Identifying Legitimate Red Flags when Performing Due Diligence

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Due diligence is the process of determining whether representations (legal, financial and otherwise) made by a seller are true; and whether the buyer's proposed bid is fair based on those representations. The purpose of due diligence is to uncover weaknesses or uncertainties that might prevent the transaction from meeting a buyer's desired goals.

In today's environment, companies that are considering a merger or acquisition must devote considerable time and energy to performing due diligence. But inexperienced buyers may feel uncomfortable with the process, unsure what they should be looking for and what might constitute a legitimate red flag.

A Team Approach

Traditionally, due diligence teams featured attorneys to examine contracts and look for potential liabilities and other legal issues. Accountants and other financial advisors were available to analyze financial data. But increasingly, companies are also adding market research professionals to provide guidance on marketing-related issues, and private investigators to perform extensive background checks on the company and its management team.

Today, due diligence needs to include issues that were barely considered several years ago, including a company's brand value and the value of other intangible assets. Additionally, you will have to include the company's reputation in regards to management. A multidisciplinary team is most likely to look at a deal from various angles and spot problems before they have a chance to explode and destroy the deal farther down the road.

While due diligence can turn up many types of problems, probably the most critical is evidence that the seller has made false material representations. Depending on how negative they are, false representations may be grounds for reducing your offer price, adjusting the terms of the deal or terminating it altogether.

Issues that Warrant Concern

Sellers occasionally make unintentional mistakes or omissions; but experienced due diligence professionals can generally identify patterns that suggest innocent errors are, in fact, willfully misleading statements. Certain types of issues will alert your due diligence team that trouble may lie ahead. Some examples are:

- **Results Inconsistent with Industry Peers -** This should tip off investment analysts. If a company's financial performance is much better than that of its typical industry peers with similar operations, something is likely to be awry.

  Financial results that seem too good to be true or are statistically implausible should similarly be scrutinized for false representations. Even if the company's financial representations are legitimate, this may be a sign that the target's management, business model or strategy is highly unusual, even unparalleled. This could make it very difficult for you to reproduce the company's success under a different management or operational structure.

- **Improbable Financial Statement Changes -** Your target's financial statements should be presented according to generally accepted accounting principles (GAAP) and be consistent with industry norms.

  The due diligence team should scour financial statements for unusual balance sheet changes or trend reversals, such as receivables growing faster than revenues.

- **Complex Business Models -** Overly complex organizational structures involving unusual legal entities, numerous managerial lines of authority or contractual arrangements without apparent business purposes are all signs that additional due diligence is warranted. Simple reporting structures and legal entities are usually best. If your due diligence team spots complex business arrangements that cannot be explained easily, or that appear counterintuitive, they may be just that.

  Remember, financially distressed businesses under threat of bankruptcy or foreclosure face enormous temptation to cook the books and occasionally they succumb. Therefore, financially troubled entities warrant an extra level of scrutiny.

- **Questionable Management Background -** Often, due diligence inquiries into the backgrounds of the target company's management team are limited or superficial. This is particularly true when the buyer and seller have an existing business relationship or are social acquaintances.

  The professional members of your due diligence team can be especially helpful in this regard. They are capable of performing objective and rigorous background searches using public records to unearth such important information as past litigation, criminal complaints or inaccurate resumé items.

Criminal convictions or even false academic credentials should make you think twice about retaining such an individual after the deal closes. You will also want to question any financial results the executive had a hand in. The team may also be able to set up confidential interviews with a broad sample of the target's employees for signs of poor morale, lack of confidence in existing management or even ethical lapses.

- **More Rigorous and Efficient -** While the issues analyzed by todays due diligence team are greater in number and complexity than those of a decade ago, the process has actually become more efficient.

Now, sophisticated analytical software and information gathering systems make legal, financial, operating and managerial due diligence reviews faster and more economical than in the past. What's more, there are plenty of experienced professionals available to help you get the information you need to complete your transaction.