Article

The Danger Of Skeletons Lurking In The Closet: Why Buyers And Sellers Of Private Companies Need To Focus On Hidden Weaknesses In Internal Controls

This article is the first in a series of articles that offer insight to buyers and sellers of middle market companies in today's merger and acquisition ("M&A") environment. (For purposes of this article, middle market companies are those companies with annual revenues or enterprise values between $5,000,000 and $500,000,000.)

Executive Summary

For the public company, ignorance is definitely not bliss. Rather, it could be a quick ticket to an SEC enforcement action if management's failure to exercise proper oversight causes a public company to violate the Sarbanes-Oxley Act's new corporate governance laws. But why should a private company worry about compliance with Sarbanes-Oxley, especially when it chooses to remain private to avoid Sarbanes-Oxley Act hassles? Because in today's M&A environment, a public company cannot risk buying a private company that has significant internal control problems.

Since public company buyers are now more cautious, they are performing a deeper due diligence review of the accounting practices and procedures of sellers. They are also asking sellers to bear more liability exposure for internal controls weaknesses.

Therefore, a private company must pay attention to the Sarbanes-Oxley internal controls requirements if it wants to maximize its appeal and value to a public company buyer. And in the current environment, a private company is far more likely to cash out in an M&A transaction than in an IPO. Thus, private companies cannot turn a blind eye to Sarbanes-Oxley's internal control requirements.

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