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M&A due diligence and the emphasis on internal control systems of the target company

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Abstract of bachelor's thesis

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Abstract

As global financial markets have been opening to the public, there has emerged a need for transparency of internal controls in public companies. At the same time, the mergers and acquisitions (M&A) activity has been in a steady uptrend throughout the business cycles for the past several decades. Through increased capital involved in these transactions, transparency can benefit the market at large.

To add to the extensive number of studies made regarding pre-decision controls of the acquiring company, this thesis focuses on the internal controls of the target company. The objective is to determine: How in-depth are these systems examined during the transaction, and which factors influence the importance of due diligence on them?

The thesis consists of a meta-analysis of studies on the cost-benefits of internal control in limited liability companies, how internal controls are considered during the M&A due diligence process, and the implications for post-deal performance. In addition, this thesis includes a field study through in-person interviews with four professionals.

This thesis found that as the research on the link between corporate governance and company performance can be seen increasing, many studies have still been inconclusive. The importance of internal control systems varies greatly between industries and particular organizational traits, and it also translates to M&A due diligence. In this thesis, it has been concluded that most M&A transactions are already labor-extensive, and internal controls are rarely examined directly. In most cases, the limited resources and time in hand are seen better in use elsewhere than in the targeted assessment of internal controls of the target company.

Keywords internal control, mergers and acquisitions, due diligence, corporate governance

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1 INTRODUCTION

1.1 Explanation of the field and sub-field of the study

The chosen research area for this thesis can be found in the field of economics. In the cross-section of accounting, finance, and management, the sub-field of M&A activities, due diligence process, and internal control systems of the target company can be determined. Internal controls can be seen as a sub-field for risk management, which in general, is left outside the scope of this thesis.

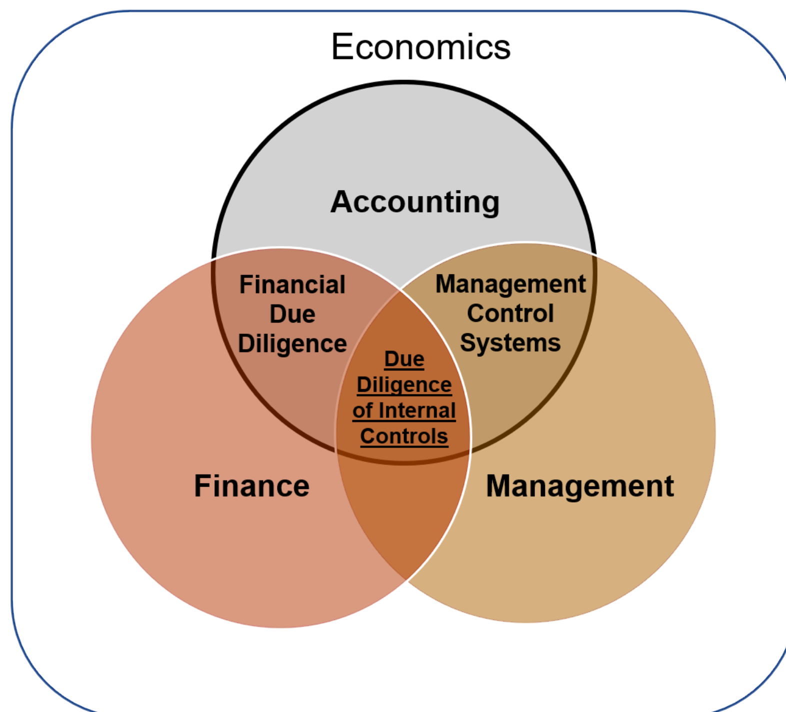

Figure 1: Visualization of the field of the study (by the author)

1.2 The research idea and questions

The extensive risks related to mergers and acquisitions (M&A) are well-researched and documented (e.g., Perry & Herd, 2004; Alkaraan & Northcott, 2007; Morrison et al., 2008; Woodlock, 2008; Skaife & Wangerin, 2013; Alkaraan, 2019; Wangerin, 2019; Bhabra et al., 2021). Also, the number and monetary value of M&A deals are higher than ever and still trending up (IMAA Institute, 2021). This development has been increasing the need for a more meticulous due diligence process to ensure that M&A deals can be value-adding.

Missteps can be costly and sometimes even fatal for the acquiring company (e.g., Perry and Herd, 2004; Skaife and Wangerin, 2013; Alkaraan, 2019).

In the early 1990s, there were already foreseen challenges (Jensen, 1993) where internal control systems failed to deal effectively with the fast-changing landscape. When moved to the late 1990s "dot-com bubble," there was a recognized need for regulation to ensure the transparency of internal control systems for publicly listed companies. This was to protect, firstly, individual investors and, secondly, the shareholders of companies engaging in M&A deals as buyers. At least minor shareholders often have close to zero influence on these transactions, as usually, the company's management makes the deals behind closed doors with the board of directors' approval. The most public corporate and accounting scandals of Enron and WorldCom accelerated the development of legislation. This legislation in the U.S. came in as the Sarbanes-Oxley Act of 2002 (also known as the Corporate and Auditing Accountability, Responsibility, and Transparency Act, or SOX). There have been many studies (e.g., Rice & Weber, 2012; Ge et al., 2017) regarding the implications, costs, and benefits of this legislation. These studies will be referred to more closely later in this thesis.

Following the footsteps of U.S authorities, there has been similar legislation implemented in several European countries (e.g., France 2003, Italy 2005). Yet, some countries (e.g., Germany, Netherlands, and Finland) have left this regulation of internal controls to the financial supervision authorities and the operators of stock exchanges in the form of Corporate Governance Codes. Regional events shape and forge these two fundamentally different approaches to regulation. This path dependence has a long-lasting effect on companies and their chosen corporate governance practices. These differences between "bundles" in procedures, their interrelations, and their link to performance have also been well studied (Aguilera et al., 2008; García-Castro et al., 2013). These studies have also shown that global markets have shaped the different approaches more towards each other.

Many studies (e.g., Alkaraan, 2019; Alkaraan & Northcott, 2007; Jensen, 1993; Morrison et al., 2008; Perry & Herd, 2004; Woodlock, 2008) were made regarding pre-decision controls of the acquiring company. These controls are created to prevent unprofitable and unnecessarily risky M&A transactions caused by management myopia and short-terminist behavior. Still, there seems to be a knowledge gap in focusing on the controls

of the target company. This thesis tries to fill at least a part of this gap. Like the studies mentioned above, this thesis will also focus on publicly listed limited liability companies, as minimal information is available from private companies. Different characteristics between the private and public firms and M&A objectives are illustrated in Appendix 1.

The research questions of this thesis can be formed as follows: How in-depth are these internal control systems examined during the transaction, and what factors influence their importance?

1.3 Achievable value from the study

The main objective of the thesis is to combine the information from the extensive research of M&A deals and internal control systems to find out: Does the “industry standard” due diligence process take the internal control systems into account? If it does, how are these systems evaluated? This information will be compared to empirical findings to determine how the theory matches reality.

Secondly, the objective is to extract some quantifiable evidence of the importance of internal controls from the most recent studies. To find out how they might affect the M&A success, achieved post-acquisition synergies, long-term value, and possible failings.

1.4 The central concepts

In this thesis, the key concepts are interpreted as follows:

The due diligence process is a process of “verification, investigation, or audit of a potential deal or investment opportunity to confirm all facts, financial information, and to verify anything else that was brought up during a M&A deal or investment process.” (Alkaraan, 2019, *p. 100*).

Internal Control is a process “effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.” (COSO, 2013, *p. 4*).

Internal Audit is the process by a management-independent entity where the company’s internal controls (e.g., corporate governance, accounting processes) are evaluated, and the findings are reported to the board of directors.

Mergers and acquisitions generally refer to a process where two or more companies merge into one via a business transaction or a single company acquires entirely or partly another company. Broadly M&A transactions can be divided into financial (buy-to-sell) and strategic (buy-to-keep) transactions (Appendix 1).

1.5 The chosen method of research

The method for the research of this descriptive-style (Vaivio, 2008) thesis is to collect qualitative information from the most recent studies close to the research question. There will be no quantitative information gathered as it would be too time-consuming regarding the scope of the thesis and available timeframe. Some quantitative data is available, at least regarding post-acquisition performance. This data will emphasize the topic's importance and make it easier to put into context. One of these quantitative concepts is the "internal control index" constructed by Chen et al. (2017), which will be discussed more thoroughly. To complement this theoretical knowledge, this thesis includes findings from interviews with four distinguished professionals from internal auditing, private equity, and management consultancy related to business transactions. This approach was chosen by the availability of information on the subject and the method of abductive reasoning is described more thoroughly in Chapter 3 of this thesis.

1.6 The construction

In chapter 2, the fundamental concept of internal control and the current state of internal control-related regulation is explained. This is to get a better understanding of what is the purpose of them and what are the most common frameworks of these systems. The second key concept is the underlying framework of M&A transactions. This is demonstrated by looking at the most recent theories of the due diligence process, which is conducted ahead of and during M&A transactions. Finally, after the transaction is complete, a post-deal assessment is usually made. Analysis of the studies made from post-deal assessments is included to link a quantifiable value to these transactions.

After establishing the foundation of critical concepts and the theoretical framework, Chapter 4 reflects on these academic findings against the gathered and analyzed empirical information. The objective is to understand how these theories manifest themselves in practice.

Finally, in Chapter 5, the implications and the possible contradicting observations are discussed. The thesis ends with a conclusion of what it has discovered and what could be the avenues for further research.

2 THEORETICAL FRAMEWORK

2.1 Framework review

The theoretical framework of this thesis is based on the current regulation and already established literature in the field. First, the thesis goes through the regulations that have been mainly evolving in the past 20 years and what kind of differences there are depending on the country of operations. Secondly, it goes through the most recent studies on M&A due diligence and how the changing landscape has affected it. Thirdly, the current state of internal controls is assessed. To summarize and end this chapter, the thesis discusses various interesting studies related to the subject. The findings and their general applicability are critically examined.

Even with this thesis's narrow subfield, it is good to point out that overall risk management in companies has become a popular topic in the past couple of decades. In their study, Soin & Collier (2013) pointed out that especially operational risks have come to the forefront. They point out three main drivers for this phenomenon: 1) increased interest in corporate governance, 2) regulation and 3) media amplification of scandals. These three drivers are most probably interrelated, as regulations (and self-regulation in applying corporate governance codes and rules within the company) can be seen as a reaction to a rising problem. In this thesis, the catalyst for the change is not in focus or thoroughly discussed.

2.1.1 How is the field currently regulated?

Different nations have decided to approach internal control regulation in two distinct ways that can be labeled as “hard law” or “soft law.” As North America is the most dominant capital market by size and activity (World Bank, 2020), the most influential “hard law” regulation can assume to be the Sarbanes-Oxley Act of 2002 (SOX). The significance of SOX has been recognized in many studies (e.g., Rice & Weber, 2012; Ge et al., 2017; Bhabra et al., 2021) and in corporate governance literature (e.g., Merchant & Van Der Stede, 2017). The

most relevant sections of this legislation regarding this thesis are Section 302: Disclosure controls and Section 404: Assessment of internal control.

Section 302 requires the management of US-listed companies to evaluate and ensure the effectiveness of the company's internal controls. This must be done within 90 days before the annual 10-K report, signed by the chief executive officer (CEO), the chief financial officer (CFO), and the external auditor.

Section 404 requires the management and external auditor to report the quality of the company's internal control on financial reporting. The section's requirements practically make the management responsible for establishing and maintaining adequate internal controls. These requirements are designed to prevent, assess, and detect material financial misstatements and fraud.

This primary legislation has been followed by a vast amount of guidance and requirements based on the interpretations of supervising and executing entities. In the U.S., many of these guidelines come from the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission (SEC). For example, PCAOB's Auditing Standards 2 (AS2) and 5 (AS5) determine requirements and guide internal controls' audit to fulfill SOX 404 requirements. On the other hand, SEC has interpreted companies to achieve effective internal control over financial reporting when internal control deficiencies do not rise to the level of "material weakness." In addition, SEC has two lower distinctions of weakness in "significant deficiency" and "control deficiency" (COSO, 2013).

In Europe, many countries have been following the tightening regulation in the U.S. and have been implementing similar rules. Yet not all countries have brought the regulation related to internal controls to the "hard laws" level. Examples of "soft laws" can be seen in the United Kingdom, Germany, Netherlands, and Finland. These "soft laws" are usually semi-regularly updated Corporate Governance Codes that overseeing institutions enforce. In these countries mentioned, the Corporate Governance Codes are structured in a generally similar way. Usually, the board of directors forms an Audit Committee, which oversees, supports, and challenges the operative management. Audit Committee can appoint a chief auditing executive (CAE) who organizes the internal audit function inside the company and reports to the committee. Disclosure of this information must be presented annually as a Corporate Governance Statement. This reporting is usually mandatory by law, but the details given in the Corporate Governance Code are provided on a "comply or explain" bases.

Some European countries have chosen arguably less flexible regulation in the form of "hard laws." For example, France introduced their Financial Security Law in 2003, and Italy introduced similar legislation in 2005. Overall, this development of tightening legislation can be seen as a global trend in the 2000s.

The development in regulation has also had its effects on rapidly growing Asian markets, especially China. According to studies (e.g., Chen et al., 2017), China did implement its equivalent of SOX 404 in 2012. Also, in 2013-2014 China Securities Regulatory Commission (CSRC) made several reforms successfully addressing the risks and information asymmetry regarding M&A transactions (Chen et al., 2022). To limit the boundaries of this thesis, Asian markets are left outside the scope of this thesis.

It is to be noted that this is a partial list of related legislation as there are significant differences between different regions, markets, and industries. For a more detailed view of the development of risk management, corporate governance, and internal control, please see the study from Spira & Page (2003).

2.1.2 Framework for M&A due diligence

Before the M&A transaction goes into the formal due diligence phase, the acquirer conducts preliminary due diligence (Skaife & Wangerin, 2013). During this preliminary due diligence, the acquirer uses significant effort to gather information about the target. From private target companies, this information gathering is usually more accessible as regulations do not limit the information sharing of target company management and directors. Public companies can only give out as much information once the confidentiality agreement is signed and negotiations for the acquisition agreement begin. When an acquisition agreement is signed and commitment to go forward with the deal has been established, transactional due diligence begins. Verifying the warranties and representations given by the target is one of the crucial phases of this transactional due diligence. This includes verifying operating performance and financial position (e.g., revenue recognition, valuation accruals, accounting estimates, etc.). If a breach of warranties is discovered, the deal can be terminated or renegotiated based on the contractual agreement.

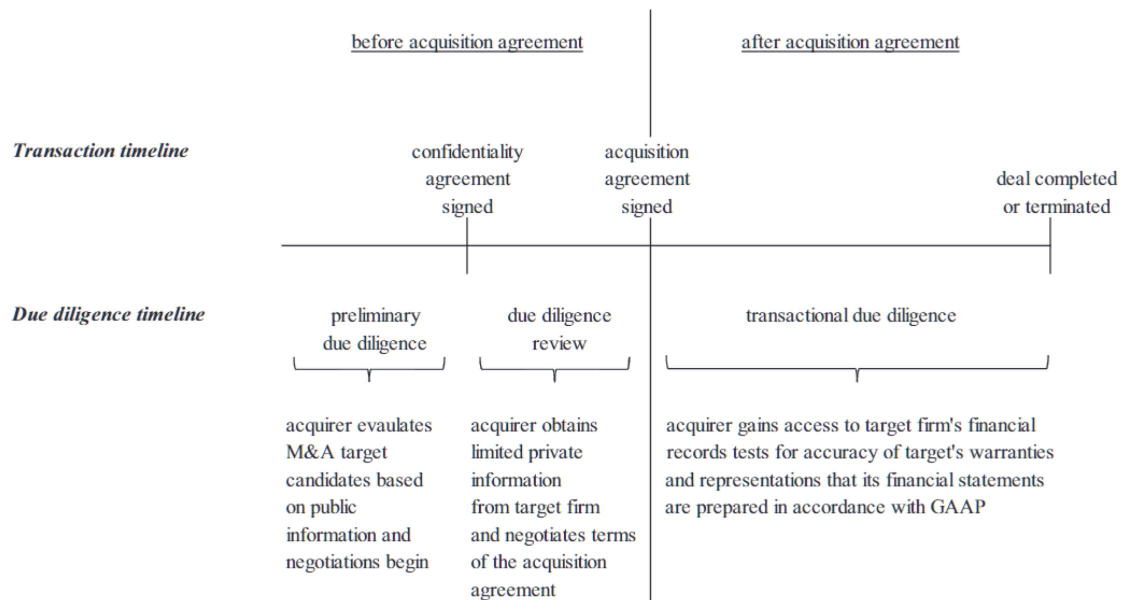

Figure 2: The M&A due diligence process (Skaife & Wangerin, 2013)

The due diligence process can usually be divided into four sections: 1) financial, 2) business, 3) legal, and 4) integrational and operational due diligence (Alkaraan, 2019). Financial due diligence focuses on revenues, expenses, assets, cash flows, vendor projections, and assumptions included in reporting. Business due diligence focuses on industry, strategy, key customers, product, sourcing, R&D and marketing, compensation, and management systems. Legal due diligence focuses on litigations, documents, contracts, accounting, and taxes. Integrational and operational due diligence focuses on synergies, cultural fit, the impact of acquisition, options, and other dilutive securities. In addition to this, depending on the characteristics of the target company, the due diligence process can include several different sections (e.g., sustainability, environmental, technology, etc.).

This thesis focuses primarily on financial due diligence, including future economic performance and current balance sheet estimation. To be noted, the line between different workflows in due diligence constantly overlaps. For example, the assessment of audited accounting information and internal controls is sometimes handled in legal due diligence. This thesis will also touch on business due diligence, as accounting information is inherently backward-looking and does not necessarily reveal all the necessary information to evaluate the firm and its future. Integrational and operational due diligence is left outside the scope of this thesis.

2.1.3 COSO – Integral Framework for Internal Controls

Since its first release in 1992, The internal control framework by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) has been globally accepted and widely referred to in business literature. Also, in this thesis COSO Framework is used as a supporting structure for assessing internal controls. This decision has been made based on the observation that COSO seems to be globally the most recognized framework in the regulations. To be noted, there are also other frameworks (e.g., ISO, COBIT) that have somewhat established standing in the field. The COSO Framework can be complemented with COSO ERM (enterprise risk management), but it has been left outside the scope of this thesis.

The COSO Framework is designed to provide reasonable assurance in achieving the set objectives by the entity that implements it. The Framework is not meant to be a fixed package. It is not to be implemented bluntly as a whole but dynamically tailored and based on the needs of the target organization. This need can vary by size, industry, legal structure, geolocation, and objectives (e.g., profit, non-profit, governmental). The Framework is trying to ensure integrity, transparency, and confidence in the quality of management to external stakeholders. Internally, for managers and the board of directors, the Framework provides means to apply internal controls and to interpret risks. With the Framework, management can build a principle-based structure that can be more easily communicated. It can also provide flexibility based on changing control environment (internally) and business environment (externally).

The Framework comprises five components: control environment, risk assessment, control activities, information and communication, and monitoring. It is divided into entity, division, operating unit, and function on the level of control. On overarching objectives, the Framework is divided into operations, reporting, and compliance. All these different perspectives are illustrated in the COSO Cube in Figure 2.

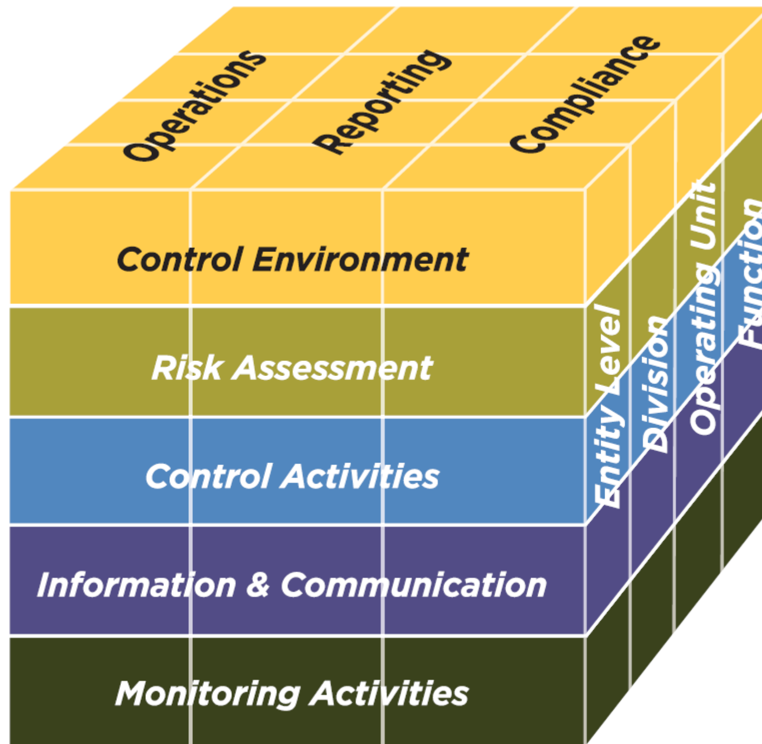

Figure 3: The COSO Cube (COSO, 2013)

The five components of COSO can be covered by seventeen principles outlined in the Frameworks documents. As it is not practical to list all of them in this thesis, it is encouraged to look for them from the executive summary of the Framework listed in the references. In implementing the Framework, all the principles are not necessarily required to be followed, but following them provides complete coverage of COSO components.

2.1.4 Internal Control Index

There have been attempts (Chen et al., 2017) to quantify the quality of internal controls in the form of an "internal control index." Even though their study is based on Chinese public companies, it can give a good indicator of what this kind of index could look like in western markets. This is mainly because it is based on the COSO Framework and SOX 404 requirements. An index of sorts can be helpful, as reporting on internal controls does not necessarily reveal much about their quality.

Chen et al. (2017) constructed their index based on the COSO Framework finetuned with the unique characteristic of the Chinese market. Their study included 99% of Shanghai and Shenzhen Stock Exchange companies. All first-level criteria of COSO were included and complemented with up to fourth-level sub-level criteria, totaling 216 specific criteria.

In this internal control index – in addition to the criteria mentioned above – external events are also considered. These events can negatively affect the company's overall rating, including regulatory penalties, exposure to violating accounting rules and laws, significant accidents, and product recalls. This information was gathered from annual and ad hoc statements, press releases, government documents, stock exchanges, and regulators' and companies' websites.

The model is based on the analytic hierarchy process (AHP), where the first step is to analyze the decision problem in-depth, extract relevant factors, and determine relations between them. Then factors are arranged in five hierarchies (top-to-bottom): overall objectives, sub-objectives, standards, sub-standards, and plan execution. The five overall objectives come directly from the COSO Framework. Same-level factors are compared and given a weight based on their relative importance. The final value of the internal control index is a weighted average of the values on the levels below based on adjustments from impact factors. These relations between the levels and different criteria are demonstrated in Appendix 2.

Interesting relation to the subject in this thesis is that in the internal control index by Chen et al. (2017), M&A activity was included as a criterion. This was justified by the increase in the likelihood of abnormal accruals in companies that have participated in M&A activity within three years prior. This criterion had a negative effect on the overall score.

2.2 Summary of other relevant literature

2.2.1 Importance of due diligence in M&A activities

Globalization, technological advances in information sharing, cross-border open capital markets, and for the last decade, low-interest rates have made capital more accessible to companies and investors. These can be assumed to influence the increase of M&A transactions and their value. As M&A can be a lucrative source for growth, they are also one of the riskiest investment types in terms of its relative size and complexity. This, in part, increases the importance of a meticulous due diligence process. *"The danger is not that*

companies fail to do due diligence, but that they fail to do it well." (Perry & Herd, 2004, *p. 12*). According to a consulting firm A.T. Kearney, half of all M&A activities fails to create lasting shareholder value. And two years after the closing of the deal, nearly 50% of the most significant mergers fail to produce greater total shareholder returns than the industry peers (Perry & Herd, 2004).

In a M&A transaction, the information is seldom distributed evenly. There usually is information asymmetry in favor of the vendor, and the buyer tries to use due diligence to narrow this information gap. Both parties typically try to capture the maximum value and margin for error in the transaction. This makes them tempted to downplay or outright hide the negative aspects and overstate the positives. Deliberate due diligence reduces the risks related to the transaction and eases the friction when negotiating transaction prices and other terms (Wangerin, 2019). It also works as a basis for litigations if a "material adverse event/change" (MAE/C) occurs after the final acquisition agreement has been made. In this case, representations or warranties of the acquiring agreement can be appealed. Careful due diligence can be used as a "diligence defense" supporting the buyer, but negligent due diligence can have the opposite effect. Less due diligence has been associated with lower-quality fair-value estimates of assets and liabilities, which can lead to a higher probability of goodwill impairments and post-acquisition profitability (Wangerin, 2019).

2.2.2 Importance of assessing internal controls in the due diligence process

After the M&A transaction, along with the company's assets and liabilities, internal control processes must also be integrated at some point. This can be for regulatory reasons as well as for long-lasting performance reasons. There might be a need to incorporate new controls into the acquired company's existing controls or establish new controls for the merged entity. Post-M&A, this can be delegated to an "integration team," which is responsible for planning for, testing, and documenting the effectiveness of internal controls (Woodlock, 2008). Assessment and planning should begin before the transaction's closing to make this post-M&A process more manageable and prevent unwanted surprises.

One example of tasks for the integration team could be assessing the strength of entity-level controls and their linkage to process-level controls. For example, suppose there are weak entity-level controls in the merged/acquired company on its payables. This can have an impact down the chain on management's assessment and external auditors' audit of internal controls, and finally, on the financial statement. If these entity-level controls are

deemed efficient to prevent or detect material misstatements and their linkage to the process level is direct, testing further controls can be reduced (Woodlock, 2008). This reduction of testing is limited outside the controls, which are considered central to the overall effectiveness of internal controls. Regarding the audit of internal control, low risk can be determined as *"inherent risk is low, low degree of complexity, there were no changes to the controls or processes since the previous audit, and the previous year's testing revealed no deficiencies."* (Woodlock, 2008, *p. 46*)

Studies regarding asset sales and the internal controls of the vendor have found that inefficient internal controls can lead to overinvestment. In their research, Hanson & Song (2006) argued that in this light, divestment could be seen as a positive for the owners of the vendor company. Selling unrelated assets or businesses may move assets to more profitable uses, make the company more focused, and undo failed acquisitions. From this observation, it can be concluded that the buyer of these assets may have a risk of acquiring some of these inefficient internal controls. This can be the case if the transaction is not purely an asset sale and includes the whole business unit.

Some studies (Skaife & Wangerin, 2013; Bhabra et al., 2021) have tried to pinpoint the link between the quality of targets' internal controls and the success of M&A transactions. In their study, Skaife & Wangerin (2013) studied almost 1,500 M&A transactions between 2002 and 2008, where the target was a publicly traded U.S.-based company. They did create a measure for low-quality financial reporting (LQFR) for public companies based on five factors: 1) the magnitude of discretionary accruals; 2) the likelihood of weakness in internal control; 3) off-balance sheet liabilities; 4) analyst forecast error; and 5) analyst forecast dispersion. A high score (in this context, lower is better) of LQFR did reflect the uncertainty of future earnings and cash flows. It also potentially increases operational risk, which increases the cost of capital.

LQFR was significantly higher with targets that ended up breaching warranties and termination of the deal. From the total number of deals, 14 percent did end up terminated, and LQFR did increase these terminations by 9 percent. Also, Skaife & Wangerin (2013) did find that LQFR was positively and significantly associated with paid premiums. They did speculate that this could result from the acquirer perceiving additional value available for extraction in high LQFR targets that the markets did not price correctly. In reflection on these findings, they could be seen as counterintuitive as lower-quality financial information

could be considered as higher risk. This increase in risk would lead to a larger required risk buffer and a lower acceptable price.

From the literature, we can conclude that recent studies have found internal control structures and SOX compliance as typical due diligence issues (Alkaraan, 2019). It is also stated (Skaife & Wangerin, 2013) that if an M&A deal is terminated by breaching warranties, it increases the likelihood of future financial restatements made by the target company. This is a result of weaknesses found during the transactional due diligence. It is in the hands of the target company management and auditor to determine the materiality of these weaknesses and report them. It was also found that among the terminated M&A transactions in the sample, the instance of restatement during the two previous years was almost doubled (15 percent vs. 8 percent) versus deals that went through. Skaife & Wangerin (2013) stated that failed statement of liabilities regarding contingencies, leases, and expense recognition is the single biggest reason for restatements. Improper asset valuation comes close second. Amel-Zadeh & Zhang (2015) also studied the consequences of financial restatements. Their study did show that firms with recently stated restatements are less-likely targets of a M&A transaction, the due diligence processes take longer, and deal multiples are lower.

Despite that increased regulation is targeted toward public companies, some research (Bhabra et al., 2021) has shown that it has had a broad ripple effect in private companies as well. In their research, Bhabra et al. (2021) did assess over 10,000 public-to-private M&A transactions in the U.S. from 1990-2015 around the 2002 implementation of SOX. Their findings were that after SOX where implemented, private companies have been increasing their efforts in better control and reporting to provide transparency. Traditionally "private firm discounts" have been around 15 to 30 percent due to information asymmetry and opaqueness. They suggested that this evolution of better control and reporting has resulted in the increased bargaining power of private companies and better premiums (from 47 percent to 67 percent by sales multiple). On the acquirer's side, it resulted in 1) higher prices paid by multiples and lower announcement returns, 2) an almost 70% larger target size based on assets, 3) an average time difference between the announcement and closing from 43 to 29 days, 4) lower investment on due diligence and audit fees paid. Also, acquirers may be tempted to announce the deal earlier in their fiscal year when they have more time to ensure the compliance of the newly acquired firms.

Still, it may be hard to prove the causality in this complex phenomenon. Bhabra et al. (2021) did point out in their research that cash-only deals had also increased from 36 percent to 54 percent during the sample period. The reason for this was not found in their study. Considering that they referred to multiple studies of lucrativeness to public firms to use equity when acquiring private firms, this development could be a sign of excess cash in the markets. A couple of alternative reasons for this public company regulation spreading to private companies could be that companies are prepping themselves to be acquired or by public pressure.

The requirement for sufficient information about internal controls is not limited to the participants in the M&A transaction. It has been shown that also investors create a demand for this information. In their study, Carnes et al. (2019) gathered information about U.S. companies, which used their right to exclude acquired businesses to some extent from their internal control audit and disclosure. Carnes et al. (2019) found that investors reacted negatively to these exclusions, and the reaction was in relation to the size of the acquisition. This demonstrates how investors and markets respond to rising uncertainty and how it reflects in the value of a public company.

During their creation of the internal control index, Chen et al. (2017) found that a high rating on the index seems to positively impact response to earnings surprises and perceived earnings quality. In their findings, the coefficient of their index and earnings management was significantly negative. This suggests that the high internal control quality – measured by the index – can effectively reduce earnings management and improve the quality of financial reporting. Their model also produced convincing evidence of improvement in internal controls in Chinese companies during the sample period from 2007 to 2010. Still, concluding the model's applicability to North American or European companies would require further research due to the unique characteristics of Chinese companies and the market.

3 METHOD

Based on the theoretical frameworks presented in Chapter 2, this study is carried through with an abductive approach. This approach can be seen as a combination of inductive and deductive approaches. The method was chosen based on the lack of previous studies on the selected thesis sub-field. The attempt was to use "systematic combining" introduced by Dubois & Gadde (2002) in their study on abductive research. In their method,

known theories are developed by matching theory and reality. Their model needed to be slightly modified, as, in its original form, the model also contains a case study. As a case study was not identified or anticipated to rise during the research for this thesis, the attempt was to move between the literature-based theoretical perspective and the interview-based empirical perspective. This back-and-forth movement has been identified as enabling a better understanding of both theoretical and empirical phenomena (Dubois & Gadde, 2002). Redirection or refocusing was a possibility in this thesis's first portion, as the chosen narrow sub-field was considered rarely studied. Without a specific case study, the approach was to look for a more comprehensive understanding of the subject. With this gained understanding, possible future theories or applications could be derived.

To be able to compare the theoretical perspective to the empirical one, the literature was complemented with observations from the field study. The field study was conducted by interviewing four professionals from various perspectives on internal controls and M&A transactions. These professionals were selected by their extensive knowledge of the subject, years of experience, and current activity in the field to ensure the most up-to-date information. All the interviewees were in a partner or a managing position of a well-established and respected organization with the area of operations in Nordics or globally. The interviewees were first contacted at the beginning of October 2022 without previous affiliation between the interviewer and interviewee. In the first email, a short introduction was made with a briefing of what the study aimed to accomplish. Also, a first draft of the Abstract was provided to the interviewees.

The structure of the interviews and questions were individually tailored and based on the interviewee's experience in a distinct sub-field of this thesis. This semi-structured method of gathering empirical information can be categorized as qualitative and no statistical methods were used. This was the preferred approach based on the recognized benefits of getting outside the textbook, economics, or consultancy view (Vaivio, 2008). The difficulties of finding the key people and asking the right questions were also considered. But based on the objective of gaining a broad understanding, this approach was deemed sufficient. General information and a summary of these interviews can be found in Appendix 3.

Despite the interviews being semi-structured, some questions did recur in all of them. These questions were: 1) In which parts of the due diligence process are internal controls discussed, 2) How are the audited accounting information and the processes behind them

verified, 3) What are the most common internal control-related "red flags" discovered during the due diligence, and 4) What are the most common post-deal control issues and could they have been prevented with due diligence.

4 EMPIRICAL RESEARCH

4.1 Research material

The empirical research material comprised interviews with four professionals. The chosen interviewees have more than 70 years of combined experience in the field of internal auditing, private equity, initial public offerings, and management consultancy related to business transactions.

Jani Heikkala (partner and co-founder at IA Insight) has over 20 years of experience in the field of internal controls, internal audit, and risk management. Before founding IA Insight in 2015, Heikkala has been in a managing position at KPMG, a private banker and CAE (chief audit executive) at Evli Bank, and CEO at IIA Finland (Institute of Internal Auditors). Heikkala provided valuable insights into this thesis, especially related to the internal audit process and how it could be considered in M&A transactions.

Pyry Vauramo (partner at Bain & Company) provided his learnings from over a decade of experience in the field of management consulting related to business transactions. His experience includes the development of businesses after the transaction, and in recent years, Vauramo has been advising private equity investors on financial M&A transactions. Vauramo has specialized in the technology field, which requires a vast knowledge of the development of technologies, trends in global markets, and how new markets can be approached.

Juha Peltola (managing partner at Vaaka Partners) offered his knowledge from the investor's point of view, with close to 20 years of experience at the helm of a private equity firm. During the time of Peltola, Vaaka Partners have invested in over 30 significant platform investments, which usually include multiple add-on investments within the holding period. For example, Peltola has been a partner in charge in Unisport – a Nordic market leader in sport facility surfaces and equipment. During the time of Vaaka Partners' ownership, Unisport has made seven add-on strategic investments.

Jaakko Eteläaho (managing director of Corporate Finance at Danske Bank) has nearly two decades of first-hand experience in business transactions and over a decade of directing the corporate finance functions at the most prominent investment banking players in Nordics. On top of strategic M&A transactions, Eteläaho has also participated in numerous initial public offerings and has knowledge of what kind of processes firms must master to be ready for listing to public markets.

4.2 Findings

4.2.1 How are internal controls being examined during due diligence?

Heikkala (IA Insight) explained that usually, the criteria for the assessment of internal controls come from the customer. The auditing of these controls will require that there is already some framework, either built or adapted, to begin with. In most M&A deals, the target companies are relatively small and usually do not have well-thought-out or documented internal control systems. This makes the in-depth assessment of these systems hard or in some cases even impossible. In the experience of Heikkala, most of the M&A-related internal control assessment projects where the expertise is bought from outside, are linked to the post-deal actions of the acquirer company. This would imply that internal controls are, in many cases, assessed only after the M&A transaction during the integration phase, which can be referred to as “post-deal due diligence.” At this point, it is usually required to integrate the acquired company into the existing internal control system or perhaps to plan and build additions to the existing preliminary system.

Heikkala (IA Insight) emphasized that the increased need for regular supervision and auditing internal controls usually arises from public listing and the increased size of the business. Usually, more robust and sufficient systems are built when a company gets closer to 200 million in annual revenues. Even in these cases in Finland, Heikkala saw that the systems might leave more to be desired. Companies often use outside consultancy to help build or audit their systems. Occasional differences emerge from the regulation of the business, the involvement of different stakeholders, the complexity of operations, and geographical diversification. During M&A, at least the companies not filling these descriptions have a strong likelihood of not having well defined internal control system in play. In the experience of Heikkala, in some cases, outside consultants are invited to help during M&A due diligence. Still, this is quite rare, as in many cases, there might be little to audit because of this underdevelopment of systems.

When asked about possible "red flags" of internal controls that could arise during the company assessment, Heikkala (IA Insight) pointed out that the most significant is whether the internal control functions exist at all. The most significant leap for a company is to build these functions in the first place. Usually, if there is a documented internal controls system, the company has already gone quite far. If there is no such system, then next to assess would be the accounting function and the external auditing statements for the company.

Vauramo (Bain&Co) disclosed that during the first contact with the target company's management, directors and owners, corporate governance-related matters are usually discussed. These discussions mainly include the decision-making processes and structure of the organization. The objective is to understand how robust and sustainable the system of critical decision-making in the target company is. Based on the experience of Vauramo, especially in the capital-intensive field, the processes and decision-making behind capital expenditures are scrutinized. Regarding the quality of accounting information and "quality of earnings," they are assessed by buyer-side financial due diligence professionals. At his point, the due diligence process is already relatively far underway. During financial due diligence, the buyer verifies recent accounting information, as it is not taken plainly as given.

Peltola (Vaaka Partners) gave his insights from a private equity firm's perspective and confirmed learnings from the interview with Vauramo (Bain&Co). These included that, in private equity investments, the sourcing phase of potential targets can take several years. After this initial phase, the official due diligence process starts, and it is usually at least partly outsourced. Peltola said that management systems are broadly assessed during due diligence. This broad assessment is justified when the target company's old management structure and corporate governance model will be replaced by the private equity firm's own validated framework for corporate governance. This is usually one of the necessary steps to develop the growing company to the next level.

Based on the observations by Eteläaho (Danske Bank), examining internal control-related matters during the due diligence process heavily depends on the individual target firm. On top of this, targets industry and countries they are based or operate in make a huge difference in prioritization in due diligence. For example, in a merger of a large bank or insurance company, it is more than necessary that there are specialists involved in assessing the risks and possible compliance issues. Corporate finance professionals have some lists of required steps to evaluate overall risks in the transactions, but they do not go nearly as deep as individual controls. For example, Eteläaho recognized an elevated need for examining

pension liabilities and insurance contracts in Southern European companies. Another observation was that sometimes management structures can get unusually complex and contain hidden risks during the transaction. Deciding power, control, and rights – especially in subsidiaries – can get complicated, even though it seems straightforward on paper. Evaluation of these items requires more resources to reach a reasonable assurance. In some cases, these kinds of issues have terminated the deal.

> *"Some companies make surprises [with results] continuously to the positive or negative direction… Often, we try to get a grip of – sometimes together with third-party auditing firms – that, is the problem with the unpredictability of the business itself or is the process [inside the company] so bad that it does not enable it [predictability]… The process is usually easier to fix."*
>
> *(Jaakko Eteläaho, managing director of Corporate Finance at Danske Bank)*

This unpredictability of business that Eteläaho (Danske Bank) is referring to can be derived from outside-of-firm factors. These could be risks related to geo-political issues or country risk, dependency on globally used resources (e.g., energy, metals, etc.), or capital market-related risks like recessions. Even in a relatively stable consumer product market, discretionary spending is the first to react to economic uncertainty. These mentioned factors can be mitigated to some extent with financial planning and anticipation measures. If the reason for surprises in the business performance is within the company's processes, these can be affected more easily by the company itself. If the faulty process causing forecasting problems is not visible, one way to determine the problem is to observe other companies in the same industry. If there is a significant difference in predictability, the problem most probably arises from within.

Based on the interviews, the answer to the question in the headline could be condensed in that usually, the direct examination of internal controls is not a high priority during the due diligence. Especially when the target company is private and still in the early years of its lifecycle. Based on the interviews, internal controls are thoroughly examined only when a particular need for this arises. An example of this could be industry-related reasons (e.g., compliance, regulation) or company-related (e.g., complex organization structure, hard-to-evaluate assets). Some internal controls are indirectly examined despite these unique needs. These are usually related to essential corporate governance, management, and decisions making. They are effectively discussed, but not as much the control function in mind, but the quality of the management.

4.2.2 Costs and benefits of examining internal controls during M&A transaction

By Heikkala's (IA Insight) observations, it is uncommon for due diligence to get as deep into the company that systems would be assessed on the control level. This is because of the limited time and resources in hand. If this assessment is done at some point, it may happen during the financial due diligence and the due diligence related to accounting information. Heikkala saw that there could be benefits from the collaboration of internal control specialists and corporate finance teams. These benefits could be pre-decision predictions of post-deal risk management and possible integration difficulties. Heikkala pointed out that even listed companies often do not have dedicated internal control functions and require consultation from external specialists. Heikkala has observed some challenges that arise during the integration phase.

> *"When the smaller [company] gets acquired, the governance [of the smaller company] in general may not have been on par. The reports may have a long delay, or the reporting systems are not insufficient... Sometimes the integration of [internal control] systems is ignored, and the organization ends up having several parallel systems. This makes it possible that mistakes may happen or from the point of view of management, the information flows too slowly."*
>
> *(Jani Heikkala, partner and co-founder at IA Insight)*

When inquired about commonly found problems, Vauramo (Bain&Co) was aware of several cases where after a year of the transaction, the ex-post EBITDA had been lower than the adjusted EBITDA estimated in the due diligence valuation phase. Vauramo pointed out that it can be hard to say if this kind of variation resulted in the vendor knowingly providing smoothed information or the assumptions made about the future being too optimistic. There also could have been changes in the external factors during the transaction process. He felt that the industry of business transactions has been developing to a point where most of these post-deal obstacles are already prevented with meticulous due diligence. Vauramo pointed out that even if the professionals involved in financial due diligence do not assess the controls of accounting information, they effectively make sure of them as questioning the accuracy of that information. Peltola also confirmed this by saying:

> *"One function of financial due diligence is to go through the historical numbers [audited accounting information]. It is exactly the bread and butter."*
>
> *(Juha Peltola, managing partner at Vaaka Partners)*

These commonly found problems were also discussed with Eteläaho (Danske Bank). He gave a general overview of one case where they needed to go very deep into evaluating certain balance sheet items that were crucial when valuing the whole company. It was found necessary to track down who makes the initial evaluation, how is the basis of the evaluation contested, and how it moves forward through the management to the board of directors. In this case, it was necessary to go through the steps together with the internal auditors of the firm. This is the only finding during this study where entity-level processes were studied ferociously. Eteläaho elaborated that with public companies, there is a kind of a "chicken or egg" problem where the company does not want to let anyone get this deep into their processes. At least not until the transaction agreement is signed. On the other hand, the buyer may not sign the agreement until the information is released.

In the interview with Peltola (Vaaka Partners), he pointed out that private equity firms' financial M&A targets are usually relatively early in their corporate lifecycle. This makes it so that their management and internal control systems are yet formed. At that point, the development of internal control systems is too burdensome, and the development of the business takes a higher priority. Building processes to gather information to enable knowledge-based management is usually necessary, and private equity investors are prepared to start this building from scratch. Peltola saw that inconsistencies in accounting information typically stem more from ignorance, not fraudulent behavior. Overall, the due diligence process also requires much work from the vendor side, and many prioritizations must be made. Peltola highlighted that the due diligence process is crucial to M&A transactions. Still, especially in financial M&A, the due diligence process must not negatively interfere with the primary business operations of the target company.

> *"There must be made prioritization [in the due diligence process]. Otherwise, we end up suffocating the [target] company during the transaction, and that is not a good thing. Already now, I do not remember a transaction process where the [target] company has not felt that this is totally too much. It is just the reality. If we measure some target, and it ends up dying during the process, it is not really a good thing."*
>
> *(Juha Peltola, managing partner at Vaaka Partners)*

Continuing this topic with Eteläaho (Danske Bank), he saw that there is undoubtedly a possibility to achieve benefits from examining internal control. Still, if there is a reasonable assurance that the processes inside the target company are up and running, there is plenty

of other things to work on and evaluate. It isn't easy to find value added in a more scrutinous examination of internal controls that would go beyond these other items in due diligence.

In discussions about regulations, Eteläaho (Danske Bank) saw that regarding public companies, it might be even easier to build internal control structures and reporting practices when there is regulation. The corporate governance code creates an elementary framework that shifts the initiative of taking specific actions away from the company. It may force the companies and limit decisions, but at least companies do not have to start from scratch. After meeting the requirements of listing to the public market, sometimes it is hard for the company to stay on top of those requirements. This probably follows from the costs of keeping these systems up and running. Sometimes it is too much even for smaller listed companies like Peltola (Vaaka Partners) also pointed out.

Eteläaho (Danske Bank) recognized a "trickle-down" effect of improvement in internal controls and compliance within private companies. Even though no binding regulations to force all companies, this can be seen as a reflection of market requirements that force private companies to implement better systems. Eteläaho saw this as a similar phenomenon as private companies either applying IFRS accounting standards or making a second set of reports with IFRS. Some companies end up in this arrangement to be able to show IFRS numbers to a possible buyer or other stakeholders. These can make the transaction process smoother and can be speculated even to provide better premiums for vendors. This arrangement can increase the pricing power of the vendor. In some cases, there could be several buyers to begin with, compared to perhaps just a couple or only one buyer when these additional requirements are not fulfilled.

> *"Otherwise – that many may think – to the vendor of the company, it is beneficial to put those systems [controls, governance, compliance, etc.] in order even if all the data would not be made public. Because if it is asked about, you can show "this is how it is handled"... If something is to be desired, it would be that companies would think ahead and prepare for possible due diligence. And it starts from that the [initial] processes are in order.*
>
> *(Jaakko Eteläaho, managing director of Corporate Finance at Danske Bank)*

To summarize the cost and benefits of examining internal controls during M&A due diligence, the general stance was clear that it is hard to find added value from a more rigorous evaluation of internal controls. The underlying financial incentives of avoiding risks, over-optimistic assessment of future performance, and cost savings seem sufficient to

steer the due diligence process. When certain risks or characteristics are detected, they may guide efforts and resources toward internal controls, compliance issues, or corporate governance. In most cases, the principle of "trust, but verify" can be seen as providing reasonable assurance, and the detailed level of controls is not necessary to evaluate.

5 DISCUSSION AND CONCLUSIONS

5.1 Implications of findings

Pre-M&A, depending on the ownership structure, the vendors' motivation should be considered carefully. A study by Hanson & Song (2006) did show that low managerial ownership can lead to overinvestment and "empire building." This can lead to poor performance and, eventually, divestments. This managerial behavior can also be linked to inefficient internal controls. When being on the opposite side of the divestment transaction of these businesses, the buyer must be aware of possible ineffective controls included in the business for sale.

One difficulty in assessing post-M&A performance is the length of the feedback cycle after the deal. Performance can be evaluated only several years after the deal; even then, it may be hard to pinpoint the reason for the success or failure objectively. A possibility of reverse causality is also making this hard to estimate. The due diligence process should be well documented for the most accurate evaluation. This could let us see what observations, assumptions, and predictions were made regarding internal controls. Also, what was the assigned value-at-risk linked to the possible control-related risks, and what was their likelihood. There must be sufficient documentation of how much resources were allocated to integrating, building, and documenting internal controls post-deal and what was finally required.

It is good to notice that regulations of more thorough reporting will require labor and increase costs (Ge et al., 2017). This can be an overwhelming burden for smaller companies, businesses early in their life cycle, and entrepreneurs. The literature has pointed out that searching for better protection of shareholders through better control, auditing, and disclosure can diminish risk-taking and flexibility (Aguilera et al., 2008). Regulators have recognized these adverse effects; for example, SOX has had additions to exempt smaller public companies from its requirements. Some countries with corporate governance codes have been creating "lite" versions of public listing – for example, in Nasdaq First North

Growth Market in Finland – which lessens the burden of requirements and decreases overall costs related to public listing. It also lowers the barrier to getting a public listing. It has been pointed out (Aguilera et al., 2008) that this more flexible "soft law" could explain the increasing number of firms preferring listing in London rather than in New York.

The negative sides of increasing regulation were discussed in all the interviews during this thesis. All the interviewees saw that "soft law" in the form of codes, guidelines, and principles is preferred instead of "hard law" forced regulation as it provides some flexibility. There was skepticism towards hard-coded requirements, as they might not be beneficial considering the overall economy. This might also lead to companies painting a slicked version of themselves without in reality changing their behavior. This preference for "soft laws" seems logical as it is closer to self-regulation. For example, the working group behind the Finnish Corporate Governance Code consists of directors and professionals from large Finnish companies and private institutions representing the Finnish business field. In support of this logic, there have been some studies (Renders et al., 2010) with findings of corporate governance ratings being a higher and stronger link to the performance in a "soft law" environment. Based on these findings, the market's "invisible hand" could be superior to regulators' judgment.

The "trickle-down" effect of regulation to even companies not forced to follow it was discussed with all the interviewees. With more expertise in public companies, Eteläaho (Danske Bank) recognized this trend and saw it as a positive. In the summary of the literature review (Chapter 2), the study by Bhabra (2021) did find that this "trickle-down" effect could have had a significant impact on the evaluation of private M&A targets. This study was discussed with the interviewees, and both interviewed private equity professionals – Vauramo (Bain&Co) and Peltola (Vaaka Partners) – did present their skepticism towards this claim. They saw that increased capital and competition in acquiring companies may have had a more prominent effect on M&A pricing. With exceptionally low-interest rates in the past, this theory of excess capital seems plausible. Still, this relationship needs to be left for future studies to confirm.

5.2 Conclusions - The current state of due diligence on internal controls

> *"The problems with corporate internal control systems start with the board of directors. The board, at the apex of the internal control system, has the final responsibility for the functioning of the firm."*
>
> *(Michael Jensen, 1993, p. 862)*

Reflecting on this almost 30-year-old observation by Jensen, it can be concluded, that since then, the regulation has taken a giant leap in the right direction. In the quote, Jensen refers to the controls of acquiring party and the value-destroying investing by M&A. But it can be safely stated, that robust internal control systems widely implemented within companies reduce risks. Requiring good structuring and reporting of these systems from the board of directors establishes a clear responsibility. It is easy to agree with Jensen that, in the end, inadequate systems or rules are the reasons for failure within the company, not bad people.

In the internal control-related assessments in M&A due diligence, the first thing to search for is an internal control system built in the first place. The second is to evaluate the robustness of this system. As in every human-made and human-operated system, there are limitations. For example, in COSO Framework, there are recognized limitations that a perfect internal control system does not exist due to the complexity of corporate governance (Mikes & Kaplan, 2014). There are still avenues for the management to override or circumvent some controls. Implementing the system and working under it involves human judgment and subjectivity. And all the external events can't be controlled. But even if the internal control system does not provide certainty, it can provide a system where some of these adverse events are prevented or discovered as early as possible to be mitigated.

In research on corporate governance (Aguilera et al., 2008), it has been stated that the creation of controls in the modern business environment is also getting increasingly complex. In their framework for corporate governance, they indicated that the interdependency and the complementary nature of control practices must be considered. Aguilera et al. (2008) speculated that cases like Enron are a domino effect of inadequate controls and incentives inside the company. They saw that a single disruption had a negative reinforcing effect where auditors and directors were all co-opted by managers, which led to the total failure of the system of corporate control.

This study managed to gather and combine theoretical information and empirical observations from a narrow M&A due diligence process sub-field. The study can be seen verifying that there is a knowledge gap in how the internal controls of the target company are assessed during the due diligence process. But it also provides a convincing explanation of why this knowledge gap exists, as the scrutinous due diligence process has many perspectives with higher priority. The simple answer to the research question is that internal controls are not assessed in depth during the due diligence, at least not in their sense. Certain aspects (e.g., complexity, industry, regulation) justify a more thorough assessment, and these aspects have been discussed more in-depth in Chapter 4. Based on the findings of this study, it is hard to universally justify a significant addition of effort and resources to the due diligence of internal controls of the target company. At this point, there is limited added value available to gain from it.

5.3 Limitations of this thesis

This thesis still has limitations, as it had most of its empirical findings from the perspective of private companies and their M&A transactions (Appendix 1; towards the upper-left corner). As regulations towards internal controls usually bind only public companies, the findings did not provide a comprehensive view of how internal controls are evaluated in public M&A transactions. One reason for this limitation is that majority of overall M&A transactions are private. The challenge is that while private companies can release more information, they do not usually have well-structured internal control systems. On the other hand, public companies have these systems but cannot release as much information. To be able to gather relevant observations regarding public transactions, this thesis should have required access to several public firms. Insights from relatively recent public M&A transactions would probably be impossible to collect due to the secrecy of this information. Public transactions being far and few, it would have also required extensive interviewing of several people, perhaps from a global investment bank. Usually, these large transactions can be almost once in a lifetime for an individual professional. When including the fact that these large transactions are very different case-by-case and the corporate governance landscape is fast evolving, research in this subject is not an easy task.

5.4 The avenues for further research

Based on the limitations of this thesis, one attractive avenue could be a targeted study of the mergers of large companies in the financial industry. This study has revealed that the evaluation of internal controls can be seen concentrated in this kind of transaction. Even this kind of future study would not directly apply to assessing the emphasis on internal controls in M&A due diligence in all industries.

In addition to overall corporate governance rating systems (Renders et al., 2010), the internal control index by Chen et al. (2017) could provide a cost-efficient tool and addition to the current due diligence processes. In the interview with Heikkala (IA Insight), he saw this kind of quantitative measure for internal controls as intriguing. Still, the level of detail in internal control reporting would require SOX-level regulations. Heikkala felt that, at least in Finland, the reporting is usually still far away from the level needed for this kind of measure. The applicability of the internal control index by Chen et al. (2017) could be validated by further research outside the sample of Chinese public companies in the original study. Changing landscape in technology and regulation would also require a frequent reassessment of the measure. When asking the interviewees for an opinion on this kind of measurement tool for corporate governance, they saw that it could be the natural continuum for ESG-measuring. Eteläaho (Danske Bank) also saw possible benefits acquired from this kind of rating but did not see it plausible to be implemented in the near future. He pointed out that at least the trust built towards this kind of measurement would take years or not even tens of years. Even in this case, M&A due diligence would need to verify the information behind the inputs that are entered into the index calculation.

> *"Regarding ESG, the E-component has been greatly highlighted during recent years. S-component has been in second place and G-component in third... I can easily see that in the future, there will be a need for evaluating it [corporate governance], especially in certain fields of business."*
>
> *(Pyry Vauramo, partner at Bain & Company)*

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Interviews

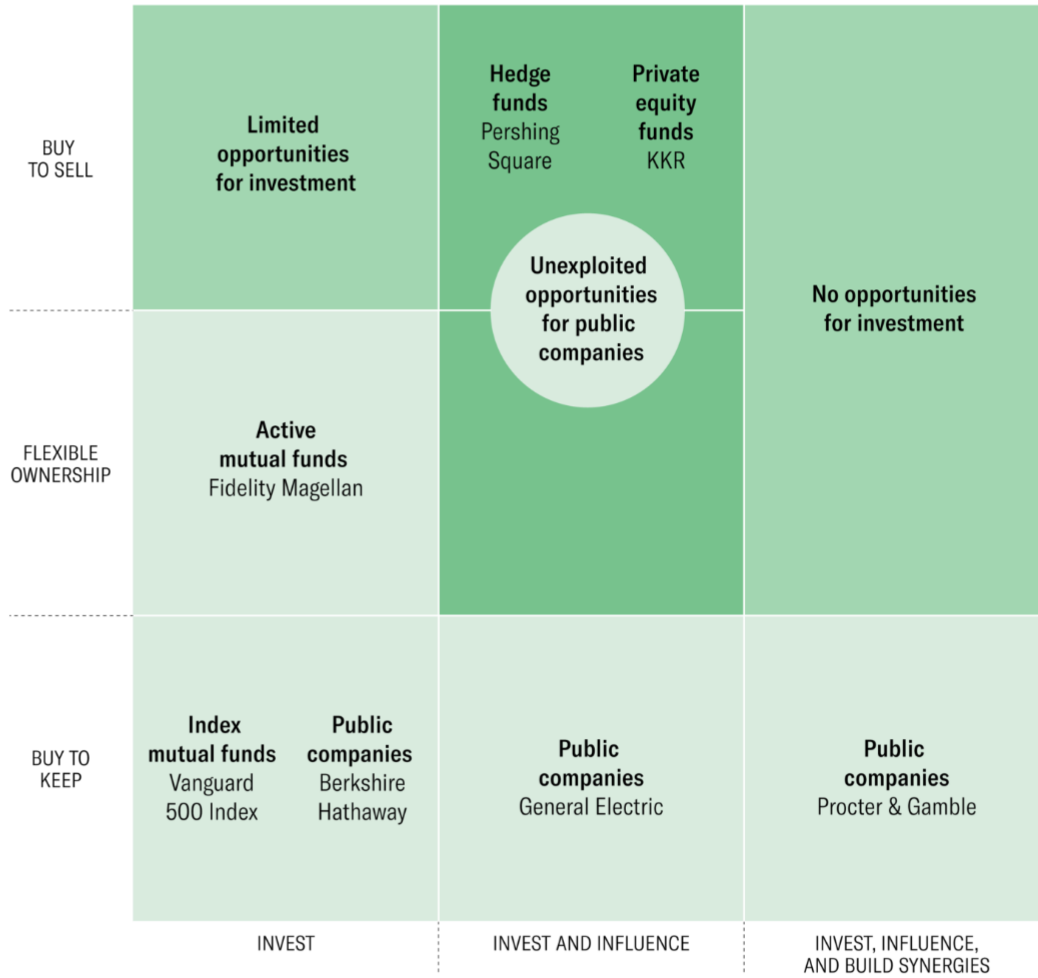
Jani Heikkala, Partner, IA Insight, 12.10.2022

Pyry Vauramo, Partner, Bain & Company, 27.10.2022

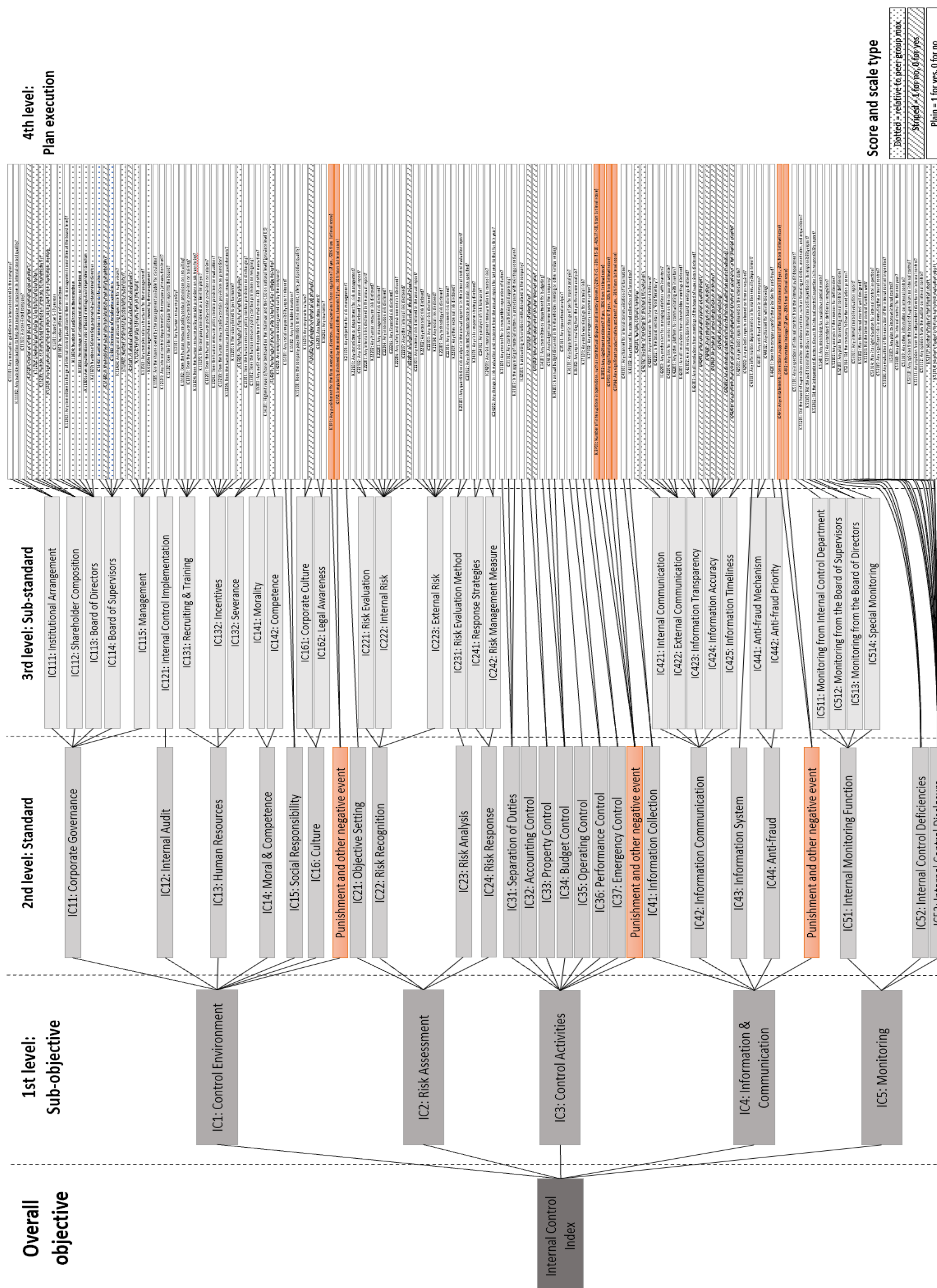
Juha Peltola, Managing Partner, Vaaka Partners, 27.10.2022

Jaakko Eteläaho, Managing Director, Danske Bank, 2.11.2022

APPENDIX 1: Mapping potential portfolio strategies by Barber & Goold (2007)



APPENDIX 2: Internal Control Evaluation System by Chen et al. (2017)



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APPENDIX 3: Summary of interviews included in the field study

Interviewee	Title	Company	Date	Location	Duration	Recorded*	The main findings
Jani Heikkala	Partner & Co-founder	IA Insight	12/10/2022	Online	60min	Yes	Usually, companies build specific internal control systems when annual revenues are getting closer to 200 million euros. The direct examination of internal controls during due diligence seems rare. The post-deal audit is more common, but some of the integration problems could be prevented by due diligence on the internal controls of the target company.
Pyry Vauramo	Partner	Bain & Company	27/10/2022	Online	60min	Yes	In the field of private equity, the buyer is usually most interested in the business outlook of the target company. To support this evaluation, the structures of decision-making and management are examined. Financial information and especially the quality of earnings will be examined.
Juha Peltola	Managing Partner	Vaaka Partners	27/10/2022	Online	30min	Yes	Private equity firms usually outsource at least some part of the due diligence process and focus mainly on the development of the business in the target company. Usually, the target company is still early in its lifecycle and the private equity firm is prepared to develop or install their validated corporate governance model into it.
Jaakko Eteläaho	Managing Director of Corporate Finance	Danske Bank	02/11/2022	at Danske Bank	60min	Yes	The company-specific characteristics steer the due diligence process. These include the complexity of organization structure, industry requirements, discretionary accruals, hard-to-evaluate assets, regulation, and compliance. Without a particular need for verifications, entity-level controls are not usually included in the due diligence.

*With every interviewee, the recording was agreed to be destroyed after the thesis is finished