

***THE IMPACT OF INTERNAL CONTROL REPORTING
ON
PUBLIC-PRIVATE MERGERS***

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The Sarbanes-Oxley Act of 2002 directly applies to SEC reporting public companies only, however, the Act's provisions concerning internal control reporting are likely to have a material impact on private companies that are active, or seeking to be active, in mergers and acquisitions. Private companies that compete with public companies for acquisitions will find themselves advantaged in many respects. Private companies looking to be acquired by public companies will need to consider upgrading their internal controls, including the identification and resolution of any material weaknesses that could negatively impact a future M&A transaction.

The Sarbanes-Oxley Act of 2002 – Internal Control Reporting

Pursuant to the mandate in Section 404 of the Sarbanes-Oxley Act, in June 2003, the SEC adopted a series of rules that, along with the related rules of the Public Company Accounting Oversight Board (PCAOB), require public companies to include in their annual reports filed with the SEC an internal control report that, among other things, sets forth management's assessment of the effectiveness of the company's internal control over financial reporting, including any material weaknesses identified by management. The company's auditor must also provide an attestation report on management's assessment. The larger U.S. public companies were required to begin complying with internal control reporting for their first fiscal year ending on or after November 15, 2004. The smaller US public companies and US listed foreign companies reporting to the SEC must begin to comply for their first fiscal year ending on or after July 15, 2006.¹

Impact of 404 Internal Control over Financial Reporting – Generally

The new internal control rules encompass processes and procedures to be established by management to maintain accurate records and prevent and promptly detect unauthorized dealings in the company's assets. The implementation of the required processes and procedures for the great majority of the public companies will require the assistance of outside consultants, typically PCAOB registered accounting firms acting in a non-audit capacity, and the documentary evidence required to support management's assessment will typically require significant processes, procedures and documentation in addition to what the well-managed public company has undertaken pre-404.

Most public companies are finding that 404 compliance requires months of planning and implementation, and that the costs of implementation range from several hundreds of thousands of dollars for the smaller and less complicated public companies to many millions of dollars for the larger companies. The ongoing costs of compliance are expected to be less, but still significant. In addition to the financial and human costs, the internal control reporting rules subject the public company to new compliance and disclosure risks. Management's failure to complete its internal control report for inclusion in its annual report on a timely basis may lead to a temporary disqualification from the use of certain SEC registration statements used to carry out employee stock plans (Form S-8) and a longer disqualification (up to 12 months) from the use of short form registration statements used to access the

¹ For a complete summary of the rules on internal control over financial reporting, please visit the SEC's web site at www.sec.gov.

capital markets (Forms S-2 and S-3). The internal control report itself will represent a material item of disclosure and, thereby, an opportunity for a disclosure misstep that could lead to a fraud claim.

The costs (both financial and human) of 404 compliance are no doubt very significant. The hope is that the benefits gained in terms of restoration of public confidence will outweigh all costs.

Impact of 404 Internal Control over Financial Reporting on M&A

It is still too early to assess the full impact of the 404 rules on internal control over financial reporting. It seems likely, however, that the rules will have a significant affect on public-private mergers. Since management's report on internal control over financial reporting must include controls at all consolidated entities, a public company's acquisition of a private company will require the public company to include the private company's internal controls in management's assessment. In light of the potential costs and risks involved in the internal controls of the acquisition target, the parties to future public-private mergers can expect:

- ***Increased due diligence prior to entry of a definitive agreement.*** Public companies have become more concerned with the target's internal controls, regardless of whether the target is public or private. Where the target is private (and therefore not yet subject to the discipline of SEC reporting) the acquirer is likely to have a heightened concern over internal controls even where the private company has been the subject of audits by a Big 4 firm. Where the target is a foreign private company, with a recordkeeping practice more in line with local accounting and business practices rather than US rules and practices, the concern is likely to be even greater. Private companies can expect from public company acquirers a due diligence process that is longer and more comprehensive than what they might have expected in the past.

- ***Increased deal costs and impact on deal pricing.*** Where the acquirer is a public company, it is likely that the post-closing integration costs will be significantly higher since in most cases the acquirer will need to upgrade the target's internal controls to conform to the 404 standards and provide for 404 reporting at the target level. It is not unreasonable to expect public company acquirers to factor the 404 related costs of integration into their deal pricing. Where the target carries a perceived 404 risk, it is even more likely that the public company will factor the 404 issues and costs into its pricing equation.

- ***Potentially disadvantaged public bidders.*** To the extent that the 404 rules on internal control over financial reporting have the effect on public company acquirers of extending due diligence periods, increasing deal costs and even impacting deal pricing, public companies may find themselves at a disadvantage when negotiating against buy-out funds and other private bidders. Private bidders are not subject to the internal control reporting rules and are likely to be less concerned with the quality of the target's internal controls. Even those private bidders that eventually may have to consider the 404 rules in connection with their own exit strategy are likely to have a longer time period within which to deal with any 404 issues. As a result, private bidders, as a group, are likely to be able to respond more quickly and with less pressure on deal costs and pricing than a public company bidder.

Private companies looking to an exit strategy that may include an IPO or a sale to a public company will need to consider the adoption of an internal control regime that is effective within the meaning of Section 404 of the Act and the related rules of the SEC and PCAOB. The costs of implementing and maintaining effective internal controls under the stringent 404 standards will be significant, but will facilitate a public exit strategy. In the case of many private companies, the implementation of an internal control review and upgrade will be a necessity.