



Abstract: Conducting thorough due diligence has always been an essential part of any successful M&A transaction. But it has become even more so now that Sarbanes-Oxley has raised the stakes for financial reporting. This article highlights areas that merit special attention — including controls and procedures, and independent audit committees — if companies want to increase the odds of their merger succeeding in a post-Sarbanes-Oxley world.

Sarbanes-Oxley raises stakes for companies considering M&As

Enron. WorldCom. Tyco. Once names of market-leading companies, they're now commonly used as one-word synonyms for accounting fraud.

Fears that similar financial disasters loomed helped lead to passage of the Sarbanes-Oxley Act of 2002. This major accounting-reform legislation has had a huge impact on nearly every facet of corporate financial reporting. Although the act's primary focus is on publicly traded companies, its provisions should be of concern to any business — public or private — that's considering a merger or acquisition.

Conducting thorough due diligence has always been an essential part of any successful M&A transaction. It has become even more so in a post-Sarbanes-Oxley world, since reporting requirements have become much stricter.

In addition to all the other items on your due diligence checklist, now you'll need to evaluate compliance with the new accounting rules. Overlooking areas of noncompliance could mean you inherit a variety of problems — problems that lead to serious consequences, or even criminal penalties, for your business.

Several areas merit particular attention while performing due diligence.

Controls and procedures

Under Sarbanes-Oxley, officers of public companies must have controls and procedures in place to ensure regular and accurate disclosure of financial information. Officers are personally responsible — and even criminally liable — for any intentional and material misstatements of fact.

This requirement raises the stakes of due diligence because you'll need to evaluate whether the target has accurately reported past financial results and whether it has implemented the necessary controls to ensure accurate financial reporting in the future.

If your potential target is a publicly traded company, it should already have these controls in place. Your due diligence should evaluate whether the controls are working.

One important question to ask: Are the controls clearly defined? A good control system will be written, followed to the letter and viewed by employees as an essential part of their daily routine.

A lack of controls should warn you about potential inaccuracies — intentional or not — in the company’s financial reports. Such questions should eventually lead to more thorough due diligence, assuming you still believe the deal is attractive. In particular, evaluate how much effort and expense will be required to get proper procedures in place before the next set of required financial reports.

Even if the target is private and therefore not subject to the strict reporting requirements of Sarbanes-Oxley, it’s still a good idea to determine what is needed to make its reporting system compliant. You never know if your company, once merged, may be acquired by a publicly traded business, or if the law’s requirements will eventually be expanded to include private companies.

Audit committees

Sarbanes-Oxley requires public companies to establish independent audit committees to appoint the company’s auditors. Members of the audit committee must consist of “unaffiliated persons,” meaning they cannot receive any compensation from the company facing the audit. (Board members may, however, receive their regular per-service payments.)

In your due diligence, make sure the potential target has the proper committee in place and that its members satisfy the independence requirement. Investigate each member of the committee carefully, scrutinizing their backgrounds to ensure independence as well as their potential to bring about a thorough and accurate audit, as opposed to serving as a rubber stamp.

Financial reporting

Another area to scrutinize is a business’s documented and undocumented financial arrangements. This is particularly important when a public company seeks to acquire a private company, as the target may not have changed its accounting methods in response to Sarbanes-Oxley.

In particular, investigate whether the company has engaged in any “off-balance sheet” arrangements. Sarbanes-Oxley requires companies to disclose all transactions with a material impact on financial results.

In your due diligence, you should request descriptions of every off-balance sheet arrangement, including its nature and business purpose, and copies of relevant documents.