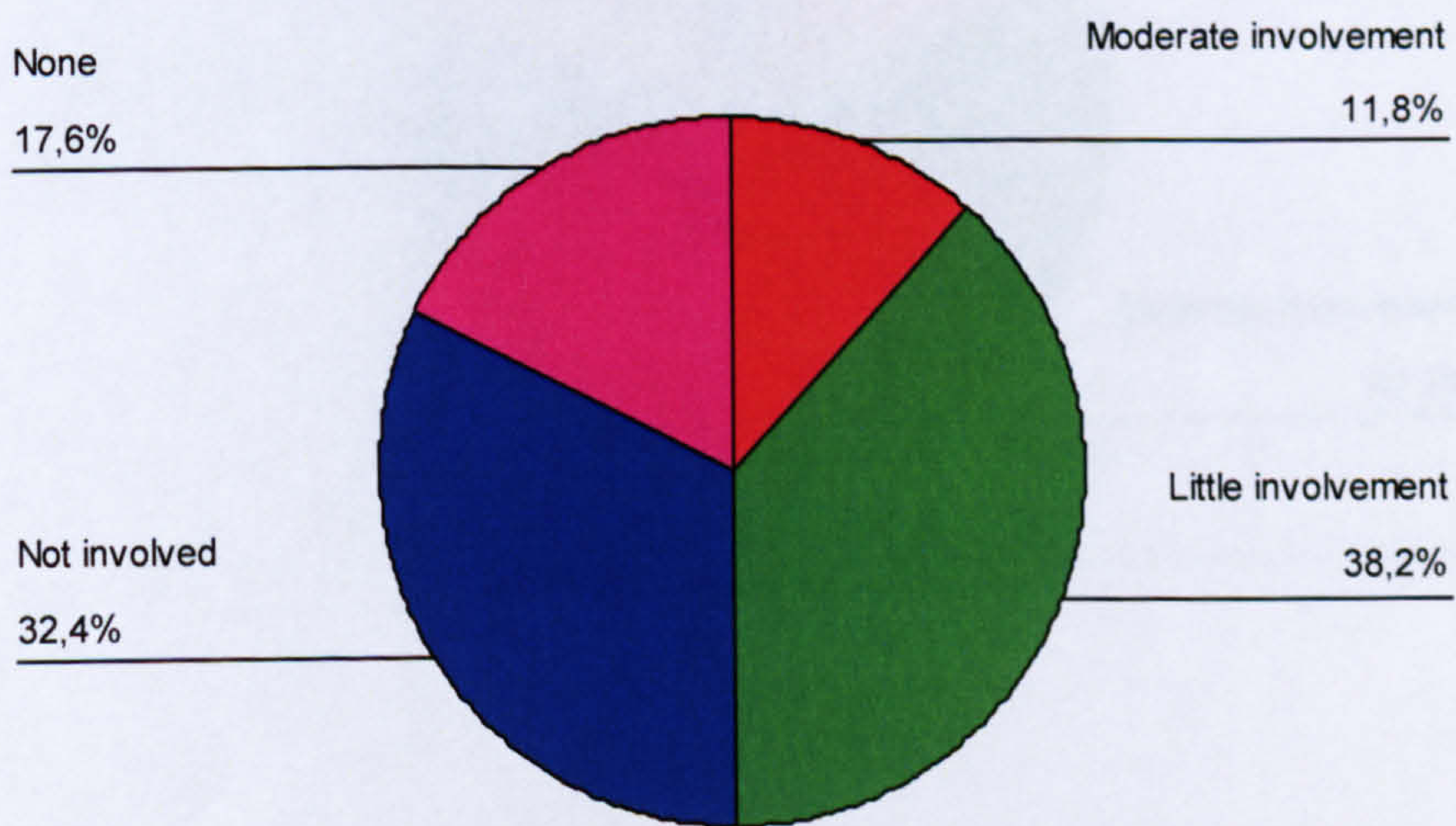
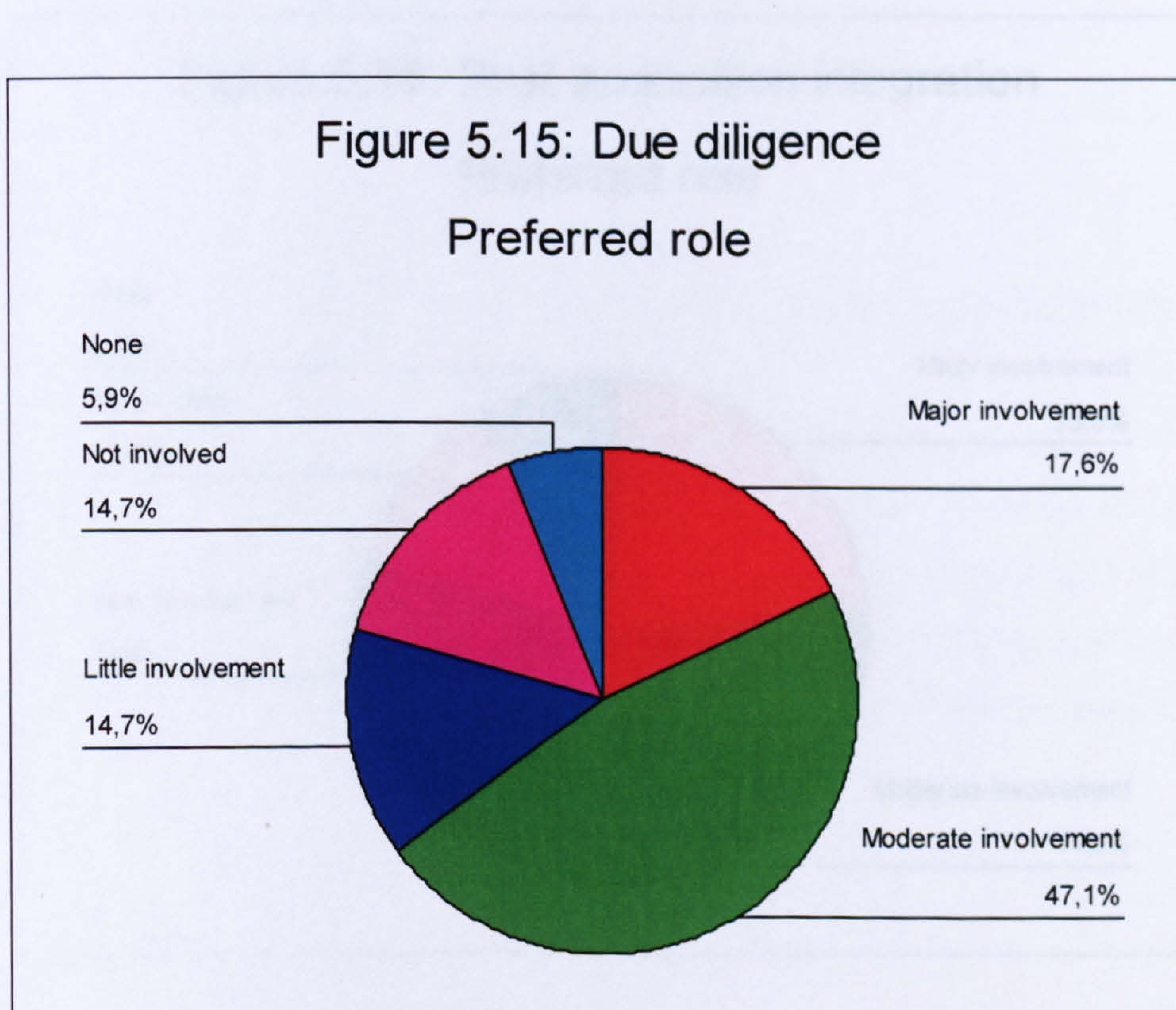


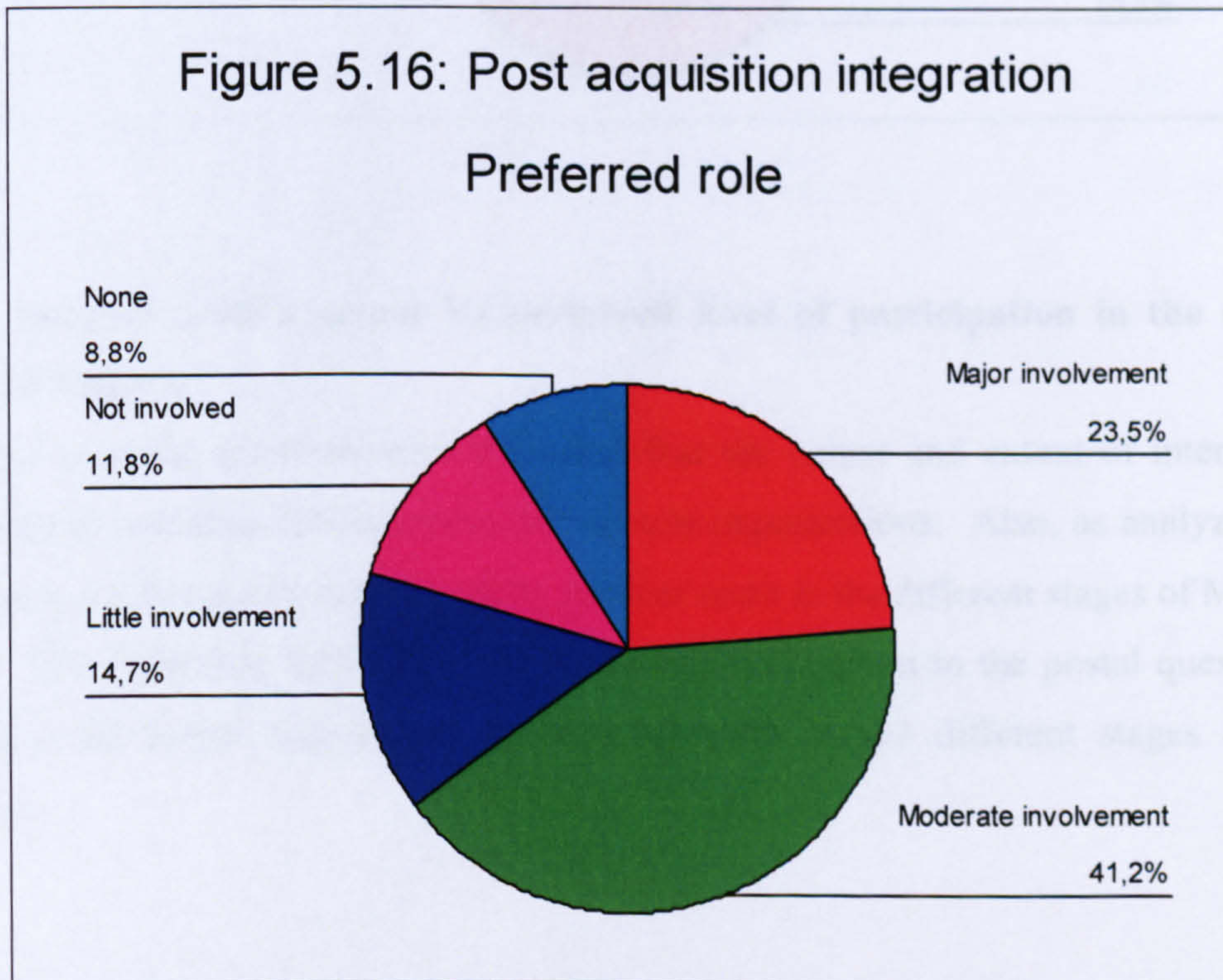
Figure 5.14: Strategy development
Preferred role
None
17,6%
Moderate involvement
11,8%
Little involvement
38,2%
Not involved
32,4%

But, on contrary to the previous results, in the question about their preferred roles during the M&A strategy development a great percentage responded that they do not want to be involved (32.4%) or want to have little (38.2%) or moderate involvement (11.8%). *Figure 5.14* illustrates these results.

Apart from strategy development stage that a great majority of internal audit departments prefer to have little or no involvement, the next set of responses about internal auditor's involvement in the next three stages reveals the preference of them to have a more coactive and collaborative role during the M&A process. Commencing from the due diligence stage we can state from *Figure 5.15* that a great percentage prefer to have moderate (47.1%) or major (17.6%) involvement.



We can observe a similar trend to the responses given at the question about the preferred level of involvement during the post acquisition integration stage (*Figure 5.16*). Directors responded that they prefer to have moderate (41.2%) or major (23.5%) involvement at this stage. Last but not least we must also note that a great majority of internal audit directors prefer to have grater involvement in the post acquisition audit stage, which represents the 'traditional' and 'after the fact' audit role. *Figure 5.17* shows that a great percentage of respondents have major (73.5%) or moderate (17.6%) involvement at this stage:



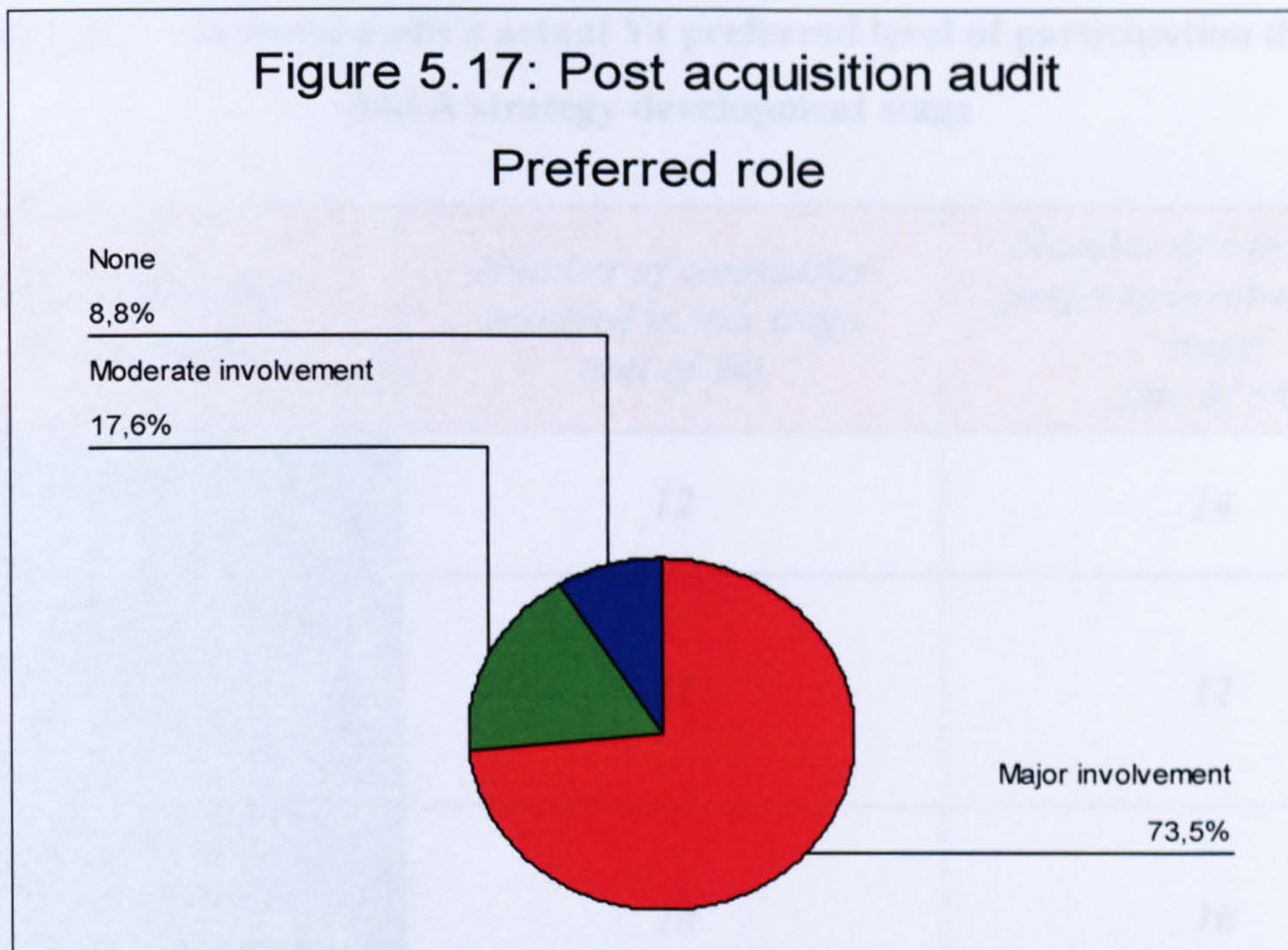


Figure 5.17: Post acquisition audit
Preferred role

5.4 Internal audit's actual Vs preferred level of participation in the different stages of M&A's

From the returned questionnaires we noted that the nature and extent of internal audit involvement activities differs across our sample organizations. Also, as analyzed in the previous parts, the actual role played by internal audit in the different stages of M&A also varies. The following tables summarize the responses given to the postal questionnaire regarding the actual role played by internal audit in the different stages of M&A activities:

Table 5.5: Internal audit's actual Vs preferred level of participation during M&A strategy development stage

Nature / extent of involvement	*Number of companies involved in this stage (out of 34)*	*Number of companies prefer to involve in this stage (out of 34)*
Audit the process used in assessing & managing risk	*12*	*14*
Receive communication about deals from Corporate Strategy department	*11*	*11*
Investigate whether control issues were addressed in the planning process	*10*	*16*
Advise on systems and processes that could reduce acquisition risk	*5*	*8*
Develop a planning model	*3*	*1*
Examine the business strategic plans	*2*	*5*

Table 5.6: Internal audit's actual Vs preferred level of participation during due diligence stage

Nature / extent of involvement	*Number of companies involved in this stage (out of 34)*	*Number of companies prefer to involve in this stage (out of 34)*
Developing plans in order to integrate internal audit of merging firms	*12*	*14*
Conducting due diligence alongside with other functions such as finance, accounting, human resources, law, etc.	*10*	*17*
Ensuring due diligence covers financial, operational and compliance issues	*9*	*14*
Working with external consultants carrying out due diligence	*8*	*11*
Auditing financial reporting systems	*8*	*10*
Auditing internal audit function in target company	*8*	*16*
Ensuring weaknesses identified in due diligence are considered in finalizing the deal	*7*	*12*
Conducting initial due diligence in assessing internal control	*7*	*14*
Advising on risks and implementation to ensure risks are taken into account	*7*	*14*
Ensuring awareness of regulatory and other compliance matters	*6*	*11*
Auditing the business processes of the target company	*5*	*14*
Reviewing integration plans for IT systems	*5*	*10*

Table 5.6 (continued)

Nature / extent of involvement	*Number of companies involved in this stage (out of 34)*	*Number of companies prefer to involve in this stage (out of 34)*
Ensure the target is complying with to the acquirer's policies and procedures	*5*	*6*
Providing advice on cross-border deals	*3*	*4*
Providing advice on contracts and accounting matters	*2*	*2*
Examining deal structuring	*2*	*2*

Table 5.7: Internal audit's actual Vs preferred level of participation during post acquisition integration stage

Nature / extent of involvement	*Number of companies involved in this stage (out of 34)*	*Number of companies prefer to involve in this stage (out of 34)*
Play an advisory role to functions carrying out integration	*10*	*14*
Audit acquired company profit performance before final closing of the contract term	*5*	*5*
Help with the development of a communication policy to inform acquired company's staff regarding systems, procedures, risk	*3*	*3*
Prepare a checklist of activities necessary to actualize expected value from the acquisition	*1*	*5*
Advise on the approaches to issues e.g human resources in planning the transition	*1*	*2*

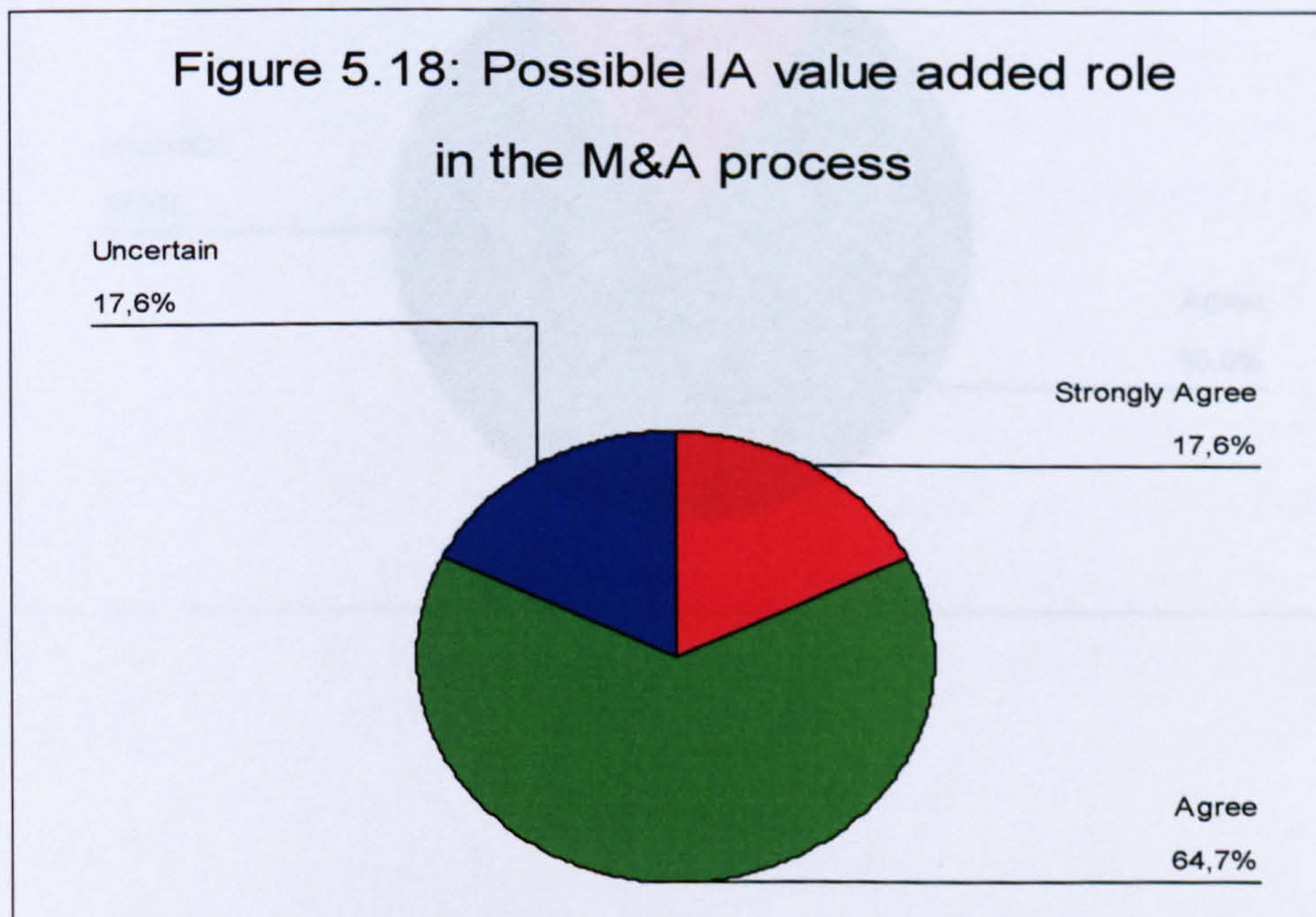
Table 5.8: Internal audit's actual Vs preferred level of participation during post acquisition audit stage

Nature / extent of involvement	*Number of companies involved in this stage (out of 34)*	*Number of companies prefer to involve in this stage (out of 34)*
Audit integration process to identify control weaknesses	*23*	*19*
Report findings to business units , audit committee, board	*23*	*19*
Risk based audit of policies, procedures and controls in merged / acquired company	*22*	*21*
Investigate whether the specific goals of the acquisition have been achieved	*12*	*16*
Prepare "Lessons Learned" document about integration process	*9*	*17*
Assess performance against benchmarks, e.g. balanced scorecard and action plans	*7*	*8*
Audit the post-acquisition appraisal system	*7*	*9*
Develop standards and checklists for the governance of stand-alone acquired subsidiaries	*7*	*9*

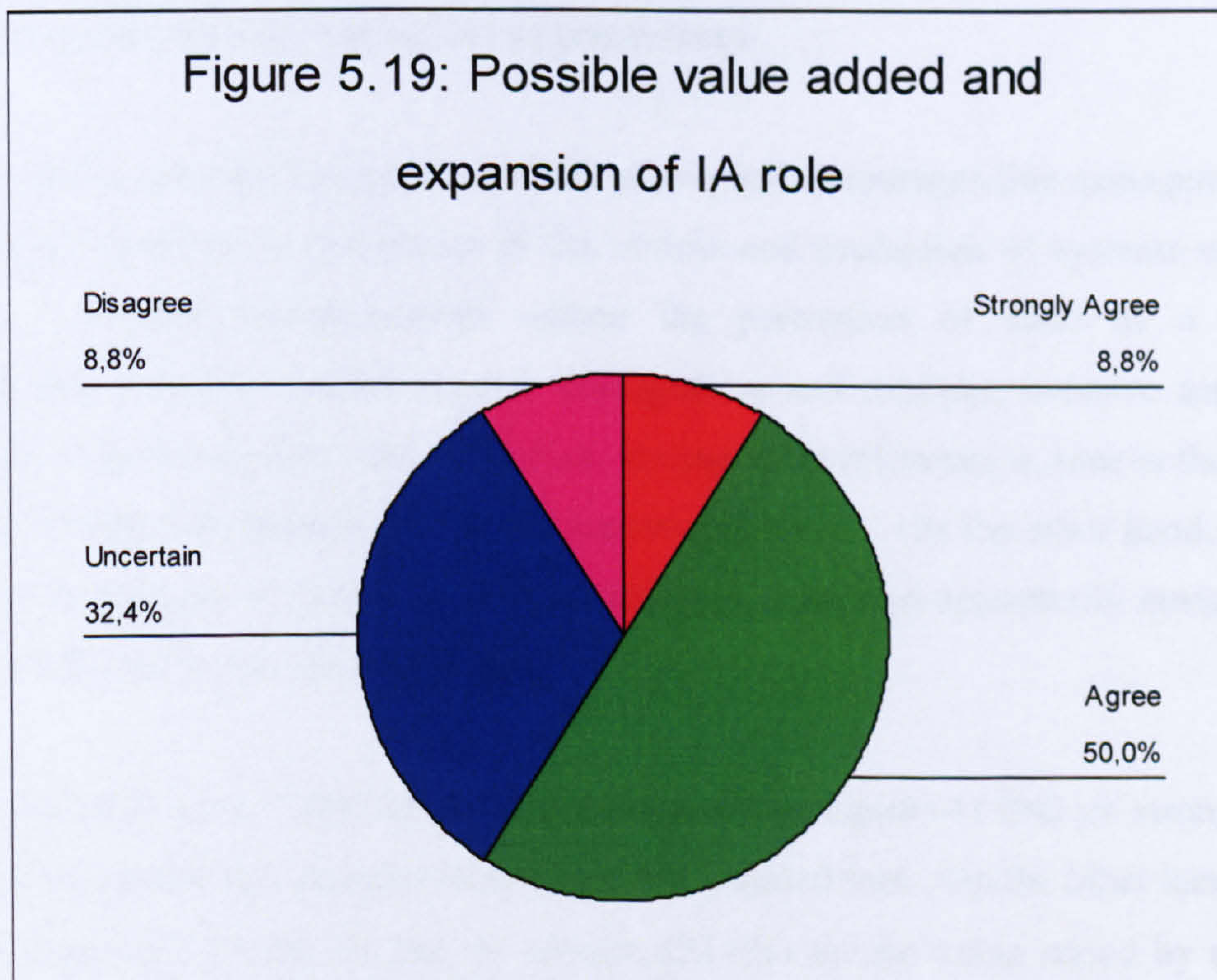
5.5 Internal audit as a "value-added" tool during the M&A process

Internal audit provides an independent and objective assurance and advice service to the board and the audit committee, assisting them in their responsibilities to comply with the business objectives. On the other hand, the Institute of Internal Auditors has updated its definition about the role of internal auditing. In this context, the key words are independent, objective, and systematic and finally add value. Despite this often top management may not realize that these attributes can be applied by internal auditors in the wider area of business risk management. Some may perceive internal auditors to have only financial expertise. Thus, boards and audit committees may therefore overlooking an opportunity to obtain greater business benefit from his skilled resource.

One of the objectives of this research is to analyze the perception of the audit executives about the possible value added role of internal auditing during the M&A process. Having in mind their rich organizational expertise we asked them at first if internal auditing, from their point of view, can add value to the M&A process. Chief audit executives replied to our questionnaire agreed (64.7%) and strongly agreed (17.6%) that internal auditing can add value to the M&A process with a small percentage to be uncertain about the "value added" role. *Figure 5.18* exhibits these results:



On the next question we asked chief audit executives to scale their perception about the role of internal audit during the M&A process. In the previous parts, we noted that a number of audit executives agreed about the new and proactive role of modern internal auditing. So, in this part we asked them if internal audit function 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 chief audit executives to perceive that a more proactive internal auditing contribution can possibly add more value to the process. More specifically half of the respondents agreed that a more expanded role could offer grater value for the deal. But, on the other hand, there is also a part of respondents (32.4%) that are uncertain about the contribution and the value of an expanded role. *Figure 5.19* represents this difference:



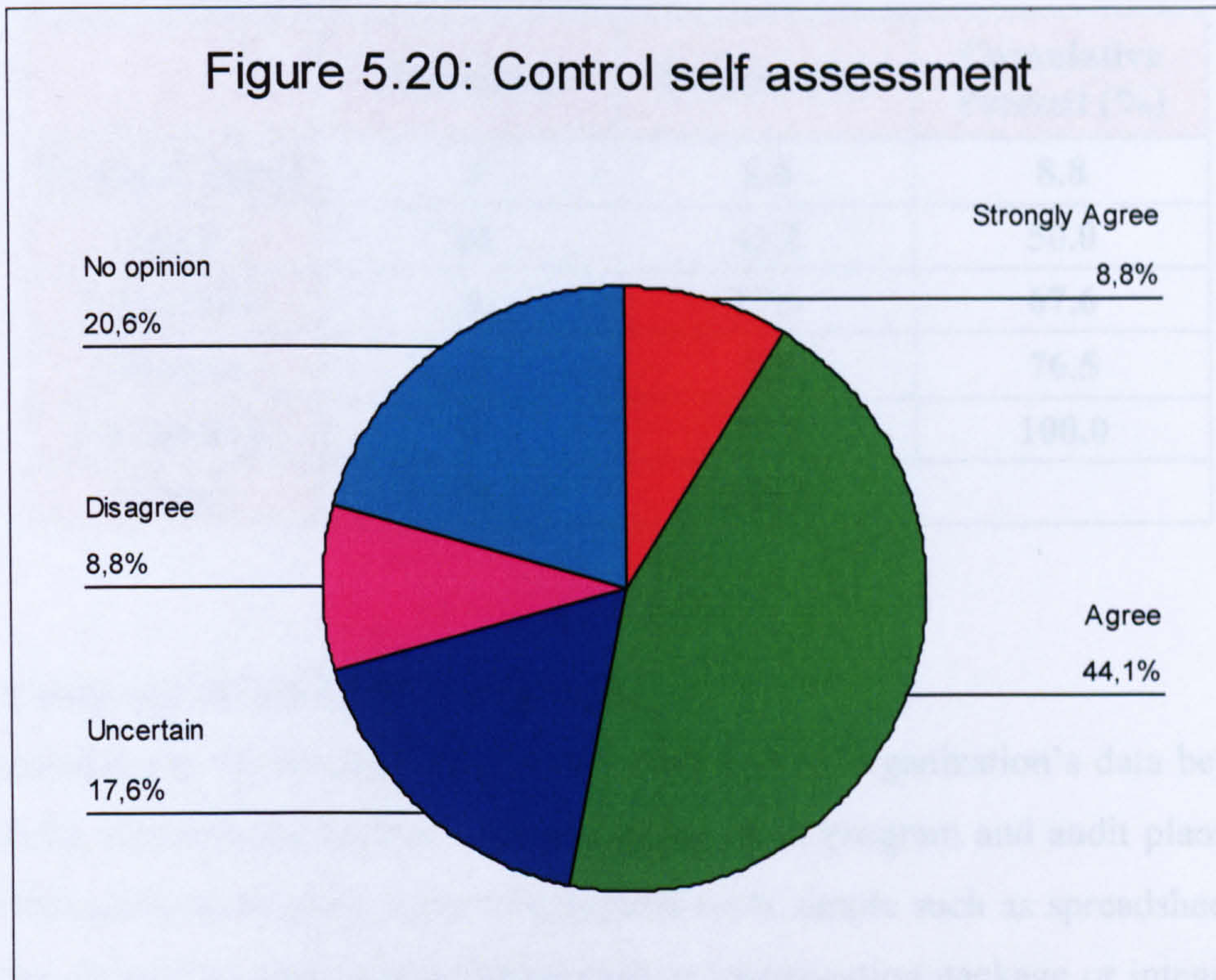
To help understand where internal audit adds value we gave chief audit executives a list, at the end of questionnaire, of the various ways and techniques derived from the literature that could possibly add value to the M&A process. These techniques and tools derived from best practices and from the thorough literature review provided at Chapter 2. Responses vary from type to type and are presented below.

5.5.1 Control self assessment

Control self assessment is a process whereby employee teams and management, at local and at executive levels, continuously maintain an awareness of all material factors affecting the likelihood of achieving the organization's objectives, thereby enabling, where needed, them to make appropriate adjustments. To promote independence, objectivity and quality within the process, as well as effective governance, it is described that internal auditors are involved in the process and that they independently report results to senior management and board committees.

Control self assessment is a process which allows and encourages line management, staff and internal auditors to participate in the review and evaluation of systems of internal control. Control self-assessment reduce the perception of audit as a negative, bureaucratic procedure, addresses risk management and analysis, improve appraisal of the 'soft' controls (such as communication, management information, tone at the top) and there is a better implementation rate of recommendations. On the other hand, it can be very costly because of factors such as consultants, time, and opportunity costs of using senior audit staff in non core activities.

In our research almost half of the respondents either agree (41.2%) or strongly agree (8.8%) that control self assessment can be a value added tool. On the other hand another part is uncertain (17.6%) or has no opinion (23.5%) on the value added by using this technique during the M&A process. These results are summarized in *Figure 5.20* provided below:



5.5.2 Consulting

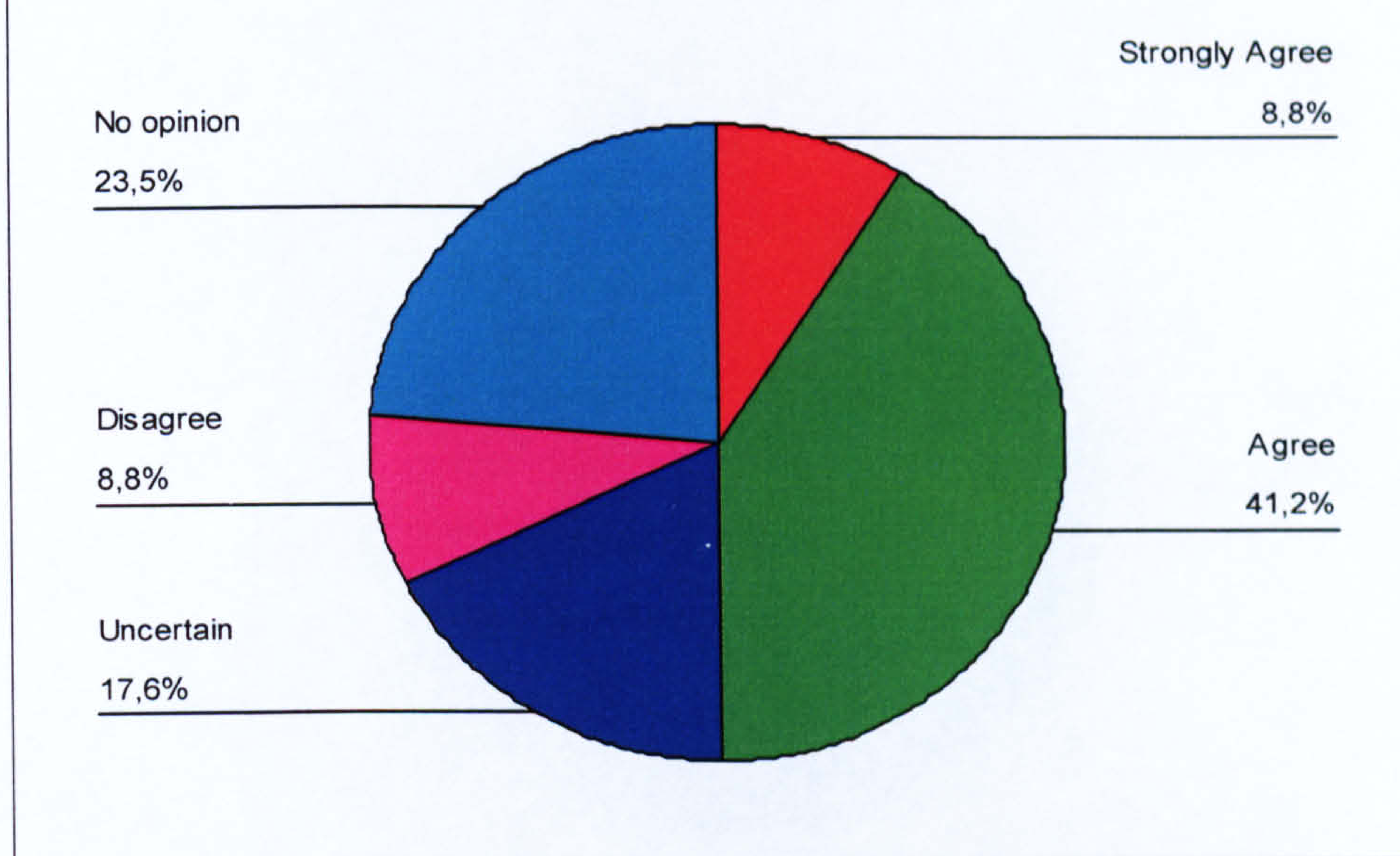
In literature review section we have analyzed the evolution of internal audit profession during the decades. The latest trend introduces the concept of consulting to the internal audit profession. *Table 5.9* represents the trend and analysis of the returned questionnaires to this new role of internal auditing, according also to the new definition of internal auditing, which is almost the same as the previous one. Almost half of the respondents agree (41.2%) or strongly agree (8.8%) that consulting role can proved as value added during the M&A process. But we can note there is also a strong opposition to this perception that is uncertain (17.6%), has no opinion (23.5%) or disagrees (8.8%) with this role.

Table 5.9: Possible value added outcomes of consulting role during M&A's

	Frequency	Percent (%)	Cumulative Percent (%)
Strongly Agree	3	8.8	8.8
Agree	14	41.2	50.0
Uncertain	6	17.6	67.6
Disagree	3	8.8	76.5
No opinion	8	23.5	100.0
Total	34	100.0	

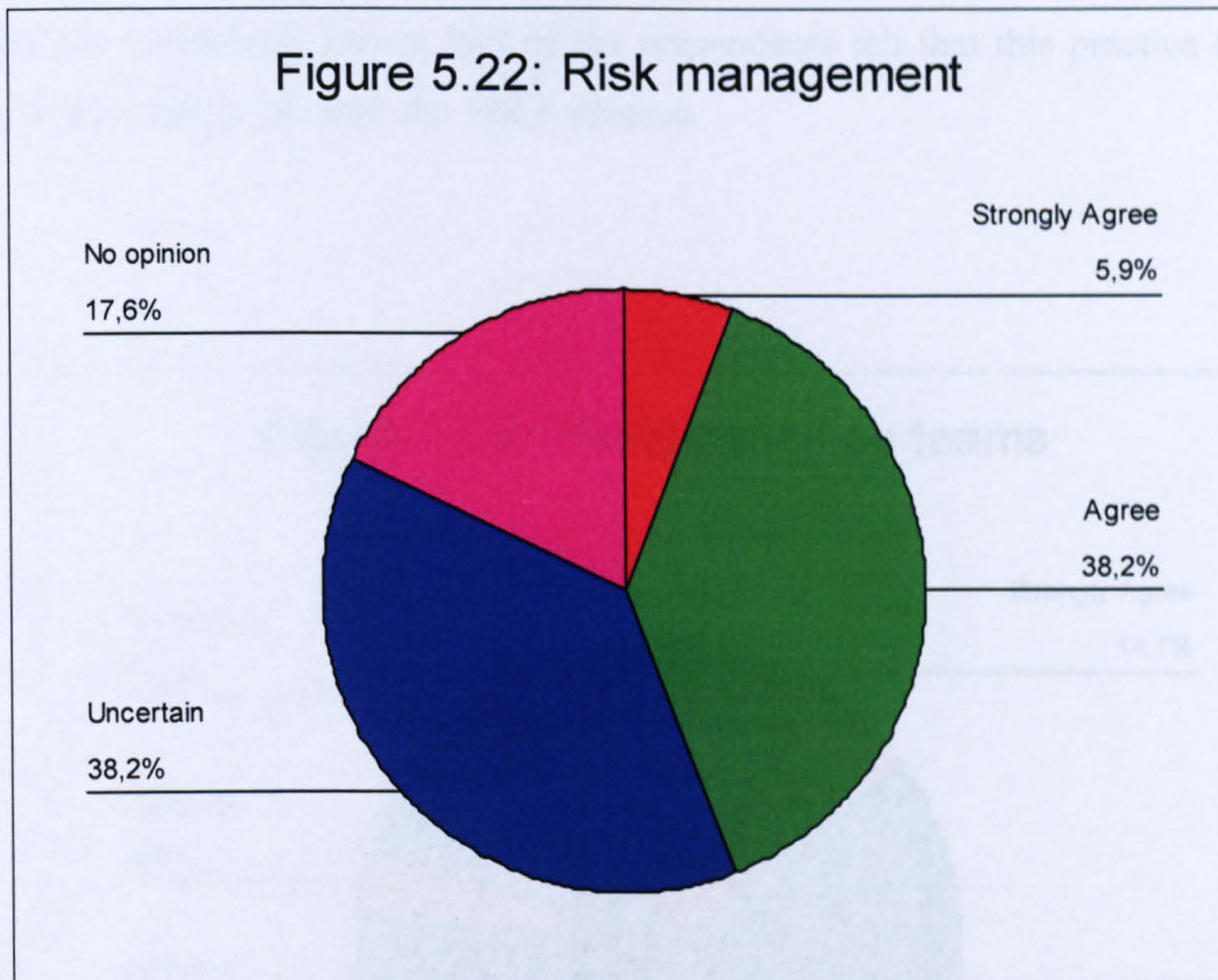
5.5.3 Computer assisted audit techniques

The increasing use of computer has, to an extent, put an organization's data beyond the reach of the conventional auditor. As part of the audit program and audit planning, the auditor frequently uses some types of computer tools simple such as spreadsheets, word processing as well as more sophisticated such as interrogation package or integrated test facility. The results showed that many internal auditors are uncertain (38.2%) that computer assisted audit techniques can be value added to the M&A process. On the other hand, many of the respondents agree (38.2%) or strongly agree (5.9%) that the use of computers in auditing can be quite value added.



5.5.4 Risk Management

According to the new philosophy of internal auditing as an effective risk management tool, key concept in risk management is the acceptance of a certain amount of risk as the price for operations and the expectation of some rewards. Once risk assessed and identified, decisions can be made about how to treat the consequences of that risk. The concept of risk is critical to the new definition of internal auditing as well as to the new COSO ERM framework. On our returned questionnaires, a strong proportion of respondents either agree (55.9%) or strongly agree (32.4%) that risk management can possibly add value to the M&A process.

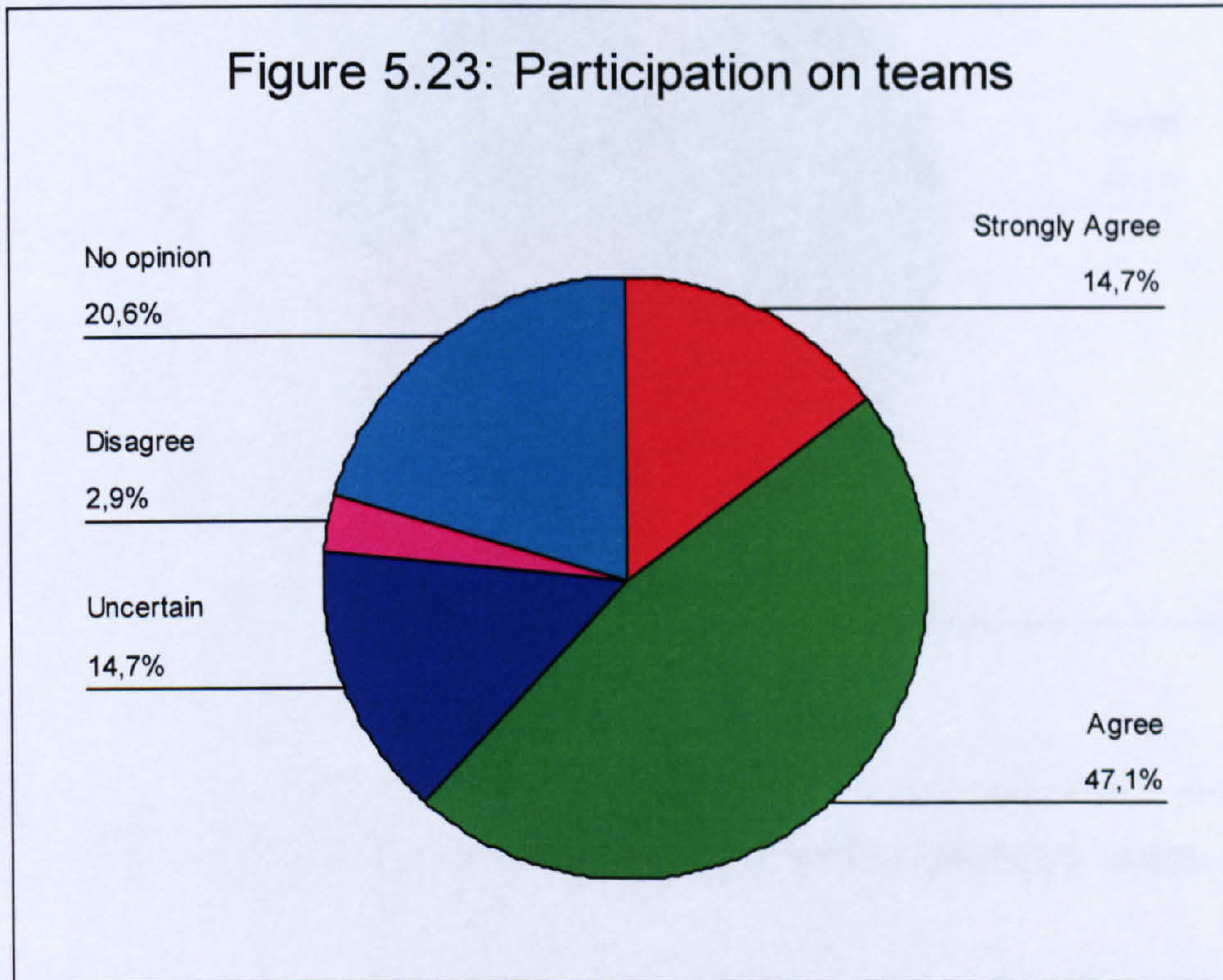


5.5.5 Making auditing more collaborative and participation on teams

M&A is a dynamic process that brings teams forms both companies together. In the case of a finalized deal these people will create a strong base for the new entity. Thus, a section on the questionnaire had questions about the participating tasks during a merger and the possible added value of an effective communication and sharing or transfer of ideas. On the question about the participation on teams (*Figure 5.23*) and the possible positive contribution to the future entity 47.1% of respondents agree and 14.7% strongly agreed on the value added effect of this participation.

On the other hand, in the question about making auditing more collaborative (*Figure 5.24*) 14.7% disagreed and 26.5% had no opinion and 14.7% were uncertain about the value added outcomes of this practice. But there was another 41.2% that agreed that while audit staff still performs risk assessment and analysis, this collaborative effort helps bring out into the open issues that auditors may not have previously detected. On a similar question about the sharing of technology with the business units (*Figure 5.25*) and the recruiting of staff from other functions (*Figure 5.26*) such as finance, accounting and

information technology almost half of the respondents felt that this practice could be a value added practice through the M&A process.



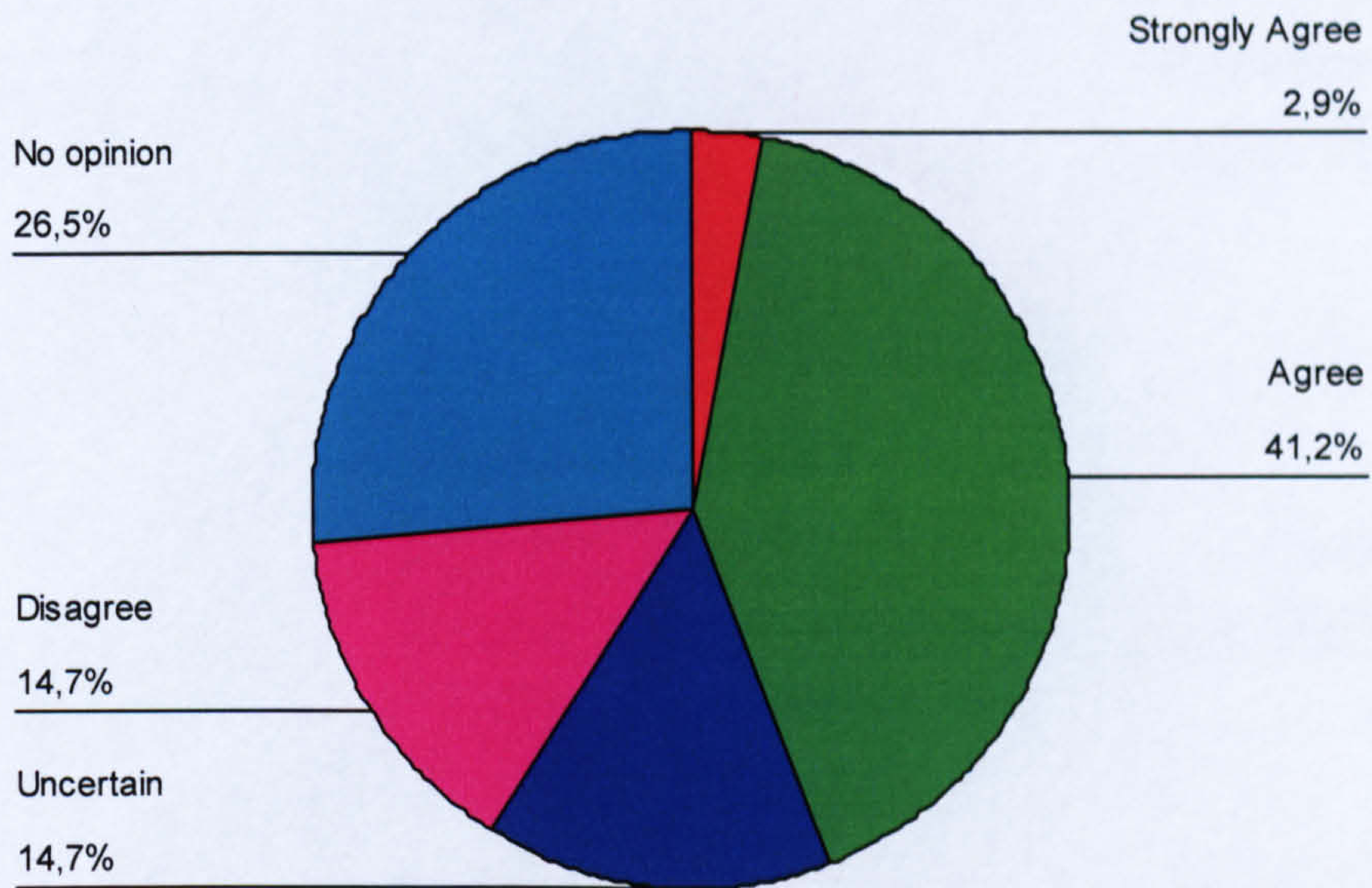


Figure 5.24: Make auditing more collaborative
Strongly Agree
2,9%
No opinion
26,5%
Agree
41,2%
Disagree
14,7%
Uncertain
14,7%

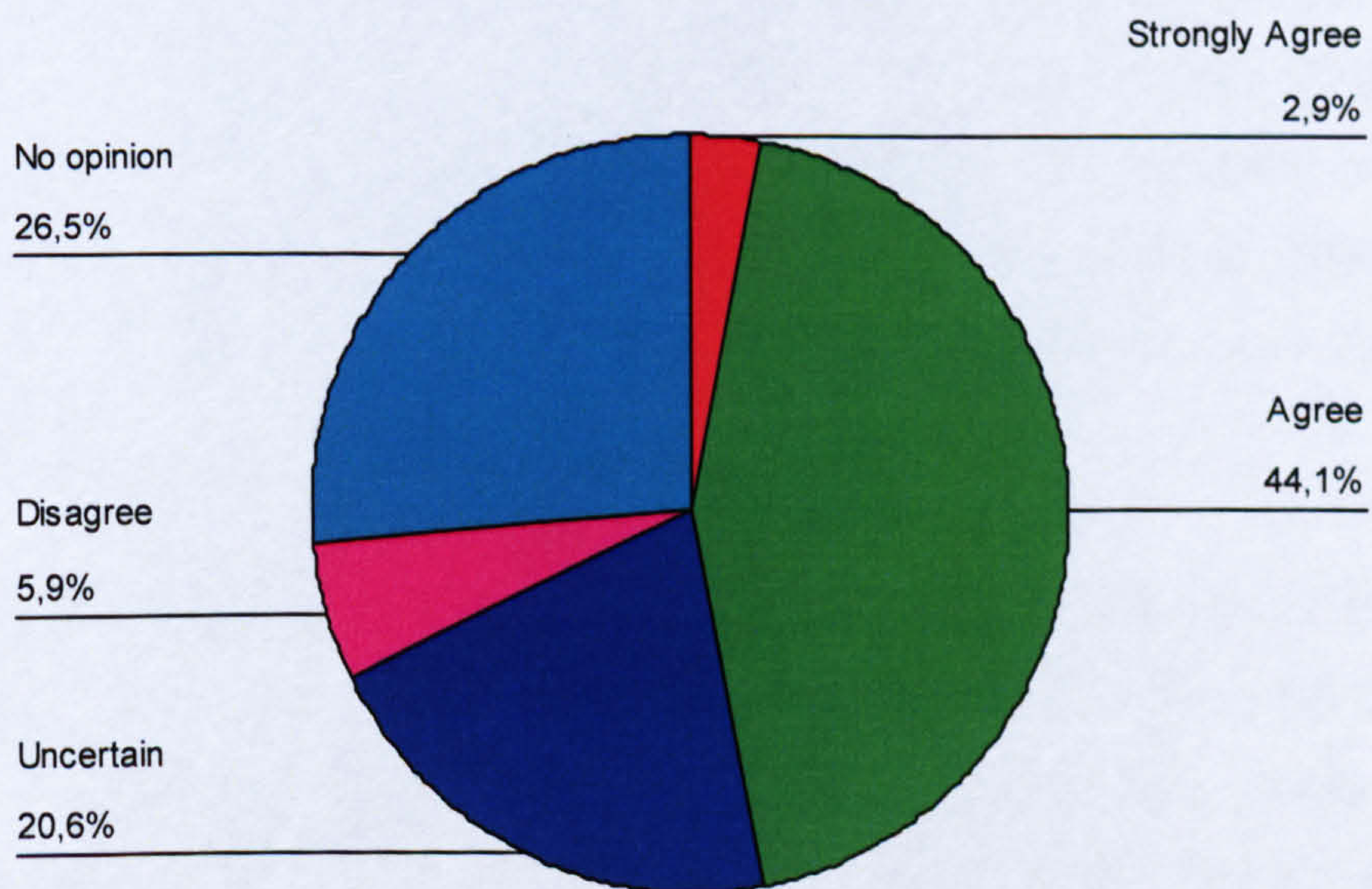
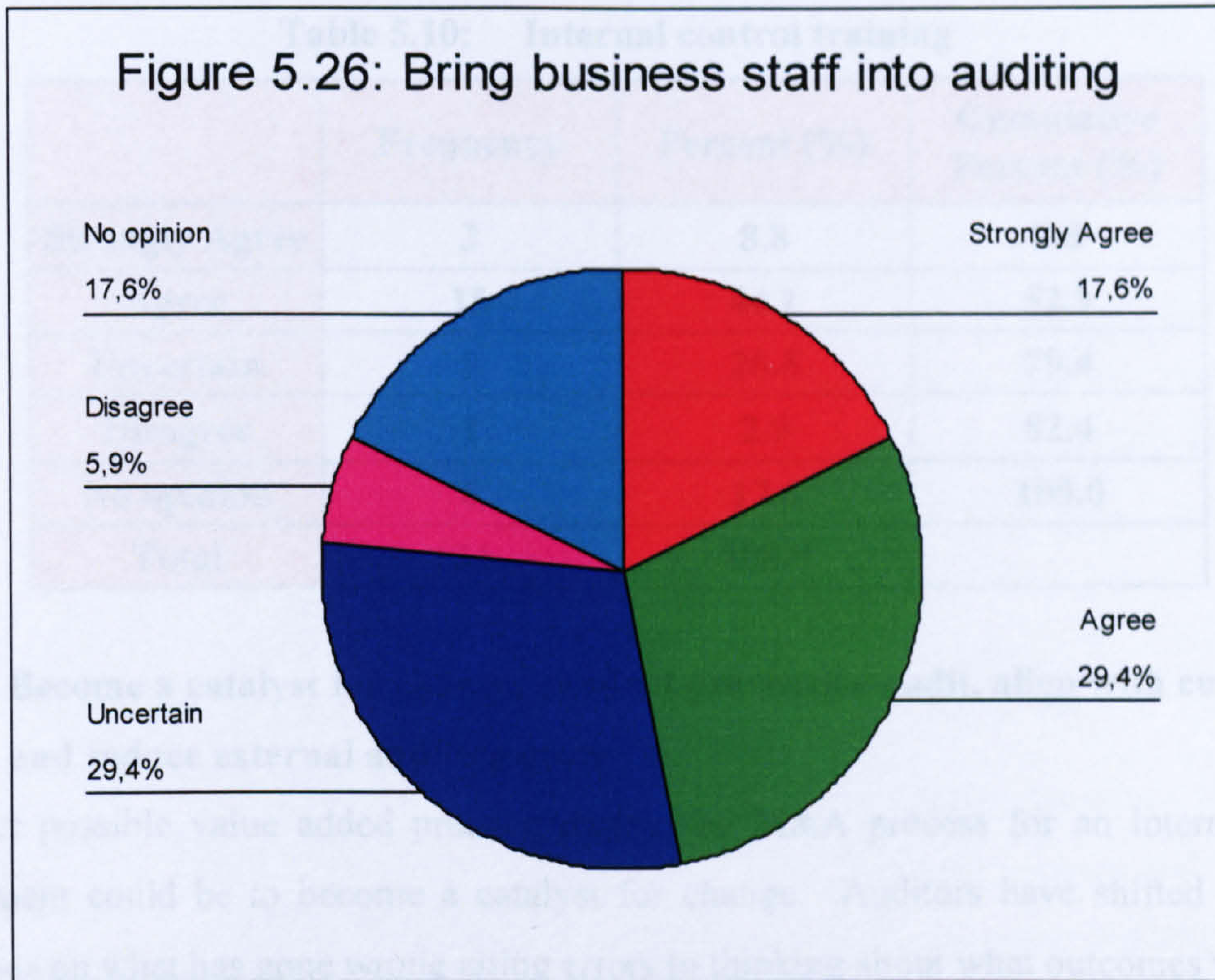


Figure 5.25: Share technology with business units
Strongly Agree
2,9%
No opinion
26,5%
Agree
44,1%
Disagree
5,9%
Uncertain
20,6%



5.5.6 Internal control training, continuous monitoring and systems implementation review

Internal auditors are often treated as internal control experts. Internal control is process, affected by an entity's board of directors, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives about the effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations (COSO definition). Thus, continuous internal control training could be more value added for both the auditors and the company.

But on this question we have a well balanced set of answers (*Table 5.10*). Half of the respondents agree or strongly agree while another half is uncertain, had no opinion or disagrees. The same trend is represented also to the question about the systems implementation review. On the other hand, we have more than half of the respondents that disagree (20.6%), strongly disagree (2.9%) or had no opinion (29.4%) about the value added role of continuous monitoring of the M&A process during the various stages.

Table 5.10: Internal control training

	Frequency	Percent (%)	Cumulative Percent (%)
Strongly Agree	3	8.8	8.8
Agree	15	44.1	52.9
Uncertain	9	26.5	79.4
Disagree	1	2.9	82.4
No opinion	6	17.6	100.0
Total	34	100.0	

5.5.7 Become a catalyst for change, conduct preventive audit, align with customers and reduce external auditing costs

Another possible value added practice during the M&A process for an internal audit department could be to become a catalyst for change. Auditors have shifted from an emphasis on what has gone wrong citing errors to thinking about what outcomes will help a business unit to operate more effectively. But, on our survey more than half of the respondents were uncertain (26.5%) or had no opinion (26.5%) while 14.7% were disagreed about the value added outcome of this practice.

One of the main components of the new philosophy for internal auditors is to conduct preventive audits rather than have a detective role. This type of auditing includes systems development review, self assessment programs and consulting and internal control education. Also, internal auditors partners with auditees to identify the most likely opportunities for continuous improvement. Responses to this question were equal distributed. 44.1% were either agreed or strongly agreed while 26.5% had no opinion and 23.5% were uncertain.

Another value added practice derived from the literature is to align with customers. This means that in the audit planning stages, the audit staff meets with key business managers to learn their views of problem areas and where they would like to see auditors focus their efforts. Whenever the auditing department develops a new audit procedure or monitoring tool, they consider how it can be transferred to management to be used by

them. But respondents were uncertain (41.2%) or had no opinion (29.4%) about the possible value added outcomes of this practice.

Finally, anything that an internal audit department can do to reduce costs can add value to the company. Sometimes internal and external auditing can have overlapping procedures or audit areas. An effective internal auditing contribution to the various stages of an M&A could reduce external auditing costs and thus add value to the process. Almost half of the respondents (47%) agree or strongly agree while a third of them (29.4%) were uncertain about the possible value added effects of this practice.

5.6 Summary – Preliminary conclusions

This part will summarize the bulk of statistical tables and figures presented above. In general this research revealed representativeness of industrial sectors and countries included in the sample. Twenty main industry sectors as well as nine out of the fifteen countries of the European Union were represented in this study. A great percentage already has an M&A department in their organizations, used external parties for the deal. Also, the majority of internal audit departments has been established in these organizations for more than twenty years and employs more than ten auditors in their internal audit departments.

A great percentage of respondents agreed that internal audit can add value to the M&A process. But if we summarize the actual against the preferred role of internal auditors (*Table 5.11*) we conclude that although a great percentage (82.3%) prefer to act "after the fact" and coactively as risk based auditors or internal consultants, 29.4% currently acts as watchdogs and internal control experts, 5.9% as box checkers and 8.8% has no role during the M&A process.

Table 5.11: 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%*

Next step on 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 current situation (*Table 5.12*) 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 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 on post acquisition audit stage the majority of respondents had moderate or major involvement.

Table 5.12: Summary table 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%*

If we want to summarize also the results for the preferred situation of the contribution of internal auditing to the M&A stages (*Table 5.13*) we can note that apart from strategy development stage that a great majority of respondents do not prefer to involve 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 5.13: Summary table 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 audit's involvement in the M&A stages are as follows:

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

We must note that *Table 4.1* and *Figures 4.1* and *4.2* illustrated country and industry classification in the sample. We have tried to analyze if there are major differences in current and preferred practices in relation with some variables such as country of origin, industry and size of the internal audit department. We found that eventual differencies in

frequencies and means are not statistically significant and this is probably due to the response rate and the distribution of the replies.

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 chief audit executives 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.

A great number of respondents believe that internal audit can add value to the M&A process. On the other hand, there is also an important part of respondents that are uncertain or disagree about the contribution and the value added of a possible expansion of internal auditing into a proactive process. We can also summarize from the current and preferred practices that most of the chief audit executives do not have some preferred practices in mind in order to expand their roles in the early stages of strategy development and due diligence. Although there was a part on the questionnaire in order to mention other current or preferred practice, different of those presented in the literature, none of the respondents contributed any innovative or different practice.

At the third stage of this research, semi–structured interviews will be conducted with practitioners on the internal auditing area in order to identify and present the reasons for the gaps previous 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 in order to present a variety of opportunities for internal audit to actively participate and respond to the needs of their organization in a more proactive and consultancy role.

Chapter 6: Empirical Data Analysis

6 EMPIRICAL DATA ANALYSIS

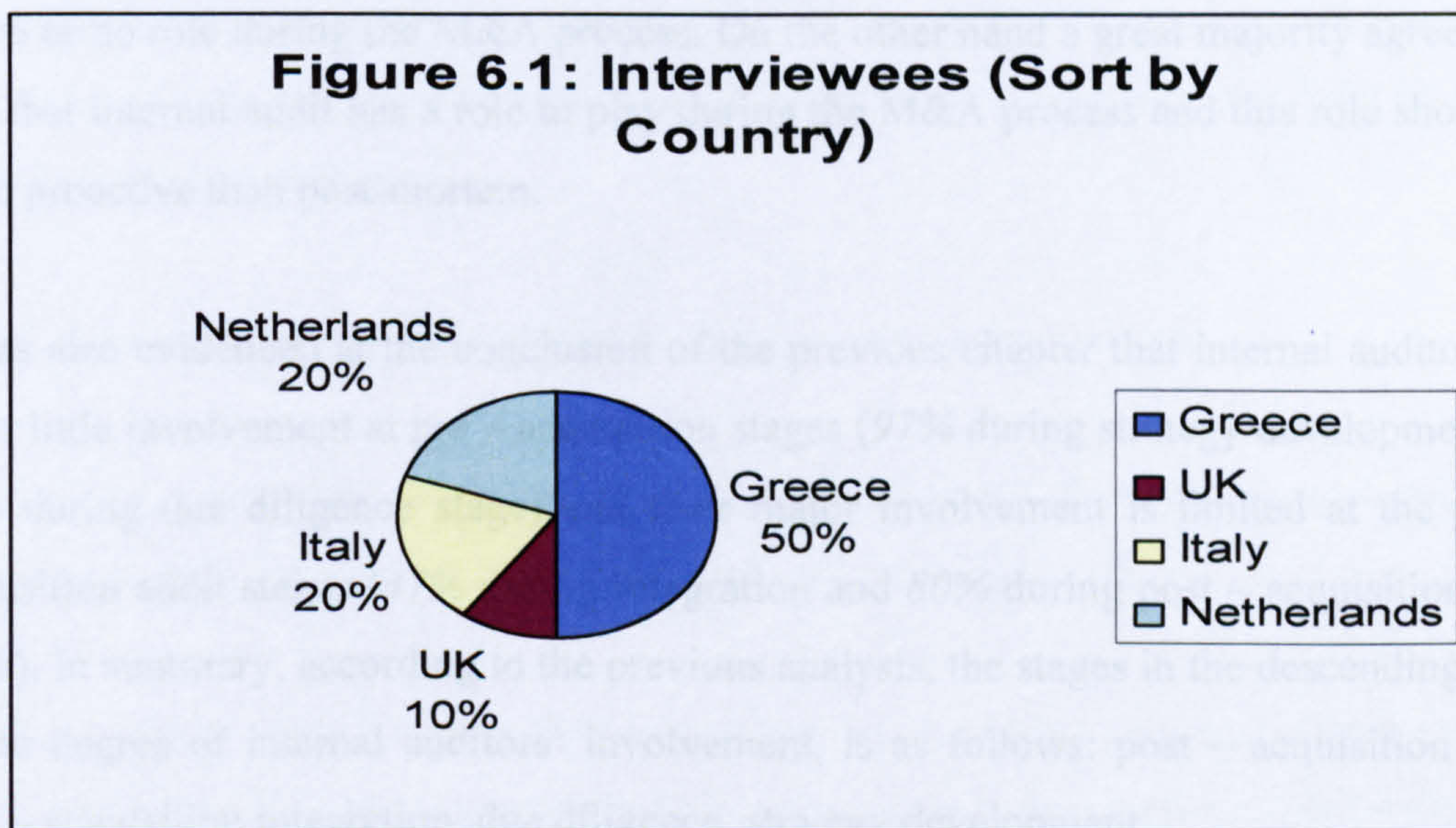
6.1 Introduction

Previous chapters presented and analyzed mergers and acquisitions phenomenon in relation to the internal auditing contribution to the various stages of an M&A. This chapter will try to summarize, analyze and validate the three different models derived from the literature review, the postal questionnaire (sent to 120 organizations in the European Union area that pursued mergers and acquisitions between 01/01/2000 – 31/12/2003) and also the use of data derived from semi – structured interviews conducted at this stage.

In order to validate preliminary and descriptive data we decided to follow a qualitative approach through semi-structured interviews. This methodology increases reliability and generalisability of "raw" quantitative data, supporting accordingly research hypotheses and questions. The main problems of a qualitative approach focus on the difficulties to replicate it, as well as, possible bias and subjective view of the participant's. On the other hand, in this research qualitative semi-structured interviews were used as a method in order to support primary data, leading to more unbiased opinions. In order to overcome participant's bias we selected our sample from different countries and industries and supported interviews with the use of an "aide-memoire" (see *Appendix C – Aide Memoire*) summarizing the main objectives of this research.

As mentioned at the research methodology, it was decided to conduct semi – structured interviews with a selection of internal audit managers and practitioners, different of those participated at the postal survey, that their organizations participated in M&A projects. It was also considered that if these opinions supported the primary analysis, the results could therefore consider as evidenced. The sample was taken from organizations that experienced mergers and acquisitions in the European Union area and were not the same as those selected in the previous sample. Communication details for the head of internal audit departments were found from existing contacts and the contribution of local Institute of Internal Auditors affiliates. The primary aim was to select a representative sample (in terms of country and industry classification).

An e - mail was sent, containing all the necessary feedback and objectives of this research in order to inform them more effectively about the aim of the interviews. Because of the low level of response rate we re-sent the e – mail to the sampling organizations. Finally, and after the follow up e - mail, ten internal audit managers and practitioners were agreed to participate and interviewed. *Figure 6.1* illustrates country classification of the interviewees participated.



Participating interviewees and their organizations were drawn from a variety of industries (three from telecommunications, three from banking and financial services, two from food and beverages and two from manufacturing). As mentioned, these interviews had as a primary objective to validate the preliminary results derived from the descriptive data analysis (such as current, preferred and ideal situation) and also provide useful feedback about the reasons for the gaps identified at the analysis and comparison of these three different models("as is", "as to be" and "best practice"). Based also on their strong organizational and audit experience we tried to formulate, having also as a basis the postal survey results, a best practices model applicable to the environment of the European Union organizations and summarize their recommendations for a possible active internal audit involvement during M&A process.

6.2 Actual participation of internal audit function in the different stages of mergers and acquisitions – Observed Model

Analysis of postal questionnaires revealed interesting points about the role internal auditors currently play during the various stages of M&A projects in the European Union organizations. The trend derived from the analysis of postal questionnaires is that, although internal audit profession has evolved during the years to a more pro – active and consulting activity, almost half of the respondents indicated that they have only post – active or no role during the M&A process. On the other hand a great majority agreed (*70, 6%*) that internal audit has a role to play during the M&A process and this role should be more proactive than post-mortem.

It was also evidenced at the conclusion of the previous chapter that internal auditors has no or little involvement at pre – acquisition stages (*97%* during strategy development and *20%* during due diligence stage) and their major involvement is limited at the post – acquisition audit stages (*47%* during integration and *80%* during post – acquisition audit stage). In summary, according to the previous analysis, the stages in the descending order of the degree of internal auditors' involvement, is as follows: post – acquisition audit, post – acquisition integration, due diligence, strategy development.

During my interviews with internal audit practitioners the researcher set this preliminary data in order to collect their opinion and also validate our descriptive analysis. The directors were asked about the nature and extent of involvement in their organizations during M&A projects and also comment on the results of the postal survey concerning current situation.

Question: Do you believe that internal audit has a role during the M&A process?

At first, in this general and introductory question, all the participants agreed on the general assumption that internal audit has a role to play during the M&A process and this role should be more proactive than post-mortem.

Question: What is the level of internal audit involvement at the various stages of an M&A projects in your organizations?

But in more specific questions, concerning the level of involvement in their organizations, responses were contradictory. It was interesting to notice that participants from mature business and internal audit environment, such as United Kingdom and Netherlands, indicated that they had a more active role and participation at the early stages of M&A projects. On the other hand, participants from countries with less mature internal audit departments (such as Greece) indicated that their role was limited only at the post – acquisition stages.

In the cases of active internal audit involvement, it was indicated that

> "*Top management believed that internal audit function contributed very effectively to the whole M&A process*", *(IA Manager, Netherlands).*

Internal auditors contributed at the early stages of the M&A process, visited acquired companies approximately four months before the acquisition in order to perform generic risk analysis and their role was

> *"To prevent the company to score their own goal", (IA Manager, UK).*

This quote forms the basis of the value added role of internal audit function

> *"Not quantifiable but based on the opportunity cost", (IA Manager, UK).*

These cases of effective internal audit contribution were taken into consideration by top management, which then wanted a more closely supervision and participation by internal audit department in the cases of M&A projects.

Also, the main task of internal auditors in the pre-acquisition stage was

> *"To visit acquired company and perform generic risk analysis and focus primarily on processes and procedures and not in financial matters", (IA Manager, Netherlands).*

Apart from these cases, general view derived from the interviews supports primary data collected through descriptive data analysis and demonstrates that internal audit function has low to moderate level of involvement during the pro – active M&A stages. All the participants indicated and recognised during the interviews this general trend and their views were based on their rich organisational and practical experience in the area of internal auditing.

Question: What is the reason of low to moderate level of internal audit participation on pre-acquisition stages (as evidenced also from quantitative data analysis of postal questionnaires)?

Directors were also asked to comment on the reasons for this low to moderate level of internal audit participation on pre – acquisition stages. It was interesting to notice that in the cases of organizations with low or no involvement at earlier stage, internal audit directors were reluctant to participate quoted that

> *"Strategy and audit are opposite because strategic decisions are taken by management", (IA Manager, Italy)*

And although they perceive that their departments possess the necessary skills in order to contribute to M&A process it was quoted that

> *"Internal audit involvement can prove time consuming", (IA Manager, Italy)*

and is also ambiguity about the final result of the deal.

It was also stated that

> *"The use of internal auditors during pre-acquisition phase is often prevented by the owners of the target company and although internal audit can add value to this process practically its role is limited by the fact that confidentiality prevails at this stage", (IA Manager, Netherlands).*

Another important factor indicated, supported also by the high level of third part involvement (such as investment banks or audit firms) evidenced at the descriptive data analysis is

> *"That target companies are very reluctant to disclose confidential information to the possible buyer and prefer outside companies / consultants, who will sign a confidentiality agreement and report to the buyer in a controlled manner", (IA Manager, Netherlands).*

An important issue, derived from the interviews and linked with the previous paragraph, relates the level of objectivity and independence of an internal audit function participated at the early stages of an M&A process. Directors supported the view, presented earlier at the literature review, of possible impaired objectivity quoting that

> *"Buyers' shareholders and management wants to have a completely independent view / check of the target company, whereas an internal auditor working as an employee for the buyer may be considered to be less independent, also depending on his/her reporting line", (IA Manager, Netherlands)*
>
> and
>
> *"Possible participation of internal audit function in the assessment of strategic decisions can increase the danger of impaired objectivity and independence", (IA Manager, Greece).*

Directors were also stated, in order to support the reasoning for management reluctance on possible internal audit participation, that:

> *"If management wants to sell or acquire another company, doesn't want to show or report problems in operations or control weaknesses that could probably delay or postpone the deal", (IA Manager, Greece).*

Fast process of preliminary communication and deal structuring often prevents the participation of internal audit function at the early stages of M&A process. Additionally, top management wants the deal done before the competitors have the time to make necessary strategic moves and create conflicts or increase the value of the deal. Also, management doesn't want to present control weaknesses or related problems to possible target companies and this perception is embedded because of possible negative reaction of the shareholders of the acquirer.

Another important issue indicated from practitioners is the perception, embedded on the different and multiple functions participated at the different stages of the M&A process (such as finance, IT, accounting, legal), of overlapping responsibilities and tasks performed by internal audit function indicating that

> *"Management often perceives that possible internal audit involvement at the early stages could be time consuming for the finalization of the deal", (IA Manager, Greece).*

Apart from these general views about the possible reasons of this low and partial level of involvement during the pre – acquisition stages, interviewees provided also very useful feedback and illustrated the picture of their internal audit departments, as well as their views about the reasons related to internal audit function from their rich experience and background.

One main aspect illustrated (especially from the interviews in Italy and Greece) is the possible weaknesses at the entity level, control environment and corporate governance practices at their organizations. It was also pointed out that internal audit function is not yet quite mature at these organizations in order to participate effectively in specialised projects such as M&A. Also, and as a result of these weaknesses at the control environment, audit committees do not effectively contribute to the M&A process and thus cannot assign necessary resources for a more active participation.

It was also quoted that

> *"Resources of the internal audit department are too limited at the present situation in order to accept any role right now in a possible M&A project", (IA Manager, Greece).*

This view correlates with the issue of poor corporate governance and audit committee contribution to the M&A process. On the other hand there are often practical aspects of this low level of involvement at pre-acquisition stages because

> *"due diligence in some cases has to be executed by local auditors for language and regulatory frameworks reason", (IA Manager, Greece)*

and also

> *"there is no flexibility, especially in small audit shops, to the annual audit plan and scarcity of resources in the staff (such as experience and expertise in such areas)", (IA Manager, Greece).*

Question: Can you indicate important steps or best practices experienced from your professional and organisational experience?

One very important aspect of this research is to decipher current situation in terms of current best practices during an M&A project. Participating interviewees were asked to propose some of their current best practices exercised in their organisations during the stages of M&A project. A more detailed and summarised (in terms of M&A stage) analysis is provided in the final part of this chapter. On the other hand, as quoted, during strategy development stage interviewees on those organizations that had some level of involvement indicated that they

> *"Audit the process of risk assessment and management", (IA Manager, Netherlands),*

> *"Investigated whether control issues were addressed in the planning process", (IA Manager, UK)*

and finally

> *"Listed possible acquisition risks in the future control environment of the new company", (IA Manager, UK).*

During due diligence stage, internal audit practitioners stated that they developed plans in order to integrate internal audit of merging firms, conducted due diligence alongside with other functions such as accounting, finance and law and worked with external consultants. In addition, internal auditors were used in order to map and assess possible risk areas and inspect, based in their knowledge and expertise, the target's company control environment.

During the post – acquisition integration stage, interviewees noted that they had an advisory role to functions carrying out integration and

> *"Determine additional synergy (such as cost savings, group purchase power), if allowed full access to the target's information", (IA Manager, UK).*

Finally, during the final stage of post – acquisition audit, internal auditors audited integration process to identify control weaknesses, reported findings to business units, audit committee and Board, investigated whether the specific goals of the acquisition have been achieved and prepared "Lessons Learned" document about integration process.

In summary, feedback and knowledge gained during semi – structured interviews with internal audit practitioners helped the researcher to confirm and support our preliminary results derived from the returned postal questionnaires. As indicated, the general trend evidenced is that current situation seems contradictory. The researcher believes that in mature internal audit departments (in countries like Netherlands or United Kingdom) current situation does not seem so negative concerning the issue of pre – acquisition level of internal audit involvement. In these cases internal audit department had an active role and helped their organizations on the buyer's procedures, reporting systems and control environment.

On contrary in other cases, in less developed and less matured internal audit departments, the pre – acquisition role was very limited and often internal audit managers were reluctant about a possible more active involvement is stages such as strategy development or due diligence. This reluctance was partly due to the management decision to not include internal audit department in pro – active stages. In general, the semi – structured interviews carried out by the researcher confirmed our preliminary results and gave as a "rich" picture of internal audit departments in leading edge organizations that pursued M&A projects in the European Union area.

The main point at this stage is the "confusion" of some internal audit practitioners about their different roles in an organisation. It is evidenced from this research that internal audit departments are not yet and often are reluctant to participate in pro-active stages of M&A, encounter also the reluctance of top management to accept their new consulting and advisory roles. The researcher believes that internal auditors are not quite confident about the possible positive contribution during the stages of M&A and also tend to act as assurance activity and after the event, in order to discharge any responsibilities in the case of negative results.

6.3 Internal auditor's preferred roles during the different stages of M&A – Preferred Model

Another important objective of this research was to identify the views of respondents in the internal audit area about their preferred role during the stages of an M&A project. Descriptive data analysis revealed that the majority (almost 80%) of the respondents prefer to act as risk-based auditors or internal consultants and prefer also to have little or moderate involvement at pre-acquisition stages (such as strategy development, deal structure and due diligence).

Having also in mind this preliminary data analysis the researcher set as aim of the semi – structured interviews conducted, the participants' (internal audit managers and practitioners) views and opinions about their preferred role during M&A projects in their organizations. Their views took also into consideration these preliminary results obtained from the returned postal questionnaires setting also the base for the formulation of the preferred model. This model represents a crucial part of this research because it sets the objectives and the direction of internal audit departments for a possible more active involvement in the various stages of M&A projects.

Question: Apart from your current level of involvement, can you suggest a preferred role(s) for your internal audit department during the stages (especially pro-actives) of an M&A project?

Concerning the issue of their preferred role, participants were asked about their potential roles in a case of a future M&A project, taken also into consideration results derived from the preliminary survey. All the participants during the interviews indicated that internal audit role during M&A projects can be more proactive but, on the other hand, some interviewees were reluctant about a possible participation of their internal audit departments in M&A projects during pre – acquisition stages. They quoted that this view is due partly on the perception that

> *"Strategy and internal audit are opposite and that major strategic moves (such as M&A) are setting by management whereas internal audit involvement could be time consuming and out of the audit scope", (IA Manager, Greece)*

and also

> *"Internal audit departments are risk averse for possible responsibility in the case of a failure" (IA Manager, Greece).*

It is interesting to note that interviewees that do not prefer and are reluctant on the issue of a possible greater level of involvement during pre-acquisition stages in their organisations, tend also to act after-the-event and participated only in post-acquisition stages in past M&A projects. Although all the interviewees preferred to act as 'risk based auditors' or 'internal consultants' apart from their traditional role of internal control expert and 'after the fact' investigators, it was also quoted that

> *"Internal auditors are often confused about management's expectations on M&A projects", (IA Manager, Italy),*

and also

> *"A possible consulting role could jeopardize their traditional role thus not contribute effectively to the audit objectives and audit plan", (IA Manager, Greece).*

On the other hand, and in the cases of interviewees willing and prefer to have greater involvement (in United Kingdom and Netherlands) at pre-acquisition stages in their organisations, it was indicated that

> *"Internal auditors can possibly add value to the M&A process because of their wide knowledge and understanding of the potential buyer's organization, procedures, reporting systems and internal controls", (IA Manager, Netherlands).*

The main areas where internal auditors ascertained their level of expertise and prefer to focus are due diligence, risk assessment and control environment assessments. They prefer also

> *"To determine additional synergy (e.g. cost savings, group purchase power), if allowed full access to the target information", (IA Manager, UK).*

Question: Do you believe that internal audit departments and practitioners possess the necessary skills in order to participate effectively during M&A projects?

Another important aspect of the interviews was practitioner's views about their internal audit departments and the ability of their staff in a possible future active involvement in M&A projects. It was not surprising that all the interviewees were quite confident that their internal audit departments are in position and also their internal auditors has the necessary skills and level of professionalism in order to participate actively and effectively on pre – active roles. On the other hand, some practitioners pointed out some concerns on the issue of

"Possible difficulties in order to gain access and useful information from the target companies", (IA Manager, Greece)

and also

"Staff availability and resources needed in order to raise the level of expertise needed in order to effectively contribute to the M&A process", (IA Manager, Greece).

<u>Question: In the case of a future active participation of your department in an M&A project; can you indicate also your preferred best practices or actions followed?</u>

Interviewees were also asked about their preferred actions in the case of a future participation of their internal audit departments in M&A projects. As indicated they

"Prefer to assess and report on the control environment and the entity – level controls of the target company in order to gain understanding and have the 'full picture' of the possible acquired company", (IA Manager, Greece),

and also

"raise and elevate the risks in the potential acquired company", (IA Manager, Greece).

On the other hand, despite their willingness to participate in M&A projects, they have to overcome budget and resources problems and negative perception from management of the target company.

Despite the fact that a number of interviewees noted that they prefer to have a low level of involvement during strategy development stage, on the other hand and in the case of a possible decision by top management for a more active participation,

"They prefer to concentrate in the areas of risk assessment of the potential acquired company", (IA Manager, Greece)

and also

"Raise the level of familiarity of the target company and have the full picture when the deal will be finalized", (IA Manager, Greece).

This increased level of familiarity will also

"Facilitate post-acquisition audit and planning because of the preliminary information gathered before the deal" (IA Manager, Italy).

Also, and during due diligence stage, it was quoted that a main objective can be

"An understanding of the risk areas of the future company and thus concentrate on high risk cycles and gain uniformity on the procedures, processes and information systems integration of the new company", (IA Manager, Greece).

This level of involvement can proved cost effective for the bidder company at the integration stage of the deal.

In summary we can conclude that a general census about the role of the modern internal auditors (supported by practitioners and academics) indicates the emphasis of internal audit departments in consulting and advisory activities apart from their traditional role. This has brought concerns about the ability of internal auditors to function in an independent and objective manner and also participate in specialized projects such as mergers, acquisitions and strategic alliances.

Internal audit practitioners participated in this research (at the postal survey and the interviews) quoted that they possess the necessary skills in order to effectively participate in M&A projects. Their responses illustrated also that they prefer to have a level (low or moderate) of involvement in pro – active stages and thus perform activities such as advising and consult on systems and processes, assess risk areas, gain useful information on the target's control environment or conduct initial due diligence.

The researcher believes, based also on the descriptive and empirical data analysis, that internal auditors have the motivation to participate on M&A projects and upgrade their role in the organisation. On the other hand, they have to overcome various and very important problems such as limited budget and resources, negative perception from management about their new role and limited allocation of audit resources from audit committee.

Also, and apart from their indicated preferred roles, the majority of interviewees pointed out that management often perceive internal auditors just as fact checkers and not as a source of important new information whereas prefer that their departments can effectively contribute and have a full picture during an M&A project, because of their deep knowledge and experience on processes and thus support senior management as key advisers through the whole process.

On the modern unstable and risky business environment of an M&A process and also the great number of failures on the achievement of predefined objectives, the implementation of a comprehensive proactive and integration process could be valuable for the bidder company. Thus, internal audit function can upgrade its role and has the potential to participate to the various stages of an M&A project and thus contribute on the achievement of predefined objectives and possibly add value to the deal.

6.4 Gap identification and analysis

Descriptive data analysis and further exploration on specific parts of the postal questionnaire revealed interesting points for the current and preferred situation, concerning the issue of internal audit involvement during M&A projects in the sampling organisations. On the other hand, extensive literature review revealed interesting issues on mergers and acquisitions in general and, more specific, on the state of the internal audit maturity across countries and the level of involvement in M&A projects.

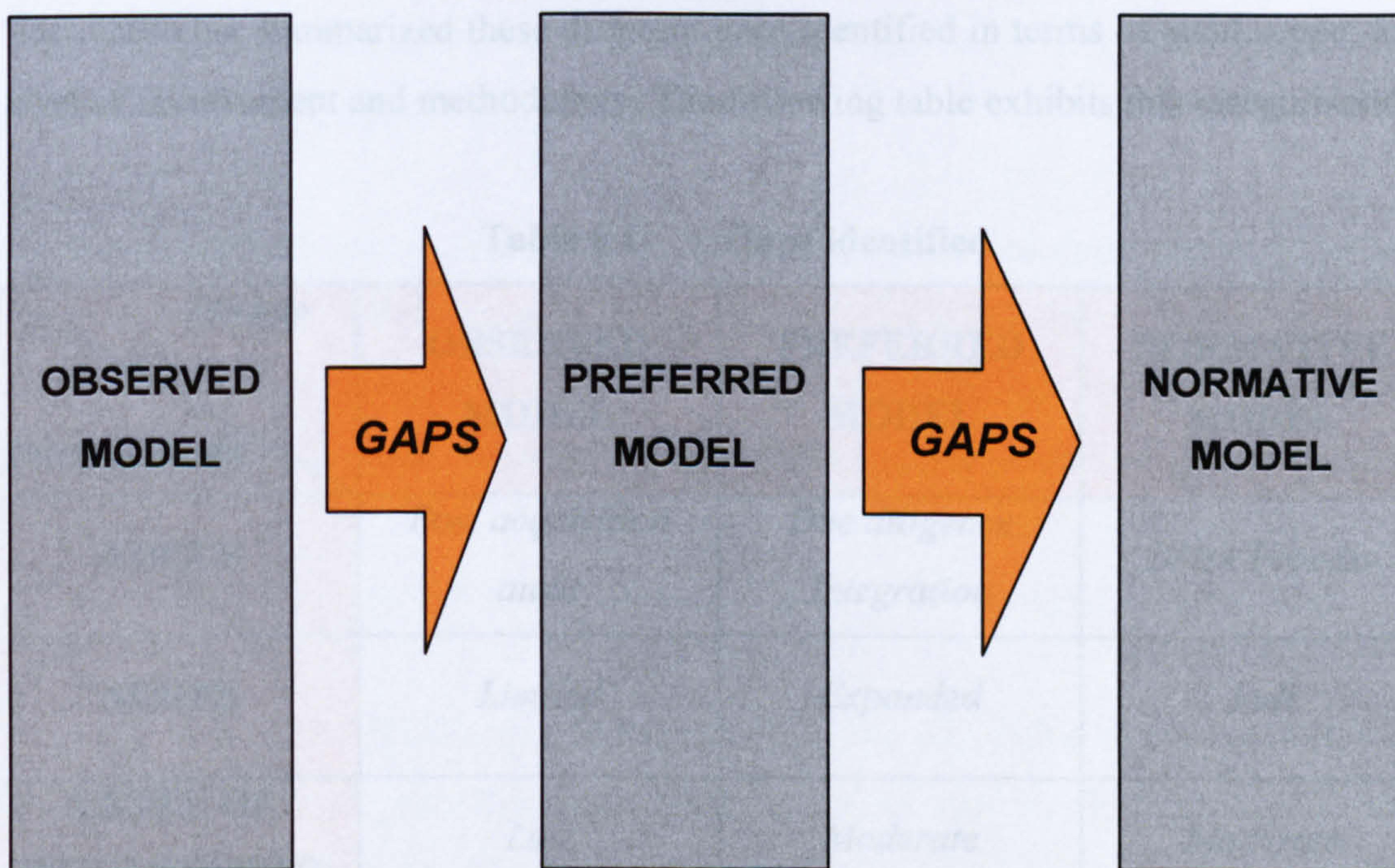
According to the normative model (derived from the extensive literature review), internal audit profession has evolved from its focus on detail testing of internal controls and checking boxes on internal control questionnaires, to a more proactive and consultancy role. Over the last few years, the importance to strong corporate governance of managing risk has been increasingly acknowledged. Organisations are under pressure to identify all the business risks they face; social, ethical and environmental as well as financial and operational, and to explain how they manage them to an acceptable level. Meanwhile, the use of enterprise-wide risk management frameworks has expanded as organisations recognise their advantages over less coordinated approaches to risk management. Internal audit, in both its assurance and its consulting roles, is in position to contribute in the risk management process.

The trend, derived also from the literature, is that internal audit function can work effectively at the pre–acquisition stages analyzing and auditing target company's operations and processes (in order to assess the level of adequacy of internal control systems), map key risks and controls and prepare a remediation plan in order to consult and help target company comply with the overall environment of potential parent company. According to this new role presented in the literature, management has the primary responsibility to assess risk and design, implement and maintain, on an ongoing basis, important control points within an organization and provide assurance to the audit committee and senior management as to the state of risk and the system of internal controls.

Finally, according to the general overview of the published best practices and directions, we can indicate a trend for internal audit departments to proceed to a more active role and participation to the M&A process and to evolve from a traditional approach and methodology to a more detailed and 'before the fact' approach. We can also note the need for a more effective internal audit contribution to post – acquisition stages and active participation to the integration stage.

When comparing the three different models (normative, observed and preferred), the researcher identified a number of possible gaps in terms of level of involvement, focus, scope or methodology (see Figure 6.2).

Figure 6.2 Gap identification and analysis



As evidenced from descriptive data analysis, a great number of respondents (*70, 6%*) believe that internal audit has a role to play during the M&A process and also that their preferred role should be more proactive than post – mortem. On the other hand, although respondents 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

(*35%* act as 'box checkers' and 'internal control experts') although almost all (*90%*) prefer to act as internal consultants and risk based auditors.

Data analysis revealed also a low level of internal audit contribution and involvement in these organizations during pre-acquisition stages (such as strategy development and due diligence). On the other hand, their responses revealed that they prefer to participate earlier and during pre – acquisition stages rather than just act as fact checkers and conduct post – acquisition audits after the M&A process. Also, a great number of respondents perceive that a possible internal audit contribution can add value to the M&A process but on the other hand an important number are uncertain or disagree about the positive contribution and the value added to the organization in the case of a possible future expansion of internal audit function into a proactive process.

The researcher summarized these different gaps identified in terms of audit scope, focus, level of involvement and methodology. The following table exhibits this categorisation.

Table 6.1: Gaps identified

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*

An important objective of this research is, apart from the gap identification, the reasoning behind these differences. These gaps were summarised and sent to the interviewees prior to the conduction of the semi–structured interviews in order to provide us with a great level of feedback and support these reasons. In order also to group and address these gaps more effectively, we divided them into two main categories such as management related and internal audit related.

6.4.1 Management related reasons for the identified gaps

The first issue set at the discussion with the interviewees was the responsibility of management as a reason for these gaps. It was indicated that the use of internal auditors during a pre – acquisition stage is often prevented by the owners of the target company

> *"Because they don't want to present control weaknesses and thus reduce the price of the deal", (IA Manager, Netherlands).*

Another important aspect illustrated at the interviews is that management often prefer outside consultants rather than in house internal audit function. The reason lies on managements' perception that outsourcing can contribute a greater level of necessary skills and needed expertise in order to successfully overcome internal audit issues and as quoted

> *"Outsourcing means shifted responsibilities", (IA Manager, Netherlands).*

This was also clear from the descriptive data analysis illustrating that a great number of deals were processed with the direct involvement of third parties such as investment banks, audit firms or both. This synergy can lead also to a full package of financial and audit services and thus decline the overall cost of the deal.

It was also indicated that a possible internal audit involvement, especially at the pre – acquisition stages, could be "time consuming". This means that often management wants to close and finalise the deal as early as possible in order to prevent possible takeover

defence measures from competitors. Also, the decision behind a possible merger deal is based on the strategic needs of the company and takes into consideration possible positive synergies for the bidder company. Thus, top management perceives that a possible internal audit involvement can delay M&A process.

Another related issue was the tight time framework of the deals. As quoted

> *"Because of the nature of M&A process there is always, especially at the early stages, the possibility of a failure and negative outcome of preliminary discussions. Tight time frames prevent management to include internal auditors in the process and postpone their participation after the deal is done", (IA Manager, Greece).*

Also, management of the target company prevents the likelihood of internal audit access because

> *"Target companies prevent to disclose confidential information to the possible buyer", (IA Manager, Italy).*

This means that management of the potential target company prevent the disclosure of potential control weaknesses identified during the pre – acquisition contacts and thus deduct the overall deal value.

The researcher believes (based also on the descriptive and empirical data analysis) that management is one pole of explanation of this low level of involvement during pre-acquisition stages. This perception is due partly to the image of traditional internal auditor used only to assure internal controls in an organisation. Although internal audit activity has as a primary objective this level of assurance, management is not yet convinced about the possible value added outcomes of an integrated internal audit approach during the whole M&A process.

As evidenced also from the interviews, top management (especially in organizations with poor control environment) seem to be reluctant and prefer to outsource necessary skills (such as due diligence). A few exceptions cannot change overall perception and it is internal audit function that needs to convince top management that possesses necessary skill and knowledge in order to participate effectively in M&A projects.

6.4.2 Internal audit related reasons for the identified gaps

Apart from management related reasons for the gaps identified, interviewees provided us with great level of feedback for reasons based solely on internal audit function. Interviewees were asked to comment on the responsibility of internal auditors for this low level of involvement as well as for not integrating to consulting activities. One important reason indicated from the interviewed practitioners is that

> *"Specific tools (such as control self assessment, risk identification and assessment, specialised audit software) are recently introduced in the internal audit profession and are not yet used and contribute during specialized projects such as M&A", (IA Manager, Italy).*

This means that existing internal auditor's toolkit cannot yet effectively contribute and support internal audit effort during M&A projects

Also, management of internal audit departments often doesn't take the initiative to change management's perception about the role of internal auditors and the possible positive contribution in M&A projects. It was indicated that this reluctance is due on the

> *"Attitude of internal auditors to not have any responsibility for a possible failure or delay during the deal", (IA Manager, Greece).*

In addition,

> *"Internal audit departments don't have, especially in the case of cross border acquisitions, the necessary knowledge of local regulatory frameworks, economical and political environment of the target company", (IA Manager, Greece).*

This situation deteriorates also current situation of limited budget and resources (especially in small audit shops), thus

> *"It is very expensive to develop the skills needed in order to overcome effectively and efficiently in an M&A project and maintain a stable and experienced M&A in order to participate in this type of specialised projects", (IA Manager, Greece).*

In combination with previous analysis, it was indicated that in order to participate and contribute effectively to M&A projects

> *"Internal audit departments need to deviate from the yearly audit plan", (IA Manager, Greece).*

This type of decision needs the total support of audit committee and supposes careful planning but often

> *"Management and audit committees perceives that there is no need of internal audit participation during the early stages of M&A, thus there are reluctant to verify a deviation or a modification of the annual audit plan", (IA Manager, Greece)*

Apart also from these two categories of reasons, interviewees provided some general points in order to evidence the gaps identified in the previous analysis. First of all, it was indicated that

"Target companies are very reluctant to disclose confidential information to the possible buyer, often being a competitor and prefer outsourcing to audit consultants, which they sign confidentiality agreement", (IA Manager, Netherlands),

and thus

"Report to the buyer in a controlled and confidential manner", (IA Manager, Netherlands).

Also, in the cases of failure of a deal, target company doesn't want to disclose confidential and sensitive information to the buyer

The issue of independence and objectivity is also very important and this is due to the

"buyer's shareholders and management need for 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 his reporting line", (IA Manager, UK).

Specialised knowledge was quoted also as very important reason because

"Some tasks, especially in cross – border acquisitions, have to be executed from local internal auditors (often outsourced) for cultural and effective communication reasons", (IA Manager, Greece)

and

"Administrative functions and legal departments are usually involved instead of internal audit", (IA Manager, Italy)

often perceived as overlapping activity.

In general, and during the interviews, internal audit practitioners agreed that the image of internal auditors as mindless box – tickers checking compliance with centrally imposed procedures, processes and systems is out of date. On the other hand they indicated, from their perception and professional experience, that internal auditors have not all become risk management professionals whose role is to identify, assesses and mitigate business risks.

They had also noticed that in some organizations, internal audit departments were more willing to proceed and organize workshops or seminars in which risks were identified and assessed and also used specialized audit software in order to prioritize risks. On the other hand, other internal audit departments prefer to act with more 'traditional' roles such as post and after – the – fact activities such as full scope audits.

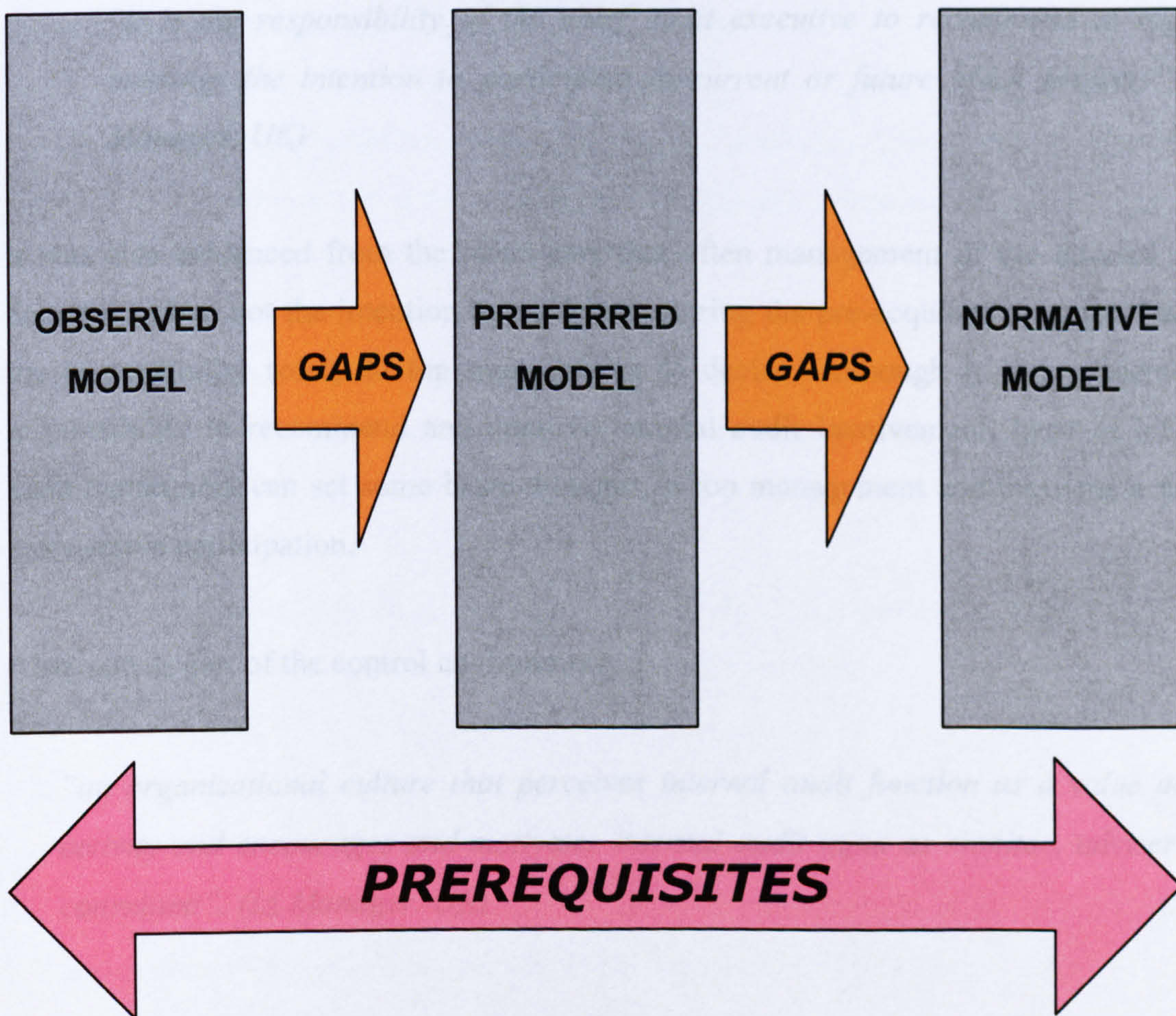
A general view derived from the interviews is that most of the responses and attitude of the practitioners were not surprising and indicated the confusion that internal auditors often perceive about their current role in the organisation, indicated also at the preliminary results derived from the returned postal questionnaire at the previous stage of this research.

It was also revealed that the great majority of internal auditors prefer to move forward and participate to proactive activities in the case of M&A projects but they are often reluctant because of the embedded perception of the management in their organizations. This explains also the current low level of internal audit involvement in pro-active activities, such as strategy development and due diligence stage, and is based on the management's perception of a possible internal audit involvement during pre-acquisition stages.

6.5 Suggested list of possible prerequisites

Apart from the gap identification and analysis, the researcher set as primary objective the identification and analysis of possible prerequisites that can bridge effectively the gaps between the three different models (see *Figure 6.3*). During the interviews, the researcher tried to explore further and set a number of questions concerning the future of internal audit profession, as well as the possible prerequisites that can help bridge the gaps and used as pillars for a possible expansion of internal audit function into consulting or pro-active stages. Their views were based on their personal perception and experience in the internal audit area as well as a deep knowledge of the economic environment in their organisations.

Figure 6.3 Possible prerequisites



Question: From you professional experience can you provide us your view on possible prerequisites in order to bridge effectively the gaps identified through descriptive data analysis?

Their responses and views were categorized in order to present more effectively the areas that possibly need further improvement in order to bridge the gaps identified.

- ***Intention from management of the internal audit department to participate in M&A projects and organizational culture***

One of the major prerequisites indicated during the interviews is the intention of the head of internal audit department to participate and contribute effectively in specialized audit projects such as mergers and acquisitions or strategic alliances. As quoted:

> *"it is the responsibility of the chief audit executive to recommend at regular meetings the intention to participate in current or future M&A projects", (IA Manager, UK)*

It was also evidenced from the interviews that often management of the internal audit department had not the intention to participate during the pre-acquisition stages, leaving the responsibility solely to top management to decide. Although it is management's responsibility to recommend and approve internal audit involvement, head of internal audit department can set some basic thoughts to top management and motivate a future more active participation.

Also, and as part of the control environment,

> *"an organizational culture that perceives internal audit function as a value added activity and encourages and motivates internal audit input as monitor, adviser and consultant", (IA Manager, UK)*

can support a possible expansion of internal audit engagement in earlier stages during an M&A project.

- ***Active participation of chief audit executive or manager of the internal audit department in the Audit Committee***

Another important factor indicated during the interviews is the possible active participation of chief audit executive or the head of the internal audit department in the Audit Committee. This participation can prove quite helpful and constitutive

> *"in order to convince top management for the possible value added from the participation of the internal audit departments in M&A projects", (IA Manager, UK).*

An effective Audit Committee

"is the cornerstone of good corporate governance" and also "has the responsibility and credibility to convince top management for the possible participation of internal audit team in the M&A process", (IA Manager, UK).

Head of internal audit department can "motivate" members of the Audit Committee to concentrate in areas of focus such as scope of audit work, risk management, control issues and non-recurring transactions such as M&A and also

> *"Can work closely with the chairman of the Audit Committee in order to identify potential risks of the parent company", (IA Manager, UK).*

Also, the chairman of the Audit Committee

> *"Must have a high level of credibility in the organization in order to convince top management for a possible future active involvement", (IA Manager, UK).*

- ***Increased level of independence, objectivity and professional proficiency***

In order to overcome possible issues of impaired independence and objectivity (set also as a reason for the reluctance of management to assign pro-active activities during M&A projects) and for the reinforcement of independence of internal audit department internal auditors and chief audit executives must report directly to the Board and the Audit Committee. Concerning the issue of objectivity, interviewees indicated that

> *"Internal auditors must remain objective in their performance of consulting activities and must make a balanced assessment of all the relevant circumstances", (IA Manager, Italy).*

They must also not be influenced by their own interests or by others in forming their judgments and thus reflect an unbiased assessment of the situation. This desired level of independence and professionalism will not result in a perceived or actual loss of objectivity and thus internal auditors can assist in order to effectively play the role of both monitor and advisor and remain objective.

An important prerequisite, linked also with the issues of objectivity and independence is the level of internal audit professionalism. Practitioners indicated that

> *"internal auditors must possess the necessary knowledge and skills in order to monitor, audit and consult on the target company's systems, processes and procedures", (IA Manager, UK).*

Top management must also be convinced that the internal audit department has the necessary expertise, in order to effectively assess control environment and activities of the target company and thus facilitate opinion at the pre – acquisition stage and have a general overview if the deal is done.

- ***Evidence and cases of effective contribution of internal audit function in M&A projects***

A good level of documentation of positive outcomes in cases of active internal audit involvement during pre-acquisition stages can be used as competent evidence. As quoted

> *"presentation of case studies or evidence of mistakes and failures in M&A projects due to the low level of involvement of internal audit departments, with parallel underlining of possible value added in cases of a more expanded role, can prove quite helpful for the reversal of top management perception about the possible future role and contribution of internal audit department in the M&A process", (IA Manager, Netherlands).*

- ***Rotation of internal audit staff***

An important factor, indicated also earlier from the interviewees, is the quality of human resources in the internal audit department in order to overcome effectively a possible involvement during the M&A stages. As indicated

> *"A good selection of human resources for the staffing of an experienced audit team can help to participate more effectively to the M&A process as well as a stable audit team with specialized knowledge and background (e.g. finance, accounting, local and international regulatory frameworks) can form the basis for an effective participation and contribution to M&A projects", (IA Manager, Greece).*

Rotation of staff between internal audit and administrative functions can prove also very helpful and constructive in order to gain experience of the various processes and procedures in the company.

- ***Use of specialized audit toolkits*** – Some interviewees indicated also the use of specialized audit toolkits or the update of existing ones in order to support effectively and efficiently internal audit work.

As mentioned

> *"The introduction of specific audit toolkits and software, properly parameterized for M&A projects could be very helpful for the support of internal audit team assigned with specialized M&A projects" (IA Manager, Italy).*

This toolkit can comprise, for example, 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 audit department.

- ***Level of responsibility of internal audit opinion in M&A projects***

Responsibility of internal audit opinion remains a key issue because, as indicated

> *"Outsourcing due diligence means also shifted responsibilities", (IA Manager, Netherlands).*

Head of internal audit function can have the opportunity to expand internal audit involvement in M&A projects

> *"If it can underline the level of responsibility of internal audit opinion in the case of negative or positive outcome in M&A projects", (IA Manager, Netherlands).*

This means that internal audit function can be perceived and used as an advisor during M&A projects if the head of internal audit accepts a level of responsibility on the opinion or suggestions of internal audit function to top management. In this case, management would prefer to use internal auditors' opinion rather than outsource during the stages of an M&A project.

- *Annual audit coverage plan*

A possible adjustment in the annual audit plan was mentioned as an important success factor in the case of internal audit contribution. Because of the nature of internal audit function

> *"There is always a bulk of audit projects, assignments and needs, thus chairman of the Audit Committee alongside with the head of internal audit function need to establish priorities and obtain the audit committee's formal approval of the adjusted audit plan", (IA Manager, Greece).*

This adjustment can be part of the risk assessment stage and would help to establish an internal audit team and assign responsibilities and tasks without interrupting normal audit activities approved in the audit plan.

- *Risk assessment*

As indicated, internal auditors together with the top management of the bidder and target company need to identify functional and risk areas, prioritize risks and create the risk profile of the target company. In order to effectively participate in this assessment, head of internal audit need to review preliminary information and data from the target company. Also

> *"An experienced head of internal audit function has the needed expertise to understand business environment as well as consult on the risk assessment stage", (IA Manager, Italy)*

resulting in pro-active participation and integration of internal audit function to more pro-actively tasks, apart from the traditional role to assure the system of internal controls.

- *Reporting findings on key risks and recommendations against the risk profile*

Last but not least, an identification of the key controls and findings of the preliminary audit as well as subsequent recommendations and list of the potential acquisition risks can form the basis for the post-acquisition audit of the new formed business, helping also expand the level of internal audit participation in future M&A projects.

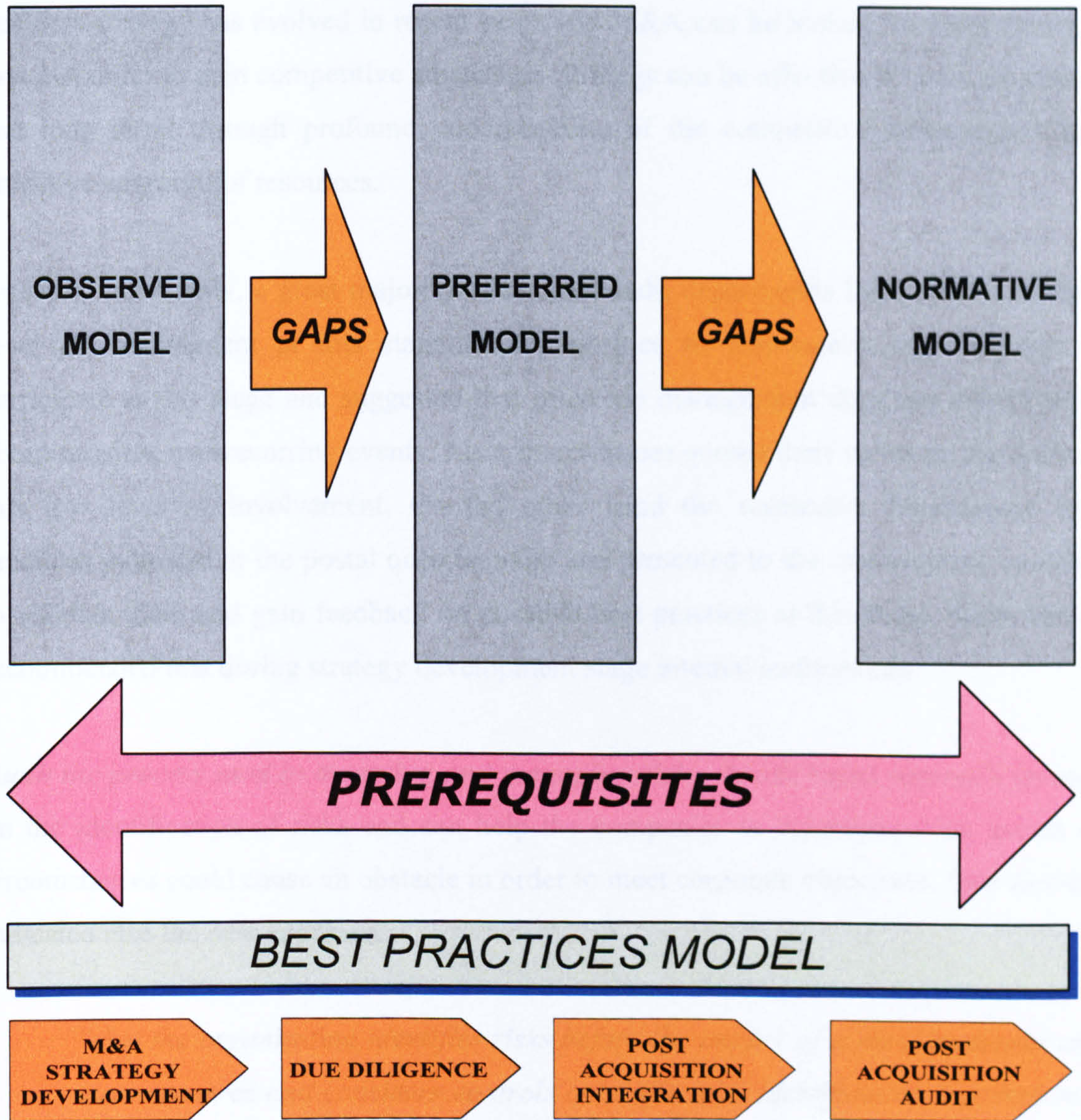
6.6 Best Practices Model for effective internal audit involvement during the various stages of M&A activities

The last objective of this research is to formulate a best practices model in order to effectively support a possibly internal audit involvement during the stages of an M&A project. At first, the researcher included a section in the postal questionnaire, contained best practices derived from the literature review. Participants were asked to choose if they had applied or prefer to apply these practices. Data analysis (provided in more detail at the previous chapter) revealed their preferences. The researcher used these findings during the semi-structured interviews in order to support and validate these data, and also gain feedback in more detail for the possible actions undertaken in these steps.

Question: Can you indicate, from your experience in your organizations, actions or best practices experienced (or prefer to experience in the future) from your company during the stages of an M&A projects (e.g. strategy development, due diligence, post-acquisition integration, post-acquisition audit)?

Best practices model (as shown at *Figure 6.4*) constitutes the final outcome of the previous analysis, concerning the identification of the three models as well as gap analysis and potential prerequisites in order to bridge them effectively.

Figure 6.4 Best Practices Model



6.6.1 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 and M&A can be looked as major strategic move 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 audit departments have no or very low level of involvement at this stage. The majorities of respondents are reluctant to participate at this stage and suggested that often top management does not inform them about possible non-recurring events. Also, interviewees quoted their views on the issue of this low level of involvement. On the other hand the researcher summarized best practices indicated at the postal questionnaire and presented to the interviewees, in order to validate them and gain feedback on possible best practices at this stage. Interviewees recommended that during strategy development stage internal auditors can:

Audit the process used in assessing and managing risk – A risk based approach focuses on the identification of risks and can help the companies to determine what events or circumstances could cause an obstacle in order to meet corporate objectives. Interviewees indicated also the new approach

> *"that the organization identifies risks before the impact of control measures and also measures and considers controls only after risk identification is complete", (IA Manager, UK).*

As also indicated, internal audit can play a greater role as a

> *"facilitator in the event identification and as a consultant in the risk assessment stage during an M&A project", (IA Manager, Greece).*

Receive communication about deals and non-recurring events – It was indicated as of great importance the communication to the internal audit department from top management and with all necessary information about non-recurring events such as possible mergers and acquisitions.
As indicated

> *"internal audit department must be the recipient of all necessary information and feedback about current or future events and also about changes in corporate objectives or strategy", (IA Manager, Greece).*

This type of communication can help internal auditors to determine possible future risks and plan more effectively audit plan and control issues.

Investigate whether control issues were addressed in the planning process – Because of the nature of business environment, often M&A deals are accomplished in a limited time framework and top management doesn't take into consideration major control issues or deficiencies of the target company.
As quoted

> *"Internal auditors possess necessary skills in order to assess and indicate if control issues addressed during M&A strategy development stage were taken into consideration after the deal", (IA Manager, UK).*

This practice can help also at the post-acquisition integration stage in order to encounter future control issues.

Advise on systems and processes that could reduce acquisition risk – A possible merger or acquisition of a target company encounters significant changes on systems and process. It was indicated that

"Internal auditors can participate at the pre-acquisition stages in order to map systems and processes of the target company and thus can help the company to reduce or mitigate possible post-acquisition risks", (IA Manager, UK).

An effective documentation and assessment of the possible risk and control issues at a pre-acquisition stage can also reduce the cost of integration of these systems and processes at the newly formed company.

6.6.2 Due diligence stage

Due diligence is the process of identifying and confirming or not confirming the business reasons for the proposed capital transaction in an M&A. As evidenced from the literature and the returned questionnaires, internal auditors are not participated in the due diligence process and if participated their involvement began later in the process. On the other hand, internal auditors can provide senior management with vital information about the value of the company being acquired, its financial condition and any weaknesses in its financing or internal controls strengths and weaknesses. 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 on the decision process.

Very often management perceives internal auditors as fact checkers and not as a source of important new information. This trend was also indicated in our research at the descriptive data analysis of the returned postal questionnaire illustrating that the majority of internal auditors have little or moderate involvement. 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.

The researcher set all this preliminary analysis to the interviewees in order to validate and gain suggested best practices during the due diligence stage. Participated internal audit managers and practitioners asserted that internal auditors can:

Conduct due diligence alongside with other functions such as finance, accounting, human resources, law – During an M&A project several functions are involved in the process.

> *"A good communication level between several functions of bidder company can help to avoid unnecessary duplicates or additional efforts and inefficiencies", (IA Manager, Netherlands).*

Also 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", (IA Manager, Italy).*

Develop plans in order to integrate internal audit of merging firms and review the internal audit function in Target Company – a major problem often noted during an M&A project is the duplication of functions and departments after the event occurs. Practitioners agreed also that it can be useful and time effective to develop preliminary planning for the audit of the new merged firm.

This practice can be effective if

> *"There is a high level of integration of the internal audit function after the event", (IA Manager, Greece).*

This high level of integration can be reality

> *"Through preliminary review of the target's company processes, organizational status and entity level controls as well as a good level of communication between the internal auditors of the target and bidder company", (IA Manager, UK).*

Also another major issue after the merger process is the integration between the new departments of the merged firm. This issue can prove time consuming and can lead to corporate failure because of the low level of integration between the various departments of the new firm. Internal audit function of the bidder company can communicate benchmark and assess internal audit department of the target company, leading to a gap analysis between the two functions and careful plan the new function in order to effectively integrate and function after the event.

Ensure due diligence covers financial, operational and compliance issues – Internal audit function can be used as "reviewer" in order to ensure that due diligence has covered all the key and major issues concerning financial, operational and compliance areas.

This objective can be achieved more effectively

> *"Through detailed review and assessment of the documentation carried out by other functions of the firm", (IA Manager, Greece),*

> *"Communication between participating functions", (IA Manager, UK)*

and

> *"Effective level of communication between various functions and top management", (IA Manager, Greece).*

Ensure that weaknesses identified in due diligence are considered in finalizing the deal – Internal auditors can assess and follow – up on the major issues identified during the due diligence stage. At this point it was indicated that

> *"Internal auditors can assess the level of compliance with the deficiencies identified and report on the issues that were not considered and can be proved risky for the success of the M&A project", (IA Manager, Greece).*

Work with external consultants carrying out due diligence – It is a very common practice, and also evidenced from the literature review and postal survey at the previous chapter, to use a third party (such as audit and law firms) and outsource the majority of actions during due diligence stage. As quoted, 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 company" (IA Manager, Greece).*

Ensure awareness of regulatory and other compliance matters – As indicated earlier at this research, 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 area) had been the reason for large M&A failures and cost heavily in order to comply with these regulations.

As illustrated

> *"Internal auditors can help during the M&A process based on their expertise and documentation of different regulatory issues", (IA Manager, UK).*

This level of expertise derives also from the main responsibility of internal audit function compliance with laws and regulations and the responsibility of the internal audit function for the level of compliance maintenance.

Document business processes and control points of the target company – It was indicated that another important success factor during an M&A process be the audit of the business processes of the target company. Practitioners revealed the importance of this action quoted that

> *"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 post acquisition audit stage and internal audit function can rely on previous documentation and focus on testing of documented controls", (IA Manager, UK).

6.6.3 Post- acquisition integration stage

The term post – acquisition integration refers primarily to the combination of two or more companies. It is the first post – acquisition stage and a well planned and integrated M&A project can be a very positive force for the successful completion of the deal. At this very important stage the main objective is to integrate smoothly to "one firm" and accomplish the planned level of synergy. Integration stage can be very risky because it is a time of great uncertainty for human resource, especially in the target firm.

As evidenced from the descriptive data analysis, internal auditors have greater level of involvement during this stage and thus can help company to generate cost savings and possibly minimize acquirer's risk and possibility of failure. Using also data derived from semi-structured interviews we can conclude that internal auditors during this stage can:

Play advisory roles to functions carrying out integration – As quoted,

"Internal auditors can play an advisory role and work as bridge builders and coordinators between the various functions of the bidder and target firm", (IA Manager, UK).

During this stage there are various changes in the internal environment of the new firm and management or employees may often be distracted. Internal auditors can ease their fears and communicate effectively the objectives of the new firm and because of their level expertise and knowledge of the control environment can assist other functions such as finance, information systems or human resource to overcome possible obstacles during integration stage.

Prepare a checklist in order to map activities and issues determined at pre-acquisition stage – In order to review effectively post-acquisition progress during integration stage

> *"Internal audit function can formulate and prepare of a checklist of activities and issues determined at previous stages, in order to ensure that predetermined steps have been followed", (IA Manager, Greece).*

Development of such list requires a mapping and setting up of core processes and systems that needs to integrate, in order to gain synergy and lead to value added from the deal, and are determined at the due diligence and strategy development stages.

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 internal audit function is the review and assurance of effective communication channels in the company. Internal auditors can work as

> *"Facilitators and implement a communication policy in order to inform effectively personnel about the new environment", (IA Manager, Italy).*

All personnel need to receive clear messages during this turbulent period in order to smoothly integrate on the new systems and processes and internal audit function can consult and advise on the formulation of a communication policy.
Also, and for the effective flow of information in a large and newly created organization,

> *"Communication difficulties can be reported timely and supported by open channels of communication and a willingness to listen", (IA Manager, UK).*

6.6.4 Post–acquisition audit stage

The final stage of an M&A project is the post–acquisition audit. At this stage, and as evidenced from the literature review and descriptive data analysis, internal auditors have the greater level of involvement comparing to the other stages. An important and crucial part at this stage is the level of involvement of internal audit function during the previous stages. As indicated from the interviewees, a low level of involvement of internal audit function can lead to difficulties and time consuming activities in order to gain understanding of the key risks and processes of the new built organization with implication in the documentation of key controls and the development of the audit plan.

On the other hand, practitioners noted that a greater level of involvement of internal audit function can lead to "a deeper knowledge of the newly acquired company and the difficulties faced at the previous stages". This means that audit planning can be designed in detail and focus in the key areas. This pre–active involvement could be also cost and time effective. As a result of greater experience at this stage, practitioners provided a great number of practices, based also at the analysis of the postal questionnaire. Internal auditors at this stage can:

Audit integration process to identify control weaknesses – One of the main tasks of the internal audit function can be the audit of the integration process. In the case of active internal audit involvement at the integration stage, internal auditors can effectively document and identify potential control weaknesses. The main areas of focus, as quoted, can be

> *"The assessment of the entity's level control environment", (IA Manager, Greece),*

> *"Review existing policies and procedures of the target firm", (IA Manager, Greece)*

and also

> *"Review the flow of information, vertically and horizontally, as well as the effectiveness of the existing reporting and communication channels", (IA Manager, UK).*

Report findings to business units, Audit Committee, Board of Directors – It was indicated as essential and important task of the internal audit function to report findings after the finalization of the deal to business units, the Audit Committee and the Board of Directors.

As illustrated by the interviewees, the internal audit report will contain the audit scope and objectives, documentation of internal control system in the target company, main control weaknesses identified and a possible remediation plan for the compliance with the control environment of the bidder company.
It was also quoted as essential

> *"the effective communication of the report to the Audit Committee and Board of Directors in order to have a first picture of the acquired company and take all necessary measures in order to integrate and operate as "one" company", (IA Manager, UK).*

Audit and review policies, procedures and controls in merged / acquired company – In order to review various policies, procedures and controls of the target company internal audit function can use the risk based approach. This means that the audit plan will be based on a risk assessment and on 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 the 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 in order to proceed to an integration of policies, procedures and controls.

Investigate whether specific goals of the M&A project have been achieved – Another important practice indicated during the interviews is

> *"The investigation and the level of compliance with the specific goals and objectives set at the beginning of the M&A project". This task can be exercised more effectively and efficiently if internal audit function participates actively to the pre-acquisition stages and had a "clear picture of the preliminary goals and objectives of the deal", (IA Manager, Greece).*

Prepare "Lessons Learned" document about M&A process – Practitioners also noted that

> *"Many companies significantly underestimate the amount of time and resources needed resulting in constraints toward the end of the M&A project", (IA Manager, UK).*

Thus, and towards the end of the project, there is a big opportunity to reflect back and document significant "Lessons Learned" implications from the M&A project. Major or minor issues arose can be summarized and used to address obstacles during the M&A project and set a smoother course for a future M&A event.

This document can also 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 deficiencies evaluations.

Good understanding of the target company – The last, but not least, action noted by practitioners is the need for internal audit department to function effectively as a "member of the new shaped company". This means that internal auditors can evaluate and review control environment, reporting lines, information systems and the structure of

the target company in order to smoothly integrate to post – acquisition audit and create an effective audit plan.

6.7 Summary and conclusion

This chapter had as a primary objective to validate preliminary data analyzed through the descriptive analysis, gain understanding of the gaps identified through the comparison of the present, preferred and normative situation and finally provide some prerequisites in order to bridge effectively these gaps, as well as, a best practices model for an effective internal audit contribution during the various stages of an M&A project. This empirical analysis was based on semi-structured interviews conducted with internal audit managers and practitioners in the European Union area.

One of the main objectives of the research was to analyze the current role of internal auditors in M&A projects in the European Union. Previous research (*Selim et al, 2002*) has shown that even though internal auditing has expanded its role in many business processes, M&A activity does not seem to be an area where it has effective contribution apart, in some cases, from during the due diligence or post-acquisition audit stage. In this study, 70 percent of respondents stated that internal auditing has a role to play in the M&A process, adding that their role should be more proactive than post mortem. One-third of the respondents described their current role in the M&A process as "watchdog" and "internal control expert," and a small percentage viewed their role as "box checkers."

The general trend derived from the interviews is that the low level of involvement in the proactive stages of M&As seems to indicate that management just wants the deal done and believes either that internal auditing cannot contribute or it will add too much time to the pre-acquisition stages. On the other hand, this survey also included questions about the preferred role of internal auditing in M&As. Fifty-nine percent of respondents say they prefer to act as "risk-based" auditors, with 24 percent saying they would like the role of "internal consultant," indicating that many practitioners want to move forward and provide a more proactive role. This trend also is represented in their responses about their

level of involvement in pre-acquisition stages, such as strategy development or due diligence.

Chapter 7: Summary, Conclusion and Areas for Future Research

7. SUMMARY, CONCLUSION AND AREAS FOR FUTURE RESEARCH

7.1 Executive summary

Previous chapters analyzed the M&A of companies and the role of internal audit function through the various stages of an M&A project. Literature review of various journals and textbooks as well as information gleaned and presented in chapter two were used to construct the objectives of this research. Next step comprised the analysis of the research methodology used, in order to effectively analyze and satisfy the research objectives. The methodology was based on a survey through the use of a postal questionnaire, sent to chief audit executives of 120 bidder organizations that pursue mergers and acquisitions in the European Union area during the period 01/01/2000 – 31/12/2003. Returned questionnaires formed the basis of the descriptive data analysis, comprised by current and preferred situation, actions and best practices.

Descriptive data analysis revealed important issues when comparing the "as is" to "as to be" situation and a number of gaps were identified. This analysis formed the basis for the empirical data analysis. This stage comprised the validation of the descriptive data and the issues identified through semi – structured interviews with internal audit managers and practitioners, in organizations that participated in M&A projects in the European Union area. Their expertise and wide knowledge supported our preliminary results and gave us strong feedback and comfort in order to validate the reasons for low to moderate involvement in M&A projects and the gaps when comparing the three different models. We identified and collected also a number of potential prerequisites in order to increase the level of internal audit involvement in M&A projects.

Final step of this research was to validate best practices and actions indicated through the returned postal questionnaires. The contribution of interviewees during the semi-structured interviews was of great importance, and their suggestions & recommendations supported and enriched our preliminary best practices model. As indicated earlier at this research, this model is not intended to limit internal auditors but it can be used as a useful tool and benchmark in order to direct internal audit function, especially in the case of active participation in each stage of an M&A project.

7.2 Conclusion

This research tried to explore the internal audit role during the various stages of M&A projects in the European Union area. As indicated in the literature review, 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 pro–active 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.

Descriptive and empirical data analysis pointed out and indicated very clearly that internal audit function, in the majority of organizations taking part in this research, has little involvement during the pro–active stages of M&A projects. On the other hand, it is interesting to notice and explore that internal auditors prefer to participate more actively in specialized projects such as M&A and also highlighted a desire to become more associated and involved at the earlier stages in the process.

Another interesting point derived is that the majority of internal auditors took part in this research perceive that internal audit participation can **add value** to the M&A process, and also this value can be enhanced if their role is allowed to expand. Overall, participants agreed that it is management's overall responsibility and decision for the participation of internal audit function at the various stages of M&A projects. It was interesting to notice that a key prerequisite indicated is the **change of management's perception** about the role of internal auditors during M&A projects. On the other hand, interviewees agreed also that internal audit function must possess the necessary skills and knowledge in order to provide quality and value added output.

The results of this research had indicated also a number of gaps when comparing current and best practices (normative) model with the preferred roles internal auditors indicated

through the postal survey and the semi-structured interviews. This means that although articles and case studies in the literature indicate a number of best practices and positive contribution to all the stages of M&A projects, descriptive and empirical analysis in this research pointed out the reluctance and confusion internal auditors often perceive in their organizations during M&A projects. This gap analysis leaded also to the identification of a number of prerequisites in order to bridge the differences in the management and internal auditors' perception, as well as, a number of best practices and actions in a possible future internal audit engagement is this type of projects.

This research has supported also the perception that although internal audit profession has evolved from a "box-ticking" perception 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, 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 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. This research highlighted the intention of internal auditors to have a greater level of involvement in this type of projects, defining also the need for expertise audit teams especially in large audit shops.

As a defined objective of this research a best practices model was also developed, in order to provide a basis and a benchmark to future participation of internal 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 (through the interviews with internal audit managers and practitioners) of the practices mentioned in the descriptive data analysis.

On the other hand, we must note that there is no evidence in this research that mentions a surely positive outcome for the bidder company if these best practices were followed. This means that the use of these best practices must not be seen as a panacea but only a useful guide derived from the organizational and internal audit experience of the participants and the interviewees.

By providing an objective and proper assessment and 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 must 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 must 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 consulting role in the organization.

7.3 Opportunities and areas for future research

Mergers and acquisitions are an area with enormous research potential and opportunities. M&A projects involve complex interrelated mechanisms for the bidder and the target company. Literature review has shown that there is an enormous number of articles and research conducted on the issue of M&A activity, from financial and managerial perspective.

On the other hand, the role of internal auditors during the stages of an M&A project as well as in different types of projects has not yet been researched in a satisfactory level. In addition to some of the issues raised above, the researcher believes that there are opportunities for future research in internal auditing and M&A activities and these studies

can help to shed more light to the possible internal audit role in a complex activity such as M&A's.

i. **Extent research questions and sampling population in order to include the enlarged European Union area (adding ten new countries recently joined)**

As indicated in the research methodology, this study has limited its sampling population in the European Union area before the joining of ten new countries in 2004. Sampling period was set between 01/01/2006-31/12/2003, and organizations selected were picked from the 15 existing countries in the European Union area. Further research may include all 25 countries and extent also the sampling period after 2004 in order to decipher the role of internal audit function during M&A projects in the enlarged European Union area.

In addition, this enlarged sampling population can lead to a greater response rate and therefore can lead to a comparison and a statistical analysis between countries, industries, size of internal audit department and the differences between current and preferred practices as well as internal audit department profile. An analysis of eventual differences in frequencies and means can lead to statistical testing and the extraction of interesting points.

ii. **Carry out a longitudinal study and replace postal questionnaires with case studies**

In this research, a number of organizations could be selected and the researchers can observe, evaluate and assess the roles played by internal auditors in the sampling organization. The researcher can collect a large number of data during the M&A project and provide a rich and "on the job" basis, in order to effectively analyze the role of internal audit function and thus propose necessary changes in the future role. On the other hand, in this type of study, the researcher must overcome a number of risks such as restricted access to the selected organizations and possible bias.

In addition, a research including top and senior management expectation's from internal audit function, alongside with their opinion for current and preferred role during M&A projects can extract very useful points and decipher management view for the direction and scope of internal audit department.

iii. **Carry out a study for the internal audit role in other forms of M&A's, such as corporate divestments, joint ventures**

A further limitation of this study, set at the research methodology stage, was that this research was based only in mergers and acquisitions and did not include other forms of corporate restructuring such as divestments, joint ventures, and spin-off. Further research can include the internal audit role in this type of projects and define sampling population (European Union, Asia etc.) as well as sampling period. The possible research methodology can include both quantitative (through the use of postal questionnaires) and qualitative methods (interviews, case studies).

In addition there are also a number of key research questions which a future study could usefully investigate:

✓ **The relationship between active internal audit involvement during M&A projects and firm performance**

Further research may include an investigation as to whether an active internal audit involvement during the various stages of an M&A project can add value to the business and contribute to the success of the project.

✓ **The relationship between active internal audit involvement at pre-acquisition stages and country of origin**

Further research may include an analysis of the correlation between country of origin and active internal audit involvement during the pro-active stages of an M&A project such as strategy development and due diligence.

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APPENDICES

APPENDIX A: Table of sampling organizations

List of sampling organizations in the European Union (01/01/2000 – 31/12/2003)				
No	**Target**	**Bidder**	**Effective date**	**Value (U.S. $ m.)**
1	Mannesman (GM)	Vodafone AirTouch (UK)	19/06/00	202,785.13
2	SmithKline Beecham (UK)	Glaxo Wellcome (UK)	17/01/00	77,255.21
3	Elf Aquitaine (FR)	Total Fina (FR)	27/03/00	55,339.80
4	National Westminster Bank (UK)	Royal Bank of Scotland (UK)	13/03/00	38,524.65
5	Seat Pagine Gialle (IT)	Tin.it (IT)	16/11/00	18,694.27
6	Norwich Union (UK)	CGU (UK)	30/05/00	11,858.33
7	Scottish Widows Fund & Life Assurance Society (UK)	Lloyds TSB Group (UK)	03/03/00	11,119.50
8	Credit Commercial de France (FR)	HSBC Holdings (UK)	01/04/00	11,100
9	Istituto Nazionale delle Assicurazioni (IT)	Assicurazioni Generali (IT)	13/01/00	10,179.62
10	Woolwich (UK)	Barclays (UK)	25/10/00	7,962.51
11	Aerospatiale Matra (FR)	DaimlerChrysler Aerospace (GM)	10/07/00	6,748.03
12	CWC DataCo (UK)	Cable & Wireless (UK)	30/05/00	5,897.63
13	Burmah Castrol (UK)	BP Amoco (UK)	06/09/00	5,578.75
14	Debis Systemhaus (GM)	Deutche Telecom (GM)	21/09/00	5,372.95
15	World Online International (NT)	Tiscali (IT)	07/09/00	4,913.36
16	AGA (SW)	Linde (GM)	N/A	4,680.06
17	VEW (GM)	RWE (GM)	N/A	4,545.69
18	TI Group (UK)	Smiths Industries (UK)	04/12/00	4,337.48
19	Flextech (UK)	Telewest Communications (UK)	27/01/00	3,750.5
20	MobilCom (GM)	France Telecom (FR)	23/03/00	3,636.77
21	Seat Pagine Gialle (IT)	Telecom Italia (IT)	26/05/00	3,599.75
22	Sun Life and Provincial Holdings (UK)	AXA (FR)	10/07/00	3,535.15
23	Bass (UK)	Interbrew (BL)	22/08/00	3,469.09
24	Coca Cola Beverages (UK)	Hellenic Bottling (GR)	09/08/00	3,459.86
25	Hyder (UK)	WPD Holdings (UK)	26/10/00	3,402.85
26	Ratin (DN)	Rentokil Initial (UK)	01/03/00	2,971.9
27	Thomson Travel Group (UK)	Preussag (GM)	17/08/00	2,730.60
28	Racal Electronics (UK)	Thomson-CSF (FR)	11/07/00	2,685.77
29	United News (UK)	Granada Media (UK)	28/07/00	2,648.8

No	Target	Bidder	Effective date	Value (U.S. $ m.)
30	Tarmac (UK)	AngloAmerican (UK)	04/05/00	2,523.33
31	United Assurance Group (UK)	Royal London Mutual Insurance Society (UK)	05/05/00	2,462.57
32	United Biscuits (UK)	Finalrealm (FR)	18/05/00	2,355.90
33	Origin (NT)	Atos (FR)	31/10/00	2,344.67
34	Scania (SW)	Volvo (SW)	18/01/00	2,335.36
35	Club Internet (FR)	T-Online International (GM)	16/02/00	2,334.16
36	Esat Telecom Group (IR)	BT Hawthorn (UK)	10/06/00	2,268.76
37	Banco Pinto & Sotto Mayor (PO)	Banco Commercial Portugues (PO)	19/06/00	2,175.54
38	Arjo Wiggins Appleton (UK)	Worms et Cie (FR)	24/07/00	1,960,80
39	Saatchi & Saatchi (UK)	Publicis (FR)	07/09/00	1,767.81
40	Tomkins (UK)	Doughty Hanson (UK)	01/09/00	1,722.62
41	Groupe GTM (FR)	Vinci (FR)	13/07/00	1,694.70
42	Scania (SW)	VolksWagen (GM)	27/03/00	1,620.66
43	Aegon (NT)	Vereniging Aegon (NT)	22/06/00	1,592.11
44	Cia de Seguros Mundial Confianca (PO)	Banco Santander Central Hispano (SP)	01/06/00	1,555.57
45	KirchPayTV (GM)	British Sky Broadcasting Group (UK)	04/05/00	1,520.29
46	Perpetual (UK)	Amvescap (UK)	19/10/00	1,513
47	Rugby Group (UK)	RMC Group (UK)	04/02/00	1,468.18
48	SAT-1 (GM)	ProSieben Media (GM)	22/08/00	1,415.92
49	Diligentia (SW)	Skandia Life Insurance (UK)	20/03/00	1,412.89
50	Banca Regionale Europea (IT)	Banca Lombarda (IT)	25/05/00	1,410
51	Cie Benelux Paribas (BL)	BNP Paribas (FR)	06/10/00	1,397.50
52	Williams (UK)	Assa Abloy (SW)	30/08/00	1,333.29
53	British Borneo Oil & Gas (UK)	Eni (IT)	29/03/00	1,256.92
54	Stagecoach Porterbrook (UK)	Abbey National (UK)	20/04/00	1,231.23
55	Cimenteries CBR Cementbedrijven (BL)	Heidelberger Zement (GM)	01/04/00	1,221.69
56	Swallow Group (UK)	Whitbread (UK)	04/02/00	1,212.20
57	Banco di Napoli (IT)	San Paolo-IMI (IT)	07/06/00	1,207.8
58	Amvest (NT)	Rodamco Continental Europe (NT)	31/07/00	1,204.55

No	Target	Bidder	Effective date	Value (U.S. $ / m.)
59	ABB Alstom Power (FR)	Alstom (FR)	11/05/00	1,201.33
60	St James Place Capital (UK)	Halifax Group (UK)	22/03/00	1,199.25
61	Druid Group (UK)	FI Group (UK)	17/03/00	1,080.74
62	Medeva (UK)	Celltech Chiroscience (UK)	24/01/00	1,055.29
63	Dresdner Bank (GM)	Allianz (GM)	20/07/01	19,655.94
64	Granada-Compass Hospitality (UK)	Shareholders (UK)	02/02/01	17,914.68
65	Ing C Olivetti (IT)	Olimpia (IT)	05/10/01	6,124.62
66	Legrand (FR)	Schneider Electric (FR)	30/07/01	5,501.56
67	Blue Circle Industries (UK)	Lafarge (FR)	11/07/01	3,737.54
68	Banca Commerciale Italiana (IT)	Banca Intesa (IT)	01/05/01	3,144.31
69	RealDanmark (DN)	Danske Bank (DN)	28/03/01	3,079.53
70	Artesia Banking (BL)	Dexia Belgium (BL)	03/07/01	3,040.42
71	Yorkshire Power Group (UK)	Innogy Holdings (UK)	02/04/01	2,707.35
72	AMS-Missiles Systems Div (UK)	Matra BAe Dynamics (FR)	18/12/01	2,694.84
73	Le Meridien Hotels (UK)	Grand Hotels (M) Acquisition (UK)	11/07/01	2,675.96
74	Scottish Provident Institution (UK)	Abbey National (UK)	01/08/01	2,589.12
75	Montedisson (IT)	Italenergia (IT)	07/01/01	2,499.94
76	Energie Baden Wuerttemberg (GM)	EDF (FR)	07/02/01	2,480.40
77	Freeserve (UK)	Wanadoo (FR)	20/02/01	2,306.47
78	Laporte (UK)	Degussa SKW (GM)	13/03/01	2,004.66
79	Caisses Regionales (FR)	Credit Agricole (FR)	14/12/01	1,790
80	Scottish Life Assurance (UK)	Royal London Mutual Insurance (UK)	01/07/01	1,614.03
81	Media Ways (GM)	Telefonica (SP)	01/02/01	1,600
82	Innogy-Yorkshire Electric Dist (UK)	Northern Electric (UK)	21/09/01	1,425.38
83	Avesta Sheffield (SW)	Outokumpu Steel (FN)	23/02/01	1,360.24
84	France Telecom Cable Networks (FR)	Suez Lyonnaise Eaux Cable (FR)	18/05/01	N/A
85	Sidel (FR)	Tetra Laval (FR)	25/05/01	N/A
86	Marconi Medical Operations (UK)	Koninklijke Philips Electronic (NT)	19/10/01	N/A

No	Target	Bidder	Effective date	Value (U.S. $ m.)
87	Euralux (LX)	Mediobanca (IT)	13/04/01	N/A
88	CIC (FR)	Credit Mutuel (FR)	01/11/01	N/A
89	Gucci Group (NT)	Credit Lyonnais (FR)	18/12/01	N/A
90	Hepworth (UK)	Vaillant (GM)	13/03/01	N/A
91	Banca Carime (IT)	Banca Popolare Commercio e (IT)	29/06/01	N/A
92	Reemtsma Cigarettenfabrik (GM)	Imperial Tobacco Group (GM)	07/03/02	4,577.25
93	Enterprise Oil (UK)	Shell Resources (UK)	02/04/02	6,231.75
94	Lattice Group (UK)	National Grid Group (UK)	22/04/02	18,439.95
95	Castorama Dubois (FR)	Kingfisher (UK)	15/05/02	4,361.67
96	Jefferson Smurfit Group (IR)	MDP Acquisitions (IR)	17/06/02	4,389.51
97	Railtrack (UK)	Network Rail (UK)	27/06/02	11,462.32
98	Autostrade (IT)	Schemaventotto (IT)	02/11/02	8,930.92
99	Infraco SSL (UK)	Metronet (UK)	05/12/02	4,710.30
100	Credit Lyonnais (FR)	Credit Agricole (FR)	16/12/02	16,760.57
101	Intercontinental Hotels Group (UK)	Shareholders (UK)	14/04/03	5,438.55
102	Cegetel (FR)	Vivendi Universal SA (FR)	22/01/03	3,986
103	Ruhrgas AG (GM)	E ON AG (GM)	07/03/03	3,824.07
104	Iberdrola SA (SP)	Gas Natural SDG SA (SP)	10/03/03	29,736.45
105	Telecom Italia SpA (IT)	Ing C Olivetti & Co (IT)	12/03/03	28,591.86
106	Six Continents PLC (UK)	Cap Management & Investment (UK)	03/03/03	10,664.06
107	D/S 1912 (DN)	D/S Svendborg	06/05/03	9,814.59
108	Safeway PLC (UK)	William Morrison Supermarkets (UK)	09/01/03	6,509.33
109	Banco Atlantico (SP)	Banco Sabadell (SP)	22/12/03	1,859.08
110	Banca Popolare di Cremona (IT)	Banca Popolare di Lodi Scarl (IT)	17/04/03	730.63
111	Interbanka Spa (IT)	Banca Antonveneta SpA (IT)	14/03/03	384.54
112	Hellenic Industrial Development Bank (GR)	Bank of Pireaus SA (GR)	28/11/03	237.80
113	Caisses d´ Espagne (SP)	CNCE (FR)	04/07/03	3,939.92
114	Gjensidige NOR ASA (NO)	Den Norske Bank Holding ASA (NO)	04/12/03	2,725.05

No	Target	Bidder	Effective date	Value (U.S. $ m.)
115	Refresco Holding (NE)	3i Group (UK)	30/09/03	279.9
116	Banco Saragozano (SP)	Barclays Bank Plc Madrid (SP)	16/07/03	1,298.45
117	FGH Bank NV (NE)	Rabobank (NE)	24/10/03	470.23
118	Banca Primavera – PFS Business (IT)	Banca Generali SpA (IT)	30/09/03	293.90
119	T&S stores (UK)	Tesco (UK)	07/01/03	766.9
120	HP Bulmer Holdings (UK)	Scottish & Newcastle (UK)	28/07/03	529.8

Source: Thomson Financial

APPENDIX B:

Questionnaire

GENERAL INFORMATION

What is the primary industry of your organization (Please circle)?

Aerospace & Defense	Electricity	Health	Mining
Automobiles & Parts	Electronic & Electrical Equipment	Household Goods & Textiles	Oil & Gas
Banks	Engineering & Machinery	Insurance	Pharmaceuticals & Biotechnology
Beverages	Food & Drug Retailers	Investment Companies	Real Estate
Chemicals	Forestry & Paper	Leisure Entertainment & Hotels	Software & Computer Services
Construction & Building Materials	General retailers	Media & Photography	Specialty & Other Finance
Steel & Other Metals	Support Services	Telecommunications Services	Tobacco
Transport	Other Utilities	Food Producers & Processors	Life Assurance

Other (Please specify)..

2. A *Number of employees*.................... **2. B** ***Turnover***..

2. C ***Country where corporate headquarter is located*** ....

Do you have an M & A department in your company? (Please tick)

☐ **Yes** ☐ **No**

If yes, please specify how many people currently employ..

Did you use external parties for the deal? (Please tick)

☐ **Yes** ☐ **No**

If yes please specify the type (e.g. investment bank, audit firm etc.)...........................

7. **How long have you had an internal audit department in your organization? (Please tick)**

☐ Under 1 year ☐ 5 up to 10 years ☐ 15 up to 20 years

☐ 1 up to 5 years ☐ 10 up to 15 years ☐ More than 20 years

How many internal auditors does your organization currently employ? (Please tick)

☐ 0-1 auditor ☐ 6-10 auditors ☐ 16-20 auditors

☐ 2-5 auditors ☐ 11-15 auditors ☐ More than 20 auditors

☐ Outsourced function

II. CURRENT AND PREFERRED PRACTICES

9. **Internal audit has a role to play in the M&A process (Please circle).**

Strongly Agree	Agree	Uncertain	Disagree	Strongly Disagree
1	2	3	4	5

10. **The preferred role of internal audit in the M&A process in your organisation should be more proactive than post-mortem (Please circle).**

Strongly Agree	Agree	Uncertain	Disagree	Strongly Disagree
1	2	3	4	5

What are the current and preferred roles that internal audit is or should play during the M&A in your organization? (Please tick one of the following)

ROLES	Current role	Preferred role
Box checker		
Watchdog and Internal Control Expert		
Risk – Based Auditor		
Internal Consultant		
Other (Please specify)	....	....

12. **What is the present level of internal audit's involvement in M&A in your organization? (Please tick)**

M&A Stages	Major involvement	Moderate involvement	Little involvement	Not involved
M & A strategy development				
Due diligence				
Post acquisition integration				
Post acquisition audit				

13. From your point of view, what is the preferred level of internal audit's involvement in M&A? (Please tick)

M&A Stages	Major involvement	Moderate involvement	Little involvement	Not involved
M & A strategy development				
Due diligence				
Post acquisition integration				
Post acquisition audit				

14. The following table lists the type of involvement of various internal audit departments during M&A. Please tick one or more of the following, which best fit with both the current and preferred role of internal audit with M&A

14.1 M & A STRATEGY DEVELOPMENT

Nature / Extent of Involvement	Current Situation	Preferred Situation
Auditing the process used in assessing & managing risk		
Investigating whether control issues were addressed in the planning process		
Developing a planning model		
Advising on systems and processes that could reduce acquisition risk		
Examining the business strategic plans		
Receiving communication about deals from Corporate Strategy department		
Other (Please specify)	…………………………………… …………………………………… ……………………………………	…………………………………… …………………………………… ……………………………………

14..2 DUE DILIGENCE

Nature / Extent of Involvement	Current Situation	Preferred Situation
Conducting due diligence alongside with other functions such as finance, accounting, human resources, law, etc.		
Working with external consultants carrying out due diligence		
Ensuring due diligence covers financial, operational and compliance issues		
Providing advice on contracts and accounting matters		
Auditing internal audit function in target company		
Providing independent validation of the assumptions used in pricing target		
Ensuring people doing the valuation have the right qualifications		
Ensuring weaknesses identified in due diligence are considered in finalizing the deal		
Auditing the business processes of the target company		
Reviewing composition of acquisition team		
Investigating whether there is too much pressure on the team to do deals		
Providing advice on cross-border deals		
Conducting initial due diligence in assessing internal control		
Ensuring awareness of regulatory and other compliance matters		
Developing plans in order to integrate internal audit of merging firms		
Reviewing integration plans for IT systems		

Ensure the target is complying with to the acquirer's policies and procedures		
Advising on risks and implementation to ensure risks are taken into account		
Examining deal structuring		
Alerting the human resource department to key personnel retention problems		
Auditing financial reporting systems		
Other (Please specify)	....	....

14. 3 POST – ACQUISITION INTEGRATION

Nature / Extent of Involvement	Current Situation	Preferred Situation
Auditing acquired company profit performance before final closing of the contract term		
Helping with the development and implementation of a communication policy to inform acquired company's staff regarding systems, procedures, risk etc.		
Preparing a checklist of activities necessary to actualize expected value from the acquisition		
Playing an advisory role to functions carrying out integration		
Advising on the approaches to issues such as human resources in planning the transition		
Other (Please specify)	....	....

14. 4 POST – ACQUISITION AUDIT

Nature / Extent of Involvement	Current Situation	Preferred Situation
Auditing integration process to identify control weaknesses		
Reporting findings to business units , audit committee, board		
Risk based audit of policies, procedures and controls in merged / acquired company		
Assessing performance against benchmarks, e.g. balanced scorecard and action plans		
Auditing the post-acquisition appraisal system		
Investigating whether the specific goals of the acquisition have been achieved		
Developing standards and checklists for the governance of stand-alone acquired subsidiaries		
Preparing "Lessons Learned" document about integration process		
Other (Please specify)	....	....

III. VALUE ADDED ROLE

15. Based on your professional experience, do you believe that:

15. 1 Internal audit can add value in the M&A process (Please circle)

Strongly Agree	Agree	Uncertain	Disagree	Strongly Disagree
1	2	3	4	5

15. 2 Internal audit can possibly add more value in the M&A process if its role is allowed to expand (Please circle)

Strongly Agree	Agree	Uncertain	Disagree	Strongly Disagree
1	2	3	4	5

15. 3 **Evidence derived from literature review as well as discussions with practitioners suggest that, the best practices described at the following table can "add value" to the organization during the M&A process. Please circle one or more of the following practices that you perceive could add value to the M&A process.**

CURRENT BEST PRACTICES	Strongly Agree	Agree	Uncertain	Disagree	Strongly Disagree
Control self-assessment	1	2	3	4	5
Consulting	1	2	3	4	5
Risk management	1	2	3	4	5
Computer assisted audit techniques	1	2	3	4	5
Participation on teams	1	2	3	4	5
Internal control training	1	2	3	4	5
Continuous monitoring	1	2	3	4	5
Systems implementation review	1	2	3	4	5
Automated workpapers	1	2	3	4	5
Risk based audit projects	1	2	3	4	5
Become a catalyst for change	1	2	3	4	5
Make auditing more collaborative	1	2	3	4	5
Bring business staff into auditing	1	2	3	4	5
Share technology with the business units	1	2	3	4	5
Align with customers	1	2	3	4	5
Conduct preventive auditing	1	2	3	4	5
Reduce external auditors costs	1	2	3	4	5
Other (Please specify)	....				

Thank you for completing this questionnaire. Please return this questionnaire using the enclosed envelope. If you would like or be willing to be interviewed, as part of the validation of this research, or just receive summary results please complete the following forms or alternatively attach your business card.

REQUEST FOR INTERVIEW

All responses will be kept strictly confidential. In order to validate our results, we will conduct semi-structured interviews within a selected sample of organizations. If you are able to spare no more than one hour for an interview please complete the following:

Name of the person completing the questionnaire...

Position of the person completing the questionnaire..

Company name...

Company address...

Telephone number..

E-mail...

REQUEST FOR SUMMARY RESULTS

If you want to just receive a summary copy of this research please complete the following details:

Name of the person completing the questionnaire...

Position of the person completing the questionnaire..

Company name...

Company address...

Telephone number..

E-mail...

APPENDIX C:

Aide-Memoire

AIDE MEMOIRE

Introduction

According to the preliminary data analysis (and the analysis sent to you via email), we can indicate that:

- A great number of respondents (70, 6%) believe that internal audit has a role to play during the M&A process and also that their preferred role should be more proactive than post – mortem.

- Although the majority of chief audit executives 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% acts as 'box checkers' and 'internal control experts' although almost 90% prefer to act as internal consultants and risk based auditors.

- Also, their contribution to 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 pre – acquisition stages rather than audit after the fact on post acquisition audit projects.

- A great number of respondents believe that internal audit can add value to the M&A process. On the other hand there is also an important part of respondents that are uncertain or disagree about the contribution and the value added of a possible expansion of internal auditing into a proactive process. This study provided some value added practices derived from the literature review. Except some practices like participation on teams, risk management and self assessment, the majority of respondents are uncertain or have no opinion about practices like computer assisted audit techniques, reduce external audit costs, making audit more collaborative, bring business staff into auditing.

- Respondents indicated also some best practices and the level of involvement of their internal audit departments.

From your point of view:

a) *Do you believe that internal audit has a role during the M&A process?*

b) *What is the level of internal audit involvement at the various stages of an M&A projects in your organizations?*

c) *What is the reason of low to moderate level of internal audit participation on pre-acquisition stages (as evidenced also from quantitative data analysis of postal questionnaires)?*

d) *Can you indicate important steps or best practices experienced from your professional and organisational experience?*

e) *Apart from your current level of involvement, can you suggest a preferred role(s) for your internal audit department during the stages (especially pro-actives) of an M&A project?*

f) *Do you believe that internal audit departments and practitioners possess the necessary skills in order to participate effectively during M&A projects?*

g) *In the case of a future active participation of your department in an M&A project; can you indicate also your preferred best practices or actions followed?*

h) *What are the reasons for the gaps identified during the analysis of preliminary data?*

i) From you professional experience can you provide us your view on possible prerequisites in order to bridge effectively the gaps identified through descriptive data analysis?

k) Can you indicate, from your experience in your organizations, actions or best practices experienced (or prefer to experience in the future) from your company during the stages of an M&A projects (e.g. strategy development, due diligence, post-acquisition integration, post-acquisition audit)?