TO IMPROVE A DUE DILIGENCE, ADD ETHICS

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Due diligence is well understood as the process of systematically checking and verifying the accuracy of a statement, for example to validate financial statements. The goal of the process is to ensure that all stakeholders have the information they need to assess risk accurately.

The term is also 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.

Value of due diligence

The value of 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. However, 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, in November 2012, led to a write-off of more than $8.8 billion related to allegedly fraudulent accounting at Autonomy. This, in turn, led to HP facing a $1 billion lawsuit from its shareholders (which is still ongoing). The class action suit named eight defendants who oversaw the botched deal and it accused them of conducting 'cursory due diligence on a polluted and vastly overvalued asset'. Amongst the defendants are HP's chief executive Meg Whitman, her predecessor Léo Apotheker, the company's former chairman Ray Lane and Autonomy founder Mike Lynch. While a breach of ethics is central to scandals such as this one, ethics has a further relevance for 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. 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 an unethical company is noteworthy, and consequently ethics – or, specifically, a lack of ethics – should be considered a material fact.

Conducting an ethics assessment

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 rests on it being totally confidential, and thus being able to tap 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) – 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, allow for the accurate reporting of ethics and 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. A comprehensive ethics assessment should provide meaningful management information by illustrating what can be done to remedy ethical weaknesses and leverage ethical strengths, and it should serve as an effective risk analysis.

Evaluating operational ethics

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 clearly – or at all? 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: Does it have a comprehensive ethics management system? 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 minimise 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.