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LITIGATION QUARTERLY

Forensic Accounting Benefits Due Diligence Process

Better to Call Off Potentially Bad Deal Than Gear Up for Litigation Later

BY KIP HAMILTON AND HOWARD SILVERSTONE
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INVESTIGATIVE DUE DILIGENCE IS one of the newest and fastest-growing forensic accounting services. But one of the oldest sayings underscores its basic philosophy: "There's no point bolting the barn door after the horses have fled."

These wise words clearly articulate the underlying principle of an investigative due diligence practice. Increasingly, the preventive approach they advise is being adopted by the corporate marketplace.

Until recently, forensic accountants were usually retained by venture capitalists and merchant bankers after the deal, when a problem emerged or the deal failed. Financial due diligence was conducted before the fact by traditional accountants, either in-house or external.

But in the past few years, forensic accountants have been brought in once the term sheet has been signed, usually at the same time as the lawyers.

Clients began to recognize that the investigative mentality of forensic accountants was far more beneficial to them than the traditional audit mentality. By focusing on risk—rather than a pre-defined checklist—forensic accountants could identify potential deal-breaking, pricing and financial exposure issues.

Interestingly, it's often legal counsel who recommend the need for forensic accountants. It's not uncommon these days for attorneys to inquire from their clients as to who is conducting the investigative due diligence.

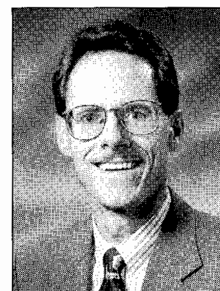
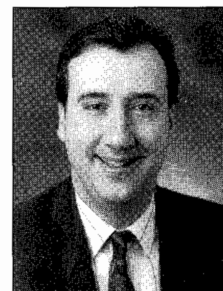
EXPECTATION GAP

Counsel doesn't want an "expectation gap" to exist, in which the client assumes certain financial risk issues would be dealt with by them when in fact they weren't. The lawyers know what areas are covered by their own expertise and what areas need to be covered by other professionals.

One of the keys to effective investigative due diligence is teamwork. The team is typically composed of the venture capitalists or merchant bankers, the lawyers and the forensic accountants, each with distinct roles and diverse skill sets.

There should be no duplication of services between legal counsel and the forensic accountants. When performing their functions properly, they should both act as natural extensions of the client's own people.

For example, if a client wanted to know the effect of a termination provision of a significant contract, legal counsel and forensic accountants would approach the question from two entirely different perspectives.

HAMILTON SILVERSTONE

Kip Hamilton, CPA, CFE, and Howard Silverstone, FCA, CFE, are the co-practice leaders of the Philadelphia office of Lindquist Avey Macdonald Baskerville Inc., an international firm of forensic and investigative accountants.

Counsel would determine the conditions under which a termination could occur, the legal basis for a termination and the remedies resulting from such an occurrence. Forensic accountants, on the other hand, would investigate the financial impact of the termination.

Both experts would be dealing with the same issue but would apply unique and discrete skills sets to related, but separate, concerns. Similarly, if a contract existed that involved patent rights, legal counsel would ensure the client was aware of when the rights expired, and all the potential legal and contractual ramifications.

Forensic accountants would ensure that the client understood the potential financial impact once the patent expired.

Beneath the Surface

As part of the due diligence team, forensic accountants can provide legal counsel with vital background information on individuals and companies. A background investigation, when conducted properly, is a relatively small cost item that can often save a client from dire consequences.

One area typically overlooked in traditional background checks—which too often fail to explore beyond the surface of credit and other financial records—is the business reputation of key players in a deal.

A senior individual, for example, can have an impressive résumé. But a background investigation can discover that he has a history of starting fast at a new firm and then crashing after his initial surge of energy burned out.

Presented with this information, the client and legal counsel can assess whether he's the type of executive capable of fulfilling the responsibilities of the position he would inherit.

Beyond the Obvious

Forensic accountants typically focus on determining whether there is:

- Misrepresentation/non-disclosure of material facts
- Unrealistic projections
- Unrecorded/understated liabilities
- Overstated revenues and understated expenses
- Overstated assets
- Hidden ownership interests
- Managerial and other business issues.

When performed properly, investigative due diligence should not only examine obvious concerns but should also uncover risks and problems that are not apparent on the surface.

It should be reiterated that investigative due diligence will not necessarily provide facts which will be deal-breakers. On many occasions the parties will adjust the proposed agreements or, as a minimum, be better informed before entering into a deal.

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As an example, a company that produced transportation components was about to be purchased. The anticipated deal was subordinated debt with warrants. One of the conditions was that the total debt of the company wasn't to exceed a certain threshold. However, this wasn't considered a problem because the company appeared well below the threshold.

During the investigative due diligence the forensic accountants discovered that the accounts payable at numerous of the company's subsidiaries were dragging from levels at the prior year-end. If this was taking place at every subsidiary it would represent several million dollars at the consolidated level.

Interviews with local management revealed that the head office sent all subsidiaries a directive to "extend payables" to maintain total debt at the same level reported to shareholders. If the plan worked it would be a legitimate source of new capital.

But the investigation found suppliers who threatened to cease supplying, increase price or demand more favorable payment terms unless they were paid. This would have reduced the profitability of the company and threatened the purchaser's security position.

Armed with the results of the investigative due diligence, the client was able to effectively renegotiate key aspects of the deal.

Horse Sense

Investigative due diligence is really a form of horse sense. An intelligent horse buyer would never make a purchase without checking out the animal thoroughly.

Still, some companies still prefer to trust their instincts on deals involving large amounts of money rather than examining all perspectives through diverse skill sets before signing on the line.

While there are no guarantees, clients should be able to ride into the sunset with peace of mind that they took the best steps to foresee problems before signing—rather than discovering them too late.

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