Transactional Law

When firm makes acquisitions, wear SOX during due diligence

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Things are looking up for the acquisition market in 2005. A continuing increase in the number of acquisitions being consummated in the last two years, together with ripe conditions at present, make the outlook for 2005 promising.


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What are some of the factors driving the current deal market?

First, interest rates are particularly favorable at present, even considering recent rate increases.

Second, as the economy continues to recover, private equity groups have found themselves with an abundance of cash available for acquisitions and are ready to utilize those assets now that the market has improved. The role of private equity has been increasing over the past year, and private equity groups remain active in seeking out investment opportunities.

Third, corporate buyers have once again become active in the acquisition market, as pressure for growth has increased.

Notwithstanding favorable market conditions at present, prospective buyers in today's deal environment who plan to take advantage of such opportunities must be cautious when evaluating prospective target companies and determining their value.

An increase in corporate skepticism caused by the rash of corporate scandals in recent years has made some buyers reluctant to acquire companies, and understandably so. However, a buyer who makes the effort to get to know what it is buying can still capitalize on today's hot market.

DUE DILIGENCE

As Warren Buffet has said, a person should never invest in a business he cannot understand. And proper due diligence is an integral part of understanding a business.

For a buyer, the primary purpose of due diligence is risk management, which covers a wide spectrum of issues such as litigation liability, potential environmental liability and the accuracy of financial information. Due diligence plays an important role in helping a prospective buyer understand the risks involved with acquiring any company; however, for public companies and prospective buyers of public companies, special considerations apply.

The benefits of being a public company include better accessibility to capital markets, greater liquidity and attractive acquisition possibilities, among others. However, there are also substantial burdens that come with being a public company. And in recent years, the Sarbanes-Oxley Act of 2002, or SOX, has added significant new obligations and provided for stiff penalties on public companies that do not comply.

SOX applies to all companies traded on United States stock exchanges. SOX implements significant reporting and disclosure requirements on such companies, perhaps most notably by imposing stringent and burdensome requirements relating to financial statements and internal controls.

SOX requires that certain company executives personally attest to their company's financial statements, a requirement which ensures that the financial management of each public company is not only aware of the company's financial reporting, but has reviewed and personally stands behind such reporting.

Companies falling under SOX will very likely have to spend much of their compliance budget on satisfying the internal control requirements it imposes. Those requirements apply to a variety of aspects of a company's business that affect financial reports. Company executives are required to attest in writing that such internal controls have been examined and are effective.

By reason of SOX compliance alone, the risks involved with acquiring a public company are significant and should be carefully considered by a prospective buyer.

The burdens of SOX compliance should also be carefully considered by public companies seeking to buy private companies. While SOX is not directly applicable to private companies, public companies are spending significant amounts of time and money ensuring that the books and records

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of their private company target can be integrated quickly into the public company's financial accounting and internal controls system after the acquisition is made.

PRICING

Although capital is abundant at present, buyers have generally continued to be prudent in their pricing of target companies. Prospective buyers are well advised to do the same.

A savvy buyer in today's market should ensure that it does not rely too heavily on the presently favorable conditions when determining what the right price is to pay for a particular company. Most companies have been through difficult times before and very likely will again at some time in the future. To paraphrase Harry S. Truman, those who do not know their history are doomed to repeat it.

Because of a variety of factors, 2005 will likely be a good year for buyers seeking to grow their businesses through acquisitions and for investors seeking out new investment opportunities. It's a good time to take advantage of what the market has to offer. However, when evaluating opportunities for acquisition, prospective buyers should be sure to take a long, hard look at the companies that they plan to buy and exercise some restraint in pricing, in order to ensure that they will maximize the likelihood of a solid return on their investment and minimize the risks that come with making it. ■

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