UNCOVERING RED FLAGS

By Susan Koss

Successful investors know the importance of quality M&A due diligence cannot be overstated. Standard financial due diligence focuses on analyzing a company's projections, historical financials, working capital needs, and accounting policies. However, there are other areas that should be analyzed in order to prepare a bulletproof assessment for investors. These other areas include quantitative factors and qualitative factors such as corporate culture. Much of the focus in due diligence is quantitative in nature where qualitative aspects are often overlooked but hold equal relevance. A reliable assessment may uncover significant issues affecting post-transaction integration and the investor's ability to successfully monitor and effect change post-transaction.

One of the most significant factors is the assessment of the management team's capabilities. Management's ability to effectively work together as a team and implement a positive "tone at the top" is critical to the future success of the company. A CEO without strategic direction or a CFO performing at the level of a controller may have a detrimental impact on an investor's ability to work with the management team to affect changes or a revised corporate strategy. Unsuccessful management teams can impact the investor's faith in the financial results post-transaction. Generally, it is preferable to assess an unqualified management team prior to the transaction closing rather than post-transaction when much damage can be done.

Financial due diligence engagements may also uncover key employees not previously considered by the investor or it may reveal gaps in talent. Investors should be aware of the responsibilities, duties and abilities of all key employees so that employment agreements and other negotiations can occur simultaneously with the purchase agreement.

Another significant factor is the assessment of the company's systems. The due diligence process should assess the overall robustness of the ERP and accounting information systems and determine where any gaps may exist in the operational data or internal controls procedures. Investors need to consider the effect of poor systems on post-transaction compliance, monitoring and reporting. Investors also need to understand whether key operational data is readily available and whether the employees are properly trained on the systems so as to ensure the completeness and accuracy of that data. In addition, the due diligence process must contemplate that investor reporting requirements are probably more robust than what currently exists for the company.

A due diligence team with a focus on accounting without operational focus is not going to provide the bulletproof assessment needed by the investors. In order to be most effective, the due diligence team should have a thorough understanding of the business objectives driving the transaction and should verify that the transaction structure is aligned with the overall business plan and model. Importantly, the team should also determine whether any cultural differences will impede the achievement of these objectives, and what can be done to bridge any cultural divides. Relatively straight forward indicators of corporate culture may lie in the degree to which financial rewards are tied solely to the financial outcomes of the company, any departures or turnover of key employees in recent years, or an evaluation of the tone and messaging in internal communications.

A check-the-box type of approach to the due diligence process will not be effective at truly understanding what lies beneath the books and records of a company. A due diligence team that can recognize red flags in both the operations and finances will prove to be extremely valuable to investors by mitigating risks post-transaction.

A company's financials only provide one dimension of the company's overall health. Quality due diligence should extend beyond quality of earnings and financial trend analyses. The due diligence team should strive to uncover all matters affecting the investor's ability to integrate the potential acquisition and achieve the investor's desired targets. Identifying and understanding red flags can help expose issues that are better dealt with during due diligence rather than when it's too late.

Susan Koss
CPA/ABV/CFF, CVA, Partner and Managing Director, leads the firm's Litigation Support Practice Group. She specializes in litigation support, business valuation, quality of earnings and forensic accounting.