Ethics is core to a due diligence

By Cynthia Schoeman, Managing Director, Ethics Monitoring & Management Services (Pty) Ltd

Due diligence is a term most commonly used for the process whereby a potential purchaser evaluates a target company for acquisition. It amounts to an investigation of a potential investment that includes reviewing all financial records plus anything else deemed material to the sale. Offers to purchase are usually dependent on the results of due diligence analysis.

The value of a due diligence is well recognised. The 2014 M&A Outlook Survey conducted by KPMG LLP amongst over 1,000 merger and acquisition (M&A) professionals in US organisations found that an effective due diligence was considered to be the third most important factor for the success of the deal.

But, as for many other business processes, the importance of a due diligence is better illustrated by its failures. One example was the due diligence conducted for Hewlett-Packard (HP) on Autonomy, the UK software company. HP subsequently claimed that Autonomy had inflated the value of the company prior to the takeover, which led to a write-off of more than $8.8 billion related to allegedly fraudulent accounting at Autonomy.

While a breach of ethics is central to scandals such as this one, ethics has a further relevance for a due diligence.

A due diligence should serve to confirm all material facts, for example in regard to a sale, and it is intended as a means to prevent unnecessary harm to either party involved in a transaction. To realise this, a due diligence checklist would typically include a focus on issues such as assets, contracts, customers, employee agreements and benefits, facilities, plant and equipment, finances, the relevant legislation, suppliers and tax.

However, it does not include ethics – despite the possibility that, in the absence of an ethical culture, the facts can be skewed by the company being sold. The acquisition can thus pose future risks to the purchaser. This can range from liabilities and penalties associated with fraudulent practices to having to change the company's entire culture. And courts are unlikely to be sympathetic to a purchaser that neglects the due diligence process, either by failing to adequately investigate or by ignoring the information discovered. Clearly the difference between an ethical and unethical company is noteworthy and consequently ethics – or, specifically, a lack of ethics – should be considered a material fact.

Conducting an assessment of the organisation's ethics as part of a due diligence can also add considerably to the depth of insight into the target company. For an ethics assessment to add this value, it is crucial that it is accurate and reliable. This rests on three factors.

Firstly, an instrument should be used that will produce correct and trustworthy results. The effectiveness of a tool such as the Ethics Monitor web-based survey is that it taps into employees' knowledge as a way of surfacing and uncovering unethical behaviour. Although there are cases when knowledge of wrongdoing is limited to the perpetrator, in most cases there are other people within the business who know, or at least suspect, that something is not right.

Secondly, the results must have a high level of credibility. To realise this, the results should be based on the experiences and perceptions of all employees (including management and executive directors) and key stakeholders – or at least the vast majority. The views of a select few, whether the board of directors or a sample group of employees, are too limited to be considered a credible, representative result.

Thirdly, an ethics assessment should be conducted by an independent third party. This adds to the reliability of the assessment and avoids any suggestion of manipulated results. An external provider should also offer the assurance of confidentiality and anonymity to allow respondents to share their views freely without fear of comeback.

As part of its contribution to a due diligence, an ethics assessment should quantify the organisation's ethics to produce an ethics rating for the organisation, allow for the accurate reporting of ethics and provide meaningful management information about any areas of concern.

A good assessment should provide in-depth insight into the ethics within the organisation and its branches, departments and work levels. This warrants that the assessment extends beyond an audit-type exercise, which would typically check for the presence or absence of policies and procedures and evaluate awareness based on a random sample of employees. Instead, the assessment tool needs to evaluate ethics at a deeper level to surface actual behaviour and practices and the effectiveness of the mechanisms that should increase ethics or reduce misconduct (such as leadership and the company's values, policies, rules and code of conduct). A comprehensive ethics assessment should illustrate what can be done to remedy ethical weaknesses and leverage ethical strengths and it should serve as an effective risk analysis.

There are five additional issues that should be investigated to evaluate the status of a company's operational ethics:

1. If the company has a Social and Ethics Committee is this viewed as a compliance exercise or is it expected to add value? The difference is a noteworthy reflection of the importance of ethics.

2. Does the company have an ethics strategy and clearly identified ethics goals? In the absence thereof, initiatives and actions to create an ethical workplace are likely to be fragmented and lose the benefits that an integrated approach can deliver.

3. Does the company report on its ethics? It should, as ethics reporting is a specific recommendation of King III and a requirement for the Companies Act Social and Ethics Committee.

4. How does the company manage its ethics? Dealing with ethics on an ad-hoc basis and reactively after there is a failure of ethics as opposed to managing ethics regularly and proactively has major implications for the quality of the company's ethics management.

5. Does the company provide meaningful ethics training? Ethics training is an effective way to address ethical challenges and establish a high level of ethical awareness, both of which contribute to building and maintaining an ethical culture.

The optimal value of the inclusion of ethics in a due diligence should be to increase the level of assurance about the value of the seller's ethical capital: In fact, the seller with a sound ethical culture should insist on an ethics assessment to clarify that value. The inclusion of ethics is also important to minimize the risk of future problems. Although it may not be possible to prevent other scandals by means of better due diligence processes, ensuring that the due diligence is the best it can be should be a recognised goal.

Retirement funds that don't report on time face penalties

By David Geral, Partner, Bowman Gilfillan.

The Registrar of Pension Funds appears to regard the problem of the late submission of retirement fund actuarial reports as pervasive enough to warrant administrative sanction.

Late in January this year, the Registrar published notice of her intention to impose administrative penalties on funds that fail to submit their actuarial valuation reports on time.

An actuarial valuation report is a critical yardstick of a fund's viability. An independent actuary comments on the financial soundness of the fund – its ability or inability to meet its retirement funding obligations on an ongoing basis. The report must be furnished to the Registrar and each participating employer whose employees are members of the fund.

Failure to submit reports timeously could compromise fund members. Decisions about a fund's investment strategy, its pensions increase policy, possible pensioner bonuses, possible surplus apportionments and the like are all informed by the data in that report.

More concerning is that a common cause for longer delays is confusion about the actual assets and liabilities of the fund. A long delay in submitting a valuation report can be indicative of a poor state of affairs regarding the asset and liability management of the fund by its board.

The valuator cannot get the necessary information, or the valuation reveals a result that the fund's board disagrees with for factual or political reasons. Actuarial valuation reports need to be submitted every three years to the Registrar and employers. However, funds usually perform them more frequently because the data is valuable for investment management.