

Navigating new obstacles during mergers and acquisitions transactions

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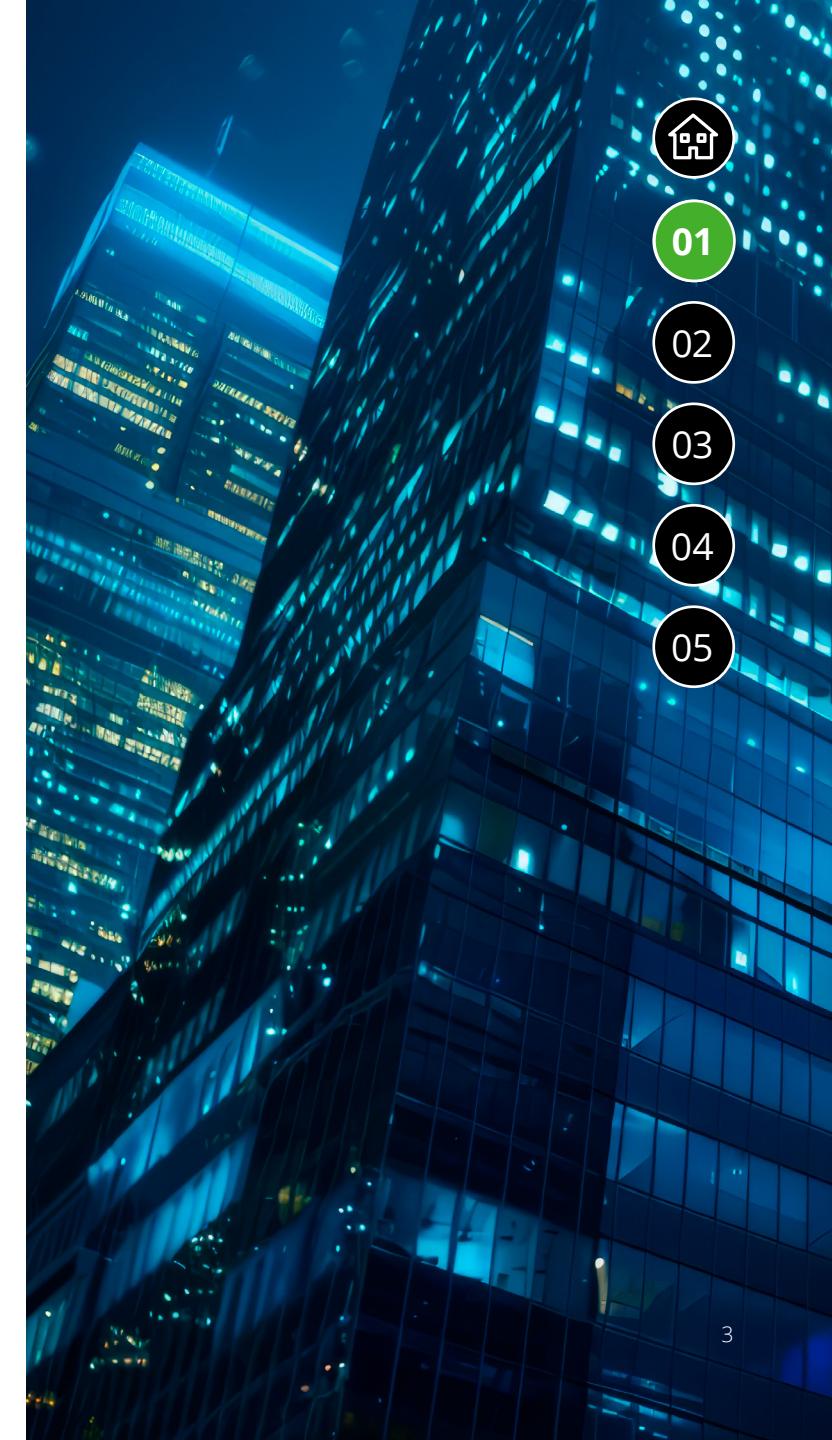
Introduction

Internal control considerations for pre-deal due diligence and post-transaction integration

Mergers and acquisitions (M&A) oftentimes represent significant milestones, driving changes in an organization's risk profile, and can require substantial financial and operational resource commitments for proper execution. 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.

A thoughtful approach for integration of a newly acquired organization into your existing business and internal controls program can help you avoid some of the common acquisition-related speed bumps.

Whether a company is public or private, navigating the challenges of developing and maintaining a strong internal controls 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's important that management understands the financial, operational, and control-related risks at both the target and acquiring entity, so they can make sound business decisions and trust that relevant financial information is reliable and consistently maintained throughout the M&A life cycle.



As organizations increasingly leverage artificial intelligence (AI) to drive efficiencies and insights, it is equally important to consider the implications of AI integration on internal controls, data privacy, and regulatory compliance throughout the M&A process. A broad AI strategy should be developed to guide these efforts and determine alignment with organizational goals.

To achieve these organizational efficiencies, intentional risk and internal controls considerations, including if (or as) relevant Sarbanes-Oxley (SOX)-specific considerations prior to, during, and after the acquisition, can help the acquirer plan to:

- Achieve risk and internal controls, including SOX regulatory compliance; estimate costs; and consider resource circumstances (number and skill set) associated with activities.

- Integrate a modern internal control, including SOX, program through process enhancements, technology, and automation. This includes evaluating the role of AI and automation in financial processes, determining that AI-driven solutions are implemented with appropriate controls and oversight as part of your AI strategy.
- Align risk and internal controls, including SOX compliance objectives and collaboration with external auditors.
- Gain early insight toward developing a post-merger strategic vision, and guide the company's expectations in relation to compliance challenges, priorities, costs, and timelines.
- Manage resources efficiently and effectively to modernize the newly combined entity's risk and internal controls, including SOX program. Resource planning should account for the experience needed to oversee both traditional operations and the integration of AI-enabled controls and processes.
- Update existing change management plans to include training of resources on new expectations.
- Avoid latent additional costs or unexpected issues by seeing that proper internal and external support is available.
- Provide guidance for effective risk and internal controls, including SOX control implementation at the acquired entity.



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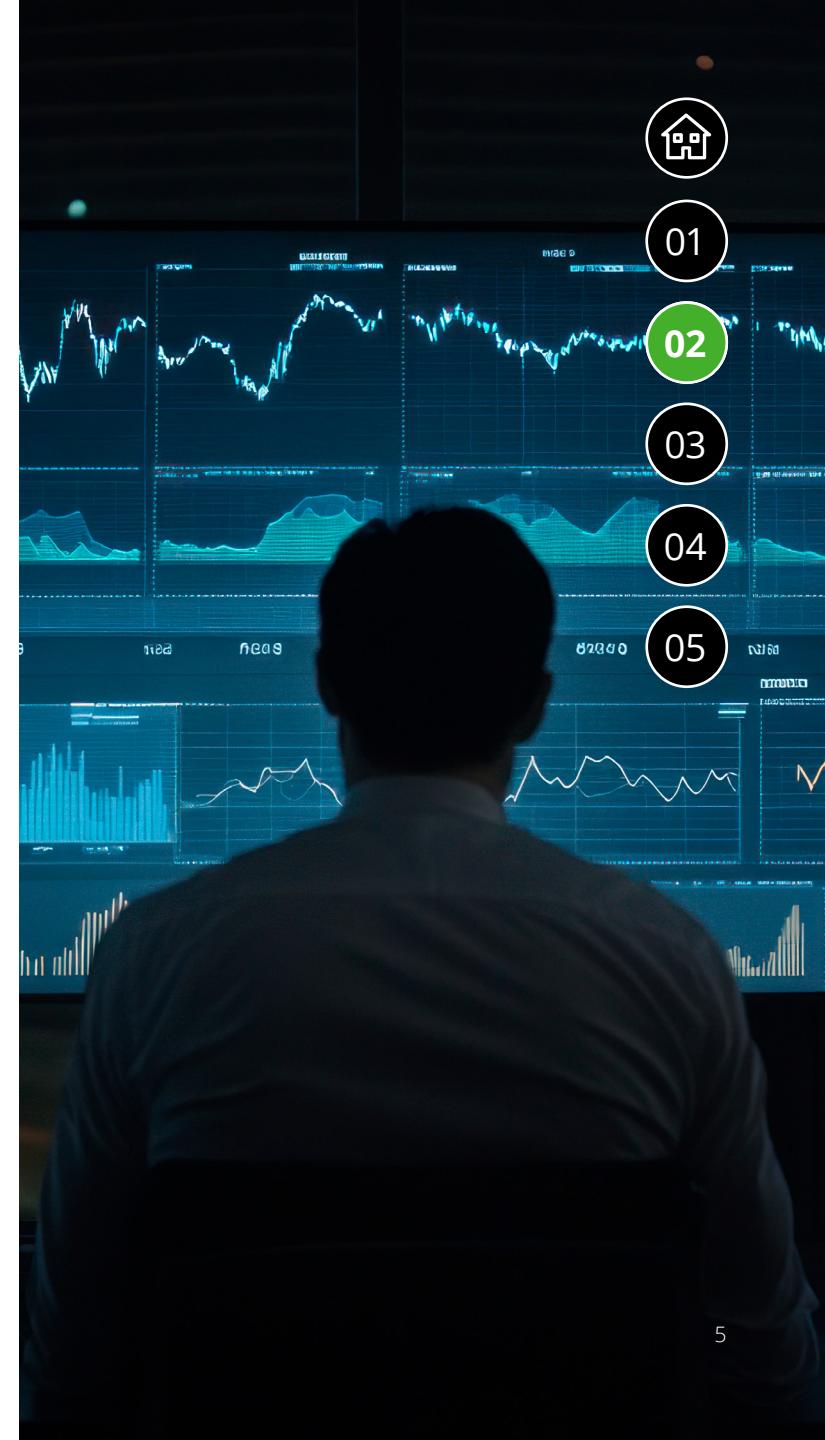
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Pre-acquisition due diligence

When it comes to M&A, internal controls diligence takes a close, practical look at how the target company manages its financial processes and safeguards its assets. It's not just a box-checking exercise; it's about understanding whether the company's controls work in real-world scenarios and spotting red flags before a deal is signed. This hands-on review can help buyers avoid surprises and provide a foundation for integrating operations after the transaction.

As part of pre-acquisition due diligence, a company should provide a seat at the decision-making table for those responsible for risk and internal controls, including SOX compliance. This could help avert future issues such as unexpected costs and capacity constraints by highlighting a potentially overlooked component of M&A transaction: an assessment of the target's maturity across elements within its overall system of internal control. Organizations should also evaluate the target's use of AI systems, with a focus on data privacy, security, and compliance with data protection regulations. Reviewing broad security protocols are in place to protect sensitive information, especially where AI-driven analytics or automation are used, should be a main part of due diligence.



During due diligence, certain questions may be on the acquirer's mind to evaluate the maturity of the acquiree and the internal controls challenges that may arise during integration. Important due diligence questions to consider may include:

01 Is management comfortable with the current level of governance and controls over financial reporting at the acquiree? If there are important improvements to be made, what is the timeline and expected cost to achieve future compliance and integrate into the acquirer's internal controls framework?

02 Does the existing accounting and finance team have the technical accounting and valuation methodology experience or bandwidth to manage the transaction and produce reliable financial reporting, while avoiding segregation-of-duty concerns? Does the acquiree have significant deficiencies or material weaknesses that require remediation during integration? What impact do they have on the business decisions and ability to account for the acquisition?

03 How are AI systems currently being used by the target, and what controls are in place to manage risks related to data privacy, security, and regulatory compliance?



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Within the system of internal control, specific action items during the due diligence phase may include but are not limited to:

- Performing a risk assessment of the target and understanding the target's internal controls environment and business process controls in place. For entities with a poor controls environment, there may be more scrutiny over the target. A private company target can also represent increased risk versus a public target due to regulatory and internal controls requirements that have historically not been required.
- Assessing the security and compliance of AI-driven systems, determining that they meet organizational standards for data protection and confidentiality during due diligence and post-merger AI integration.
- Understanding and assessing the sophistication of 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 up-front activities focus on the organization's system of internal control. This approach provides increased visibility into the target company's operations, leading to strong 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. These can include technology-related risks as well. Early identification of AI-related risks and opportunities can help organizations avoid unexpected costs and compliance challenges later. Further, with up-front SOX leadership involvement, decision-makers may be able to more precisely estimate potential future compliance costs, timelines, and complexities to avoid speed bumps further down the road.

Purchase price allocation, acquisition accounting, and initial recording

For an acquirer to correctly record the initial values as the result of M&A activity, it is important for management to understand the internal controls over valuation and purchase price accounting process.

Regardless of management's evaluation of the target's internal control system, the acquirer is required to completely and correctly record the acquisition and the subsequent activity related to acquired balances during the measurement period. This may likely 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. A broad risk assessment process and strong framework of acquisition-specific controls are important for companies to account for a material transaction and provide guidance for the implementation of controls going forward.

With many organizations now leveraging AI and automation in these processes, it is important to determine that these tools are implemented with appropriate oversight and controls. Regular compliance audits related to AI data use, customer consent, and employee contracts should be conducted in adherence to legal requirements.

Relevant internal control areas could include the following:

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

Management, in coordination with risk and internal controls, including SOX, and quality assurance teams, should identify broad controls over risk assessment, balance-sheet entries, valuation, and financial reporting. Careful documentation and early auditor alignment are important for effective integration and long-term compliance.



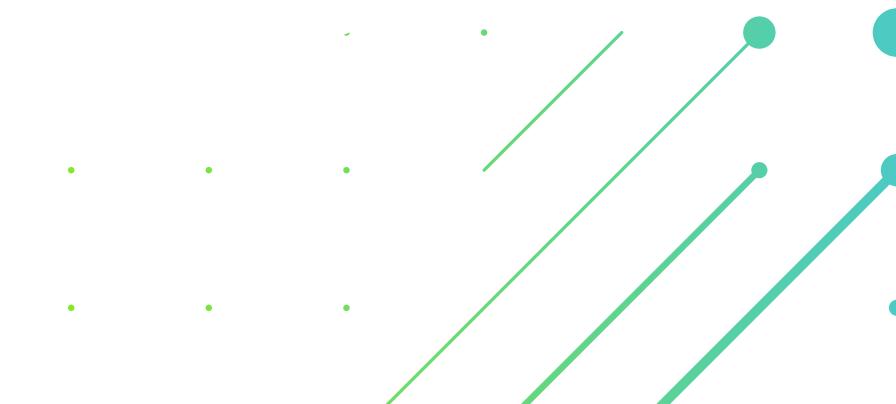
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Post-merger integration and control rationalization

Promptly 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, there may require a fundamental change in mindset from process to risk and controls, which may reach departments beyond accounting and finance including legal, treasury, human resources, and payroll. Management should also consider bandwidth of staff across these departments and implications of downsizing operational roles.

Technology is a fundamental building block for effective ICFR. When planning for risk and internal controls, including SOX, considerations in an acquisition, it's important to fully factor in the technologies currently in place at each entity, along with anticipated changes to these systems. As organizations increasingly adopt AI and automation technologies, it becomes important to evaluate how these tools may affect the internal controls environment. Integrating AI systems should be done thoughtfully to provide reliable financial reporting and ongoing compliance. To address potential resource constraints, organizations should proactively plan for the required experience and capacity—determining effective oversight and integration of both traditional and AI-enabled controls within the broader operational landscape.



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Takeaways



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

Culture

Consider the “risk and control culture” and establish a new risk and control mindset within the new team of individuals at the acquired business early on.

These principles are directly relevant during mergers, acquisitions, or other business combinations, as such transactions introduce new risks, require integration of objectives, and often bring increased fraud risk.

Risk assessment

Consolidate the acquired entity's risk assessment and scoping, with a focus on:

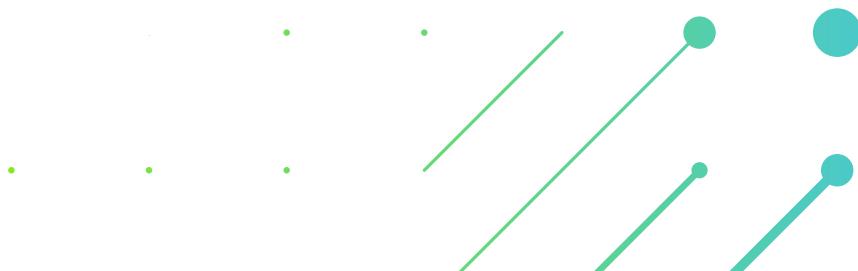
- Selecting and developing control activities that help mitigate risks to acceptable levels, determining actions are aligned with objectives and risk tolerance.
- Selecting and developing general controls over IT and technology environments (including the integration of AI and automation technologies), which helps maintain information systems and technology that enable effective internal controls and provide reliable information.
- Deploying control activities through well-documented policies and procedures and determining they are communicated and performed in a timely manner.

Resources

Plan for the required resources to support both traditional and AI-enabled operations and controls.

Modernize

Consider opportunities to embed common and/or standardized controls across the enterprise, rather than quick-fix controls to fill gaps. Utilizing AI and automation may also improve the efficiency and effectiveness of controls.





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Taking a step back

Consider these leading internal controls practices throughout the transaction life cycle:

- Do not forget to consider risk and internal controls, including SOX compliance, in many phases of M&A activity: before the acquisition as part of due diligence; when determining acquisition accounting including calculating purchase price allocation and initial recording; and following deal closure for post-merger integration and control rationalization.
- Document 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. This includes proactively identifying and managing risks associated with AI integration, such as data privacy, security, and regulatory compliance.
- Encourage early involvement from risk and internal controls, including SOX teams, prior to the acquisition, to proactively align with your external auditor.

Where to go from here

As companies pursue growth opportunities through mergers or acquisitions, they should move beyond a compliance-only approach by strategically planning for risk and internal controls, including SOX integration, early in the M&A life cycle. 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 proactively incorporate control enhancements during their integration process can provide greater transparency and confidence to stakeholders, thereby strengthening risk management and contributing to value creation. In addition, by embedding AI considerations into each stage of the M&A process and determining that appropriate controls, oversight, and resources are in place, companies can gain the benefits of AI while mitigating potential risks.

By refreshing and modernizing the role of internal controls in M&A activity, a company can meet the ever-increasing responsibilities for governance and oversight while shifting focus and efforts to areas that matter and reducing the long-term cost of compliance.



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