Deloitte.

Navigating new obstacles during mergers and acquisitions transactions

Internal control considerations for M&A

Mergers and acquisitions (M&A) oftentimes represent significant milestones and changes in risk profile for an organization and require substantial financial and operational resource commitments to properly execute. Given the importance of these transactions, companies can spend much thought and effort on the financial side of the deal, including performing due diligence analyses, identifying synergies, and planning for systems integration. What may be overlooked, however, is the importance of the processes and internal controls required to effectively assess, record, and integrate the acquired company into the overall financial structure—let alone evaluate its culture and organizational fit.

A thoughtful approach to avoiding some of the usual acquisition-related speed bumps can help your organization effectively and efficiently assess, account for, and integrate a new organization into your existing business and internal controls program.

Whether you are a public or private company, navigating the challenges of developing and maintaining a strong internal control program over an acquired business is considered fundamental to meeting the increasing expectations of the broad range of stakeholders, including regulatory bodies, shareholders, management, boards, and audit committees. It is important that management understand the financial, operational, and control-related risks, at both the target and the acquiring entity organizations, to not only see that a sound business decision is being made, but to be comfortable that the relevant financial information is complete and accurate throughout the entire M&A life cycle.

To achieve these organizational efficiencies, intentional Sarbanes-Oxley (SOX) considerations (or quality operational considerations, if private) prior to, during, and after the acquisition can help:

- Understand the SOX requirements to set a plan that will achieve regulatory compliance, estimate costs, and consider resource needs (number and skill set) associated with activities that may include:
  - Scoping of acquisition-related controls.
  - Potential Year 1 exclusion of SOX requirements.
  - SOX readiness activities at the acquired company.
  - SOX program integration.
  - Post-merger strategic vision.
- Plan for modernizing from the start by considering impact on operating model, and integrating process enhancements, technology, and automation as part of SOX program integration.
- Align SOX compliance objectives and collaboration with external auditors.
- Gain early insight toward developing a post-merger strategic vision and guide the business's expectations in relation to compliance challenges, priorities, costs, and timelines.
- Manage resources efficiently and effectively to modernize the newly combined entity's SOX program.
- Look to lay out a robust groundwork for SOX from the onset and avoid latent additional costs or unexpected issues by seeing that the proper internal and external support is available.
- Support an effective SOX control implementation at the acquired entity.

We have you thinking about intentional steps you can take to support a thoughtful M&A life cycle, but let's go a little deeper into the risks and considerations prior to, during, and after the acquisition milestones.

Pre-acquisition due diligence

Once a target for a potential merger or acquisition has been identified, it is important for management to understand, prioritize, and plan a response for potential risks to make the most informed decision possible. An important driver in a decision to acquire a business is providing a seat at the decision-making table to those responsible for SOX compliance, which could help avert future issues, including but not limited to unexpected costs, bandwidth resources challenges, and the need for SOX readiness activities, by highlighting a potentially overlooked component of any M&A transaction: an assessment of the target's governance, risk, and controls (GRC) maturity.

To achieve accretive benefits during the due diligence process, certain questions may be on the acquirer's mind to evaluate potential hygiene of the acquiree. Critical due diligence topics, themes, and questions to ask may evolve around the following:

1. What level of publicly available information is obtainable?
2. What will the impact be on future compliance for legacy business processes as well as the additional SOX readiness procedures at the newly acquired entity?
3. Could the additional responsibilities resulting from a merger or acquisition lead to personnel capacity constraints or segregation-of-duty issues?
4. What is the timeline to integrate and the impact on the acquirer's framework?
5. What resources will be required to support the new acquisition integration or control execution and assurance? What is the future-state cost to comply or potential cost to integrate?
6. Does the existing accounting and finance team possess the technical accounting and valuation methodology expertise or capacity to manage the transaction and support reliable financial reporting?
7. Are the business's expectations in line with compliance challenges, priorities, and timelines?
8. Is management comfortable with the level of governance and controls over financial reporting at the acquired company?
9. What impact does a significant deficiency or material weakness have on the company?

From a GRC lens, important action items during the due diligence phase may include but are not limited to:

- Performing a risk assessment of the target to understand if the acquired company represents a material impact on the newly combined entity, as well as identifying business processes that represent increased risk due to complexity or judgment. For example, a private company target can represent increased risk versus a public target due to increased regulatory and internal control requirements that have historically not been relevant.
- Gaining an understanding of the target's internal control environment by looking at its business process controls, technology stack, and cyber footprint.
- Determining the nature, timing, and extent of procedures based on the target's current-state control environment. Poor controls equate to potentially more scrutiny.
- Understanding and assessing the information technology (IT) environment and resulting information provided by the target to determine the level of analysis and documentation that will be required of management during the acquisition accounting phase.

These upfront GRC activities provide increased visibility into the target company's operations, which leads to high-quality oversight by organizational management through the identification of broader business red flags about the target before the company devotes significant resources to pursuing the acquisition. Further, with upfront SOX leadership involvement, organizational leadership may be better informed and able to estimate potential future compliance costs, timelines, and complexities with greater precision to avoid speed bumps further down the road and be better prepared for the journey ahead.

Purchase price allocation, acquisition accounting, and initial recording

For an acquirer to enhance value and comfort over the initial values recorded as the result of M&A activity, it is important for management of the acquiring entity to understand the role internal controls play in the valuation and purchase price accounting process, starting with the regulatory requirements.

Regardless of management's evaluation over the acquired business's system of internal control and its impact on the acquirer, the acquirer is required to include the relevant controls over the proper recording of the acquisition and the subsequent activity related to acquired balances during the measurement period. This would include controls to assess and monitor the appropriateness of the financial information provided by the acquired entity for inclusion in the acquirer's financial reports. Although requirements may be different between public and private entities, in either case, a robust risk assessment process and strong framework of acquisition-specific controls are essential for companies following a material transaction and support the implementation of controls for the future, rather than the past.

These needed risk assessment and control procedures can be performed by management, with the aid of individuals responsible for the company's SOX program, or quality assurance, to obtain sufficient comfort over the acquired balances. Areas of relevance and potential categorization of internal controls could be include the following:

- Risk assessment procedures
- Opening balance-sheet controls
- Controls over valuation report and purchase price allocation
- Financial reporting controls

These areas of consideration in Year 1 of the acquisition are important to long-term effectiveness and execution of financial reporting. Appropriate effort and care should be given by management, especially when thinking through the extent of management's documentation used to support the determination of the fair value of the acquired assets and purchase price allocation. There will inevitably be several discrete controls steps that need to be considered and documented based on significance. Leading key assumption documentation practices include determining upfront which assumptions are required and could represent a risk of material misstatement and therefore require more robust documentation; and early alignment directly with the external auditor to clarify what type of documentary evidence is expected, including contradictory evidence. This middle phase, completing the acquisition, is important to long-term effectiveness and sustainability of the acquired entity.

Post-merger integration and control rationalization

Immediately following the close of an acquisition, companies have an opportunity to harmonize their risk assessment efforts beyond simply combining established internal controls over financial reporting (ICFR) frameworks. For entities without previous experience of control requirements, the shift in mindset can pose a significant challenge to control standup. Internal controls can sometimes require a fundamental change in mindset from process to risk and control, not to mention they can reach further avenues of the organization including legal, treasury, human resources, and payroll.

Common pitfalls here include attempting to complete acquisition SOX implementation projects with existing staff without adding additional bandwidth, or innovative technologies, geographies, or business models. Acquired businesses often also see downsizing of operational roles, which can lead to additional compliance risks within the organization, including, but not limited to, segregation of duties and resource bandwidth due to competing integration priorities. Careful planning of an integration strategy, including an internal controls plan that aligns to wider integration efforts, is important to potentially avoiding inefficiencies in control standup.

Technology is a fundamental building block to effective ICFR. Any planning for SOX in an acquisition needs to fully consider the technologies in place at the acquiring entity, as well as the future planned changes to these systems. IT controls can be both inefficient and costly to resolve, especially for legacy or bespoke technologies or for organizations without a previous history of control compliance requirements. Businesses are also placing significant reliance on third parties as part of their operations. This complexity is commonplace, especially with the increased focus on cloud and hybrid operating models. In our experience this is one of the leading causes of delays to control implementation projects following acquisitions. Third parties do not own the risk on behalf of the acquisition but may be a significant party in relation to control operation and assurance activities, including providing support and functionality.

Leading practices for assessing potential future-state risk and control activities may include:

Culture

Consider the "risk and control culture" and embed the change within the mindset of the individuals at the acquired business early on.

Risk assessment

Consolidate the acquired entity's risk assessment and scoping.

- Consider the role and extent of third parties within the expected SOX control framework
- Inventory IT systems
- Sustain the ongoing post-acquisition controls environment

Resources

Don't try and go at it alone. Pick the appropriate operating model to meet the aims and expectations of the organization in relation to control standup.

Modernize

Consider opportunities to embed common and/or standardized controls across the enterprise, rather than quick-fix controls to fill gaps.

Taking a step back

There are opportunities to enhance your goals through internal controls during the transaction life cycle. It's important to have an effective strategy that may consider the following leading practices:

- Do not forget to consider SOX compliance in all phases of M&A activity: before the acquisition as part of due diligence; during purchase price allocation, acquisition accounting, and initial recording; and following deal closure for post-merger integration and control rationalization.
- Document focused procedures performed to assess completeness and accuracy of information and third-party data used in the target's valuation.
- Focus on the potential risks to compliance (both internal and external) to help increase efficiency.
- Carefully consider the operating model to help achieve compliance, including consideration of the integration strategy of the newly combined entity.
- Encourage early involvement from the SOX team, prior to the acquisition, to aid in proactively aligning with your external auditor.

Where to go from here

As companies seek out opportunities for growth through a merger or acquisition, they should challenge the "check-the-box" mindset and reconsider the potential benefit of a thoughtful, strategic SOX integration plan as early in the M&A life cycle as possible. Organizations have an opportunity to get ahead of the complexity of compliance related to acquisitions by getting those charged with integration of the business involved pre-acquisition and gathering information to better plan, prioritize, and time the path to compliance. Organizations that then also weave control optimization into their integration process may be able to provide greater assurance and value to their key stakeholders. By refreshing and modernizing the role of internal controls in M&A activity, a company can meet the ever-increasing expectations of management while shifting focus and efforts to areas that matter most and reducing the long-term cost of compliance.

Contact us:

AUTHORS

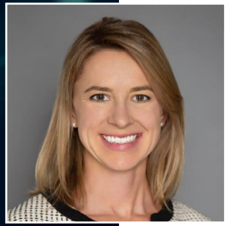
Stefan Ozer
Partner, Accounting & Reporting Advisory
Audit & Assurance
Deloitte & Touche LLP
+1 203 423 4731
sozer@deloitte.com

Kajal Shah
Partner, Accounting & Reporting Advisory
Audit & Assurance
Deloitte & Touche LLP
+1 408 704 2428
kajshah@deloitte.com

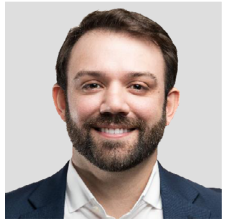
Jim Traeger
Partner, Accounting & Reporting Advisory
Audit & Assurance
Deloitte & Touche LLP
+1 713 982 3574
jtraeger@deloitte.com

Patty Salkin
Managing Director,
Risk Advisory Services
Deloitte & Touche LLP
+1 609 806 7279
psalkin@deloitte.com

CONTRIBUTORS



Corrie Sparks
Senior Manager, Accounting & Reporting Advisory
Audit & Assurance
Deloitte & Touche LLP
+1 720 693 3400
corsparks@deloitte.com



Ross Hargis
Senior Manager, Accounting & Reporting Advisory
Audit & Assurance
Deloitte & Touche LLP
+1 713 258 2966
rhargis@deloitte.com

Jack Dean
Senior Manager,
Risk Advisory Services
Deloitte & Touche LLP
+1 703 251 3775
jacdean@deloitte.com

Appendix A: Leading practices

Below, we include some of the specific considerations and leading practices to consider during each stage of the acquisition process.

Pre-acquisition

Pre-acquisition due diligence: SOX leadership should have a seat at the table in decision-making. Timing of the acquisition should consider SOX requirements and allow time to achieve compliance, particularly if management elects not to take the exception for Year 1 reporting. Organizational leadership should estimate additional compliance costs and resource needs for potential SOX readiness and SOX program expansion due to change in risk profile and expanded scope. The impact of this effort is a leading practice and should be part of overall decision-making to avoid speed bumps further down the road and be better prepared for the journey ahead. New acquisitions in SOX scope inevitably increases the amount of effort for the SOX program each year, so consideration of the ongoing compliance activities and the impact on overall program cost and resources should be considered as part of the operating model.

Risk assessment: Revisit the risk assessment following the identification of an acquisition. No two acquisitions are the same and some balances or key business cycles may not represent a risk of material misstatement, which can help to reduce or even eradicate the burden of standing up SOX within the business. Identifying those focus areas early, based on quantitative and qualitative factors can help make implementation efforts laser focused, reducing the time and cost of implementation.

Target's risk and control culture: Do your due diligence on the entity for SOX requirements. Take time to consider the current regulatory for the target as part of due diligence activities. Consider whether they are an existing public filer and review their previous SEC submissions in relation to their controls opinion. Unremediated material weaknesses in the 10-K should prompt management to revisit its implementation and integration plans, allowing more time and resources to achieve compliance. Consider other publicly available controls information, including any third-party assurance reports. These sources should provide input to integration plans, including the timelines to integrate the acquired entity onto existing systems and processes. In the event of a material weakness within the acquired entity, management may elect to accelerate integration plans rather than invest in remediating existing issues.

Exemption for Year 1 SOX: The runway for SOX compliance at the acquisition can be lengthened by one year by electing to take the exception in the first 10-K filing following the acquisition. Management can consider this option using the points above, but also in relation to timing of the acquisition. Acquisitions close to year end without taking the exception can significantly shorten the runway to SOX compliance. Should the exception be taken, the basis for this decision should be documented and retained by management as well as made available to external audit. It is important to note that during the determination of materiality in the Year 1 exemption assessment, intangible assets including within the scope of purchase price allocation controls would be excluded from calculation as they are subject to Year 1 acquisition controls.

To help determine whether the transaction meets the criteria of a "material" purchase business combination, management could apply the three threshold tests (investment, asset, and income) of significance under SEC Regulation S-X, Rule 3-05 as a proxy, as the SEC SOX exemption guidance does not explicitly define "material" for purposes of a business combination. Other qualitative factors management can consider, in addition to the results of any materiality calculations, may include:

- Amounts of time between deal consummation and year end.
- Size and complexity of the company acquired.
- Level of effort and time to integrate the processes and systems of acquired entity.

Post-acquisition

Educate and train: If SOX requirements are new to the acquired organization, then upskilling, education, and cultural change should be at the forefront of the implementation plan. This should include control training that focuses on the why as well as what their responsibilities entail as risk and control owners for the parent company. All stakeholders should be brought along for this ride, including IT risk and control owners.

Control environment integration: The technical abilities and bandwidth of in-house teams should be considered, especially with current SOX obligations and proposed timelines for readiness. Effective SOX implementations at acquisitions rarely utilize solely internal teams, and a mix of third-party providers to help bolster existing teams and bring additional technical knowledge can ultimately increase the efficacy of the implementation and resultant control framework. Standing up controls twice may not be the most cost-effective or efficient model. Time spent to consider the overall integration road map alongside compliance timelines is important, including whether to take the exception for the first year of SOX compliance. While delaying control implementation may seem counterintuitive, time spent thoughtfully planning SOX control standup against implementation plans can save time and cost in re-implementing and revising control frameworks following shifts in business practices and systems.

Take the implementation opportunity to establish a solid foundation for SOX from the beginning, including building out modernized controls and taking advantage of new technologies and SOX modernization ideas. Review a holistic control framework when implementing controls to consider:

- The possibility for the use of automation or technology within the control environment to build controls for the future, not for the past.
- Commonality wherever possible to keep complexity out of the control framework, increasing efficiency while reducing the overall cost of compliance.
- Downstream controls. It is possible that downstream controls at the acquiring entity could mitigate the same risks of material misstatement (ROMM), which could mean that some controls within the acquired business add no real value to the SOX program.

Resource mix: Consider an appropriate blend of existing headcount, additional internal resources, and third-party specialists needed to complete integration and SOX readiness activities at the newly combined entity. Additional time constraints may stem from upskilling existing headcount on additional ICFR requirements, including training in new IT systems.

Third-party considerations: Prioritize understanding the relevant third parties in place for the SOX control program at the new entity. Third parties can range from technology providers to independent process owners (including payroll). Once third parties have been identified, it is important to understand the current contractual arrangements as well as the current avenues of assurance in place (such as SOC reporting). A lack of timely third-party assurance reports with a vendor, teamed with no contractual ability to audit the third party included within the contract, can significantly increase the complexity for controls implementation and should be a priority within a SOX integration plan. Re-contracting or resourcing the service can take time, so it should be considered early on to avoid delays to your project timelines.

IT controls considerations: Create and maintain a system inventory for those systems deemed relevant for SOX (e.g., supporting automated controls or source data for key reports). Consider the age and complexity (including whether the system is bespoke built) of the system inventory to identify potential pain points for both business process and IT controls. Focus on high-risk controls initially and understand the ability for the system to support them; usually change control and access security controls are the most difficult to implement in legacy or home-grown technology environments. Seek subject-matter support should technologies be new to your SOX team.

[SOX and internal control over financial reporting services]

Deloitte.