

skills to detect signs that your target is cooking the books. Red flags include:

- ❖ Increased accounts payable, combined with dropping or stagnant revenues,
- ❖ Excess inventory,
- ❖ Decreasing reserves against bad debt,
- ❖ A large number of account write-offs,
- ❖ Increased purchases from new vendors,
- ❖ The recent introduction of new methods of calculating revenues and expenses, and
- ❖ Excessive tax-driven earnings reductions.

Fraud experts don't only examine financial statements, but also look at business practices that might provide motives to perpetrate fraud and cultural conditions that enable fraud to thrive. For example, domineering and bullying owners and executives are more likely to feel entitled to break accounting rules and coerce employees to participate in such activities.

Similarly, businesses that offer financial incentives for employees to meet high, even unrealistic, sales growth numbers — particularly if employees are meeting them — merit a closer look. High employee turnover and worker, customer and vendor complaints are also strong indicators that something is amiss. Finally, if the seller tries to restrict your due diligence

A due diligence frame of mind

Even before you begin formal due diligence, conduct an initial assessment of how “fraud resistant” your target company is. For example, does the company appear to have effective governance and antifraud policies? What about defined and enforced codes of ethics and strong internal controls that are regularly reviewed and tested for compliance?

When companies have invested time in identifying and solving corporate governance and financial issues, it reduces the risk that those issues will emerge later. Depending on the industry, you may be able to review results from regulatory examinations to help identify potential weak spots early.

team's access to financial data or prevent them from speaking with key employees, be wary.

Too good to be true?

When buying a company, it pays to be skeptical — particularly if its earnings or selling price seems too good to be true. Keep in mind, however, that inaccurate financial statements may be a sign of incompetence or poor management, not an attempt to mislead potential buyers. A fraud expert can help you tell the difference and ensure that you make a well-informed decision. ■

Buying damaged goods?

HOW TO EVALUATE A DISTRESSED COMPANY'S POTENTIAL

Just because you're paying a relatively low price for a financially distressed company doesn't mean you're getting a bargain. Some companies are simply too troubled to turn around. Thorough due diligence and a professional valuation can help reveal whether you're buying a diamond in the rough or whether your potential acquisition's flaws are fatal.

Troubling signs

To prevent a bad acquisition, know the signs of a troubled company. During the due diligence stage, look for:

- ❖ Debt reduction programs, such as asset sales and equity offerings,
- ❖ Cost reduction tactics, including layoffs,

- ❖ Changes in senior management, especially those with fiscal responsibilities,
- ❖ Changing customer profile activity, extraordinary sales and customer refunds,
- ❖ Strained relationships with auditors, suppliers and lenders, and
- ❖ Pending regulatory matters that could trigger lawsuits related to sales and trading practices or employee issues.

Keep in mind that any one or a combination of these factors doesn't necessarily mean that a company is in financial trouble. If you spot them, however, it's a signal to dig deeper and evaluate the degree of the problem.



It's also essential to pinpoint the cause of the trouble. Once you determine why a business is struggling, you can decide whether you'll be able to turn the situation around.

For example, buyers often assume that troubled companies are dragged down by excess debt and that an infusion of cash or a debt restructuring program will reverse the situation. Debt may be one factor, but dealing with it won't do much good if the company's biggest problem is poor management, labor issues or mature product lines that no longer meet their market's demands.

Shopping for value

Not all companies are turnaround candidates — or even salvageable in pieces. To determine if your target is likely to respond to either minor correctives or a major overhaul, consider its market share, demographic trends and competitive threats; financial fundamentals, such as revenue growth, cash reserves and debt; new opportunities for growth; and industry conditions and possible regulatory challenges.

Also crucial and frequently overlooked in the initial stages of a deal are the costs required to rehabilitate the distressed company. Financial and operational assessments can help you determine how much the acquisition will cost in the long run.

Finally, consider how well the target company has managed its financial distress. Has it been operating

in crisis mode for some time — holding lenders at bay, stretching cash resources and employing other damage-control tactics to protect its officers and directors? If so, the business may be beyond recovery. Its short-term survival methods may have undermined its long-term prospects. For example, slashing prices to retain customers will make reverting to the previous pricing structure extremely difficult — if not altogether impossible.

Measure for success

A professional valuator can help you compare the distressed company's current value against its liquidated value to determine if it's worth more up-and-running or liquidated. In some cases, you may be able to sell off, or divest, the nonperforming segments of your target's business while keeping its viable divisions running.

Valuing a financially distressed company can be challenging. Market-based valuations require analysts to compare businesses to comparable companies or transactions, which generally isn't possible when valuing a distressed company.

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Income-based valuation methods — which rely on historical performance — may be no better. The company's future income, after all, depends on a combination of a workable strategy to return to profitability and the buyer's ability to realize synergies and cost savings.

Typically, valuation methods depend on the selling company's level of distress and sense of urgency. Companies that are only lightly distressed or subject to competing offers can negotiate a better price — or a valuation based on future cash flows. Because a high level of judgment is necessary when evaluating the potential of a financially distressed company, be sure you work with a valuator experienced in analyzing distressed businesses.

Rewarding ... or not

Acquiring a financially troubled business can be very rewarding — as long as you choose your target wisely. To ensure you're not buying a hopelessly distressed business, perform adequate due diligence and team up with an experienced valuator. ■