Board Matters Quarterly

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Board Matters Quarterly offers thought-provoking perspectives and insights into leadership and governance issues for boards and audit committees, providing support to navigate an increasingly complex business environment.

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How boards can manage integrity risks in M&As and investments

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The Board Imperative: Is your people strategy human enough?

How boards can manage integrity risks in M&As and investments

In the last decade, fraud issues in relation to acquisitions or investments had led to global companies making billion-dollar write-offs. In some cases, respected and experienced boards were forced to admit that they had not paid sufficient attention to what might have appeared to be straightforward acquisitions. These incidents led to severe financial and reputational losses for the companies concerned and sometimes left their directors open to personal liability risks. More recently, corporate failures of entities that attracted high-profile and sophisticated investors have led many to question the degree of due diligence and monitoring put in place by these investors.

There are examples of companies across the Asia-Pacific region manipulating financial statements to overstate their value as they enter acquisitions or joint ventures (JVs) or accept a minority investment. Improper practices include artificially inflating revenue by manipulating sales data, channel stuffing or fictitious round tripping of sales countered with purchases from the same counterparties without real delivery of goods or services. In other cases, companies misstate assets and liabilities or local JV partners pad expenses with those of their other non-related businesses through the JV's books.

Such fraud is not isolated to higher-risk geographies. Accounting frauds have been perpetrated in some of the world's most hallowed financial hubs. The message for directors is clear: every deal needs to be protected by compliance due diligence. Without the expertise of forensic professionals, acquirers and investors risk having to explain flawed deals to shareholders and financiers alone. They would have to explain why they spent millions on an essentially worthless asset or worse, one saddled with liabilities due to bribery and corruption.

37%

of emerging market respondents in the EY Global Integrity Report rated fraud, bribery and corruption as the greatest risks to the long-term success of their organization, ahead of pandemics, and cyber and ransomware attacks.

1 Involve compliance teams from the start

An investment or deal team's number one key performance indicator is to get the deal done. As a result, it can be hesitant to involve the compliance team. This is a critical error. The compliance team should not only be involved from the outset but must also have sufficient influence and authority so that compliance-related issues and concerns related to the deals reach the board.

Hopefully, after a careful review, the deal will still get done with a more favorable negotiated deal value and a confident plan to remediate potential issues. But it should not be concluded at any cost or for any reason other than a compelling business case. Boards should watch for deals being aggressively pushed through by individual executives as well as those that are light on information or lack representation from the compliance team.

> "Boards should be wary of deals being aggressively pushed through by individual executives as well as those that provide little information or lack representation from the compliance team"

2 Involve forensic professionals in the diligence process

In every deal, forensic professionals experienced and adept at identifying red flags and issues should be called in to conduct one or more of the following typical forensic due diligence procedures.

3 Integrity or reputation due diligence

This will include checks on the target entity and its key personnel, using specialized databases, sanctions lists, open-source information, discreet interviews and targeted site visits. These look for any incidents of legal or regulatory violations, disputes, adverse media coverage or association with politically exposed persons.

4 Anti-bribery and anti-corruption due diligence

Anti-bribery and anti-corruption (ABAC) due diligence involves assessing and testing the effectiveness of the target's ABAC program, taking the level of interaction with government-exposed entities into account. This test is especially important because of the long reach of laws, including the US Foreign Corrupt Practices Act – one of the world's most punitive regulations – and the UK Bribery Act. There are also ongoing crackdowns on corruption in many Asia-Pacific jurisdictions.

5 Anti-fraud due diligence

This involves tailored forensic procedures and targeted integrity testing of financial statements and representations crucial to the deal valuation. Forensic specialists with extensive fraud investigation experience check that revenues and asset valuations stand up to scrutiny. Where possible, they will assess key third parties and search for evidence of coordinated fraud, conflicts of interest or related-party transactions. They will also conduct forensic data analytics of customer transactions to identify anomalies in customer profiles or activities to verify that reported sales stack up.

The extent of these additional diligence practices in the pre-deal stage will depend on the time available, level of access to information and granularity of information. In some cases where the target has many “suitors”, the target entity may refuse access to data requested by the compliance team. This is not necessarily a red flag, but directors should ask themselves why the target is reluctant to share information. They should also be prepared to walk away or have warranties drafted into the sales and purchase agreement pending the conduct of these procedures.

Forensic accountants can advise on whether there are red flags identified from their work procedures and help the board weigh the risk assessment. While higher risk developing markets promise strong growth opportunities, high costs to clean up improper operations or limited compliance information to do comprehensive diligence may present enough cause for not proceeding

6 Growing the asset post-investment

Getting the deal done is just the first step. As companies seek to realize deal value or grow the asset for a future exit strategy, establishing a robust governance, risk and compliance (GRC) framework with a strong fraud and compliance monitoring program is essential. Forensic capabilities can be valuable for the following.

7 Cyber compromise due diligence

An IT forensic assessment is crucial to uncover likely indicators of an active cyber compromise that could expose sensitive data, particularly if the asset value resides in patents, trade secrets or proprietary technology. The existence of advanced persistent threats will likely impact the target's data assets and must be investigated and eradicated before interconnecting the target entity's IT networks with the acquiring entity.

8 Fraud and compliance monitoring program

A GRC framework needs to be established for the target entity, including ongoing compliance monitoring. Establishing a culture of compliance that incorporates data-driven insights is the new standard that regulators expect today. The US Department of Justice's revised guidance on corporate compliance programs signals the importance of proactive data analytics in compliance programs — from using data and analytics in identifying and monitoring misconduct to testing the effectiveness of policies, standards and procedures. For example, a multinational conglomerate, Honeywell International, tapped into the EY Virtual technology platform to optimize compliance analytics.

Actions for boards and C-suites to consider:

To enhance oversight of the sustainability and digital agenda, boards should consider the following questions:

- Is the target's reputation or that of its key personnel tainted by offenses, litigation or dispute matters, compliance issues or adverse news?
- What is the risk that financial statements or key representations disclosed by the target have been falsified to make the deal more attractive?
- Is the target paying bribes or generating sales from corruption activities to grow or sustain its business?
- Is the target's sensitive data (trade secrets, intellectual property or personal data) compromised or at risk due to insider or external threats?
- Is the target's GRC program adequate and effective in safeguarding against fraud and compliance risks and monitoring them?

Reference

- *Is your organization upholding its integrity standards?*, EYGM Limited, 2022.

The Board Imperative: Is your people strategy human enough?

The social contract governing the relationship between employer and employees has been shifting since before the COVID-19 pandemic. Contributory factors have included rapid advancements in automation, along with the growing importance of commitments to environmental, social and governance (ESG) and diversity, equity and inclusion (DE&I).

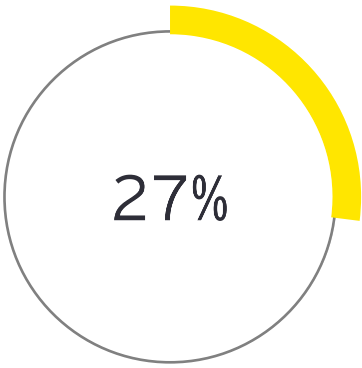
The COVID-19 pandemic and its impacts have changed the relationship still further by elevating factors such as organizational purpose and employee wellbeing. Employees now want to work for socially responsible organizations that share their values, while offering flexibility and tailored opportunities for skills and career development. Unsurprisingly in the current economic climate, they also want a transparent reward and recognition scheme that includes fair pay. The EY 2022 Work Reimagined Survey found that the opportunity to increase their salary was the top reason why employees would change jobs.

Organizations are recognizing the need to address these changing expectations. An EY CEO Outlook Survey found that two-thirds of CEOs agree that pandemic-induced working practices are increasingly critical to reducing employee churn and attracting new talent. But the EY 2022 Work Reimagined Survey revealed that just a third of employers are proactively adapting their approach to those practices – specifically, around flexible work, real estate and technology.

At the EY Center for Board Matters, we wanted to investigate how boards can contribute to reshaping the evolving social contract between employer and employees. For our latest film of the Board Imperative Series, we interviewed a cross-section of people to gather helpful insights into the future of work. In this article, we look at three areas where boards can support their organizations, and suggest some questions they can ask of themselves and their management teams.

1 Fraud and compliance monitoring program

It's no secret to organizations globally that Gen Z employees are driving many of the fundamental changes in employee expectations. A heightened focus on sustainability might have been "nice to have" for millennials, for example, but it's non-negotiable for Gen Z. "I majored in sustainability because doing something good for the world is part of my purpose," says Sarish Shashidhar, Head of New Product Development at BioPak. "This role encompasses what I studied as well as what I'm passionate about."



Gen Z workforce by 2025

What's more, for this cohort, embracing and embedding tech is a way of life. As true digital natives, Gen Z are at the forefront of developing the products, customer experiences and ways of working that are transforming life and work for us all. Increasingly influencing everyday life, **Gen Z will make up 27% of the workforce by 2025** and employers have a lot riding on them actively contributing to the organization's future success.

So, how can boards help their organizations tap into this potential? By working with their Chief Human Resources Officer (CHRO) or equivalent to build a bridge to younger employees. That means fostering relationships based on listening and two-way communication, together with shared purpose and value. Here are some suggested actions to take:

Find ways to engage young professionals – not simply by listening, but by encouraging active participation in decision-making.

Build the ability to make choices based on individual values and preferences into the employee value proposition. Emphasize the scope for collaboration, whether face-to-face or virtual, along with the availability of resources to support health and wellbeing.

Challenge the organization to be transparent about its operations, including its ESG and DE&I efforts, and to address any misalignment between commitments and reality.

While CEOs are ultimately responsible for the organizational culture and people strategy, talent transformation is critically important, and CEOs and their boards might consider elevating how the CHRO is supported to drive the necessary changes.

2 Tailor the employee experience for long-term success

Successfully attracting, engaging and retaining talent is about paying attention to the right signals, then acting on them to make change happen.

For boards, this means having a process for tracking external trends and their impact on talent. Inviting external experts, such as behavioral psychologists or anthropologists, to the board is one way to do this.

Collaborating to develop an employee value proposition that meets the needs and wants of a multi-generational workforce is also key. This should reflect diversity in the broadest sense: of choice and opportunity, and the application of skills, as well as demographic diversity and inclusion. As Shyam Gidumal, Board Director at RenaissanceRe, says in our Board Imperative Series film: "Successful organizations are going to adjust to make people feel special, individually, when they come into work."

Boards can also expand the remit of the compensation committee to reflect the fact that talent is a long-term issue as well as a short-term hurdle. The reality is that in today's tight labor market, pay is a factor in driving moves. However, a compensation strategy must balance the short-term need to support employees' financial wellbeing with the longer-term need to build a brand that attracts top talent.

3 Challenge management to prioritize upskilling

The changing talent dynamic is inevitably forcing organizations out of their comfort zones and requiring a swift and proactive response. One of the ways organizations can respond is by recognizing the need to prioritize the ongoing use of technology, and upskilling employees accordingly. Digitization can transform public services, for example, but EY research shows that just 7% of government organizations have achieved their digital transformation objectives. Meanwhile, 77% say competition for workers with in-demand technology skills has intensified since the pandemic.

This talent shortage means two-thirds of governments globally are prioritizing the reskilling of existing staff over hiring externally. And, thanks to recessionary pressures, more CEOs are focusing on ways to retain talent than are focusing on managing talent costs.

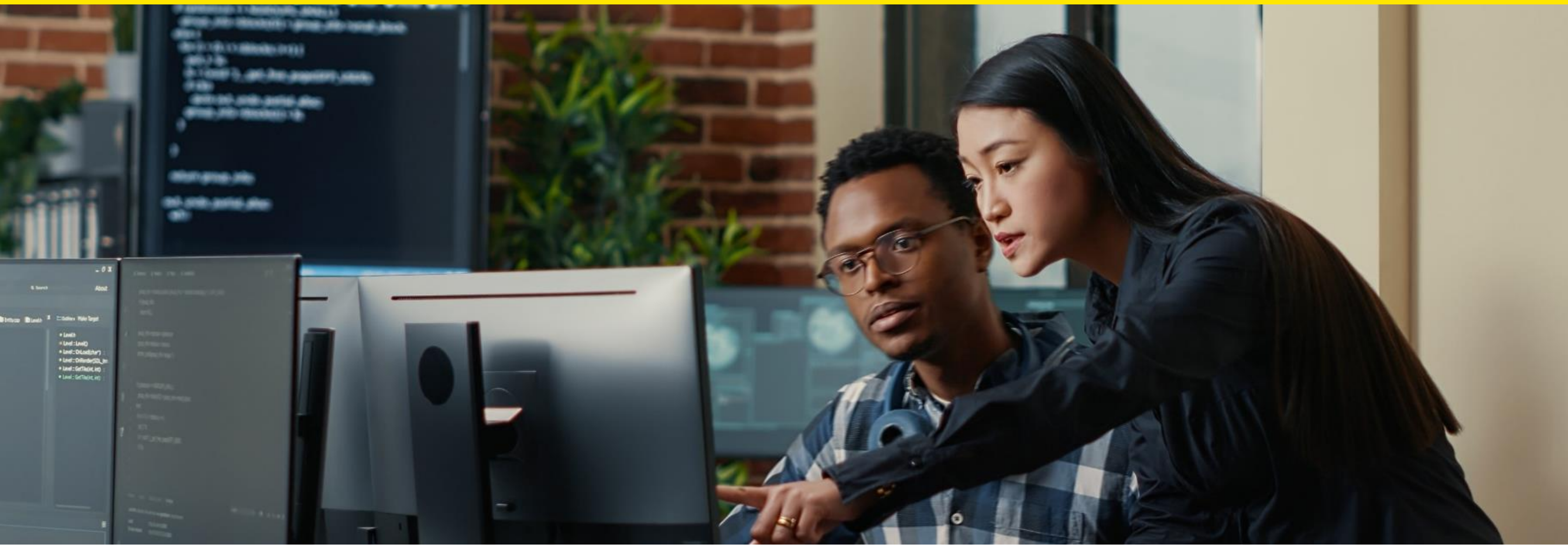
Another way for boards to work with management to retain talent is to consider talent development as a process of progressing individuals along a series of "S-curves," which is an S shaped graph that can be used to describe how ideas, products, or in this case, talent, experience rapid growth followed by a levelling out (or saturation). Rather than risk disengaging people when they hit the top of a developmental curve, which would signal mastery of a new job or skill, employers could encourage continuous growth by offering opportunities along a new S-curve. Yet, as the pace of change increases, S curves are getting shorter, and skills need renewing sooner. Employers have to adapt how their learning functions provide skills and experience in more agile, timely, and interesting ways. Bruna Gil, Channel Sales Manager at LinkedIn, captures this well in our film: "The demand for skills keeps changing. It's really top of mind for me to keep my team upskilling and developing themselves."

To effect change, boards themselves need to change and ask the right questions

Boards can clearly influence the speed and urgency with which organizations refresh their social contracts with employees. However, to have the biggest possible impact, they will need to challenge and encourage management, and themselves, to apply diversity of thought. In doing so, they will be able to evolve and affect change.

Some of the key questions for boards to consider are as follows.

- How is the board supporting and reflecting the strategic importance of the CHRO role and talent issues through improved talent governance? Has the board considered expanding the remit of existing board committees, or implementing new ones to address shifting employee expectations?
- How is the organization measuring and making progress on building trust with employees across all generations (for example, through listening posts)? Has the organization adapted how it reflects changing sentiment about loyalty, employee experience and other traditional measures in employment practices?
- Are there any technology investments and initiatives that your organization would accelerate as it considers the needs and expectations of Gen Z? How is management prioritizing capital allocation for digital transformation in light of demographic trends?
- What assumptions about future employees are management making as part of their longer-term growth strategy?
- As a board member, how do you test whether your view of what new entrants want and need aligns with theirs, or simply reflects your own perspective and bias?



This article was adapted from EY Center for Board Matters: The Board Imperative: Is your people strategy human enough?

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