Why Fraud-Based Due Diligence Is Critical in M&A—And the Steps to Take

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Fraud can take many forms. Sometimes it comes in the form of stealing from a company, and other times it takes the form of inflating earnings. Both fraud types can be prevalent in many companies, even the ones where it is least expected.

Fraud can have a major impact on the earnings of an entity and have an impact on value and price. Finding fraud before a transaction occurs would be in the best interest of both the buyer and seller. For the seller, it could potentially increase the value or price a buyer is willing to pay, as the relative earnings would potentially increase in the future. For the buyer, if the fraud is something that would decrease earnings in the future or increase risk of incurring costs, a buyer would want to understand and estimate the impact of that fraud prior to the purchase.

The focus of transaction due diligence is typically on financial performance and making sure the deal can fulfill its promises to both sides of the transaction. And while due diligence also focuses on uncovering potential problems or risks, steps in typical due diligence are not specifically developed to uncover fraud.

But when fraud-based due diligence is not performed, the future consequences could be detrimental to either party’s return on investment.

Buyers typically perform some level of due diligence prior to a transaction, but sellers should also consider performing due diligence in advance of a sale. Such a proactive approach provides three significant benefits: First, it allows the seller to identify and address fraud and compliance issues in a timely and early manner. Second, being proactive allows the seller to better position itself to potential buyers, making it more likely to garner its desired price and set the transaction up to have a smoother and faster close. Last, if the fraud is identified by the buyer during their due diligence, it could either decrease the price the buyer is willing to pay or derail the transaction all together.

For buyers, the risks are even greater! Finding fraud that could entail future fines, penalties, criminal sanctions, and other results prior to a transaction can save the buyer from major hardship. Depending on the nature of the fraud, it may have such a significant impact on the future operations or potential liability as to warrant withdrawing from the transaction.

Additionally, both buyer and seller can experience a smoother post-acquisition integration because the information identified during the due diligence, whether positive or not, provides valuable guidance for post-acquisition integration and remediation planning.

Fraud: Prevalence and Impact

In 2018, $3.6 trillion was spent on health care in the U.S. The National Health Care Anti-Fraud Association (NHCAA) conservatively estimates that at least 3% of that number was lost to fraud—indicating the revenue lost to fraud totaled $108 billion. Not all entities would be impacted by such losses, which means the impact for other entities would be more and could be significantly more than 3%.

With those levels of potential staggering impacts, it is critical for entities to consider fraud-based due diligence in their transaction.

Risky Areas to Consider

There are many different types of fraud that can be perpetrated in a company, including:

- Noncompliance with regulations
  - Stark, Anti-Kickback, private inurement, licensing, etc.
- Corruption (e.g., bribery and illegal gratuities)
  - Kickbacks for referrals, procurement fraud
- Financial statement misstatement
  - Off-balance sheet debt
  - Recording assets at higher than fair market value
  - Inflating revenue
- Tax return misstatements
  - Decreasing earnings to pay lower taxes
- Asset misappropriation (e.g., embezzlement and larceny)
  - Using assets for personal use
  - Increasing personal compensation
  - Using company purchased supplies for personal use
A fraud risk assessment has the flexibility to adjust to the specifics of each business and limit areas where financial loss could be detrimental to the acquisition or merger.

Four Signs of Potential Trouble
There are certain areas where a fraud-related assessment will focus to assess the risk of fraud or other noncompliance. Highlighted below are a few of those areas:

High turnover
Look for high turnover in key roles. This can indicate that the former employees knew inappropriate activities were going on and disagreed with them. If the targeted organization has an anonymous reporting mechanism and has received whistleblower complaints, review those complaints and the resolutions as part of the due diligence process.

Spikes in inventory, receivables, or other key accounts
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Similarly, unexpected spikes in key performance metrics can indicate a range of issues, from intentional manipulation of results to actual, but unsustainable, performance. Thoroughly researching these unexpected spikes can help determine whether the results are sustainable and whether the metrics were the result of intentional manipulation in light of the proposed deal.

For example, a benchmarking analysis performed for a client showed higher than average supply costs. A review of the information revealed that an employee was using company funds to pay for personal expenses through an extra credit card taken out in her name.

Another example may be where accounts receivable are high, and the days outstanding are higher than normal. It could mean cash is being misdirected and not applied to the customer receivables.

Extraordinary results
While it’s natural for an acquirer to be looking for a great performer to join forces with, acquirers should beware, or at least be skeptical, of a target with extraordinary results.

Perform data analytics on financials and look at how the targeted entity compares to similar entities. Where exactly do they stand out from the herd? Can management articulate reasonable explanations accounting for the extraordinary performance? Are there components with subjective elements, such as management estimates for reserves or methodologies that could be affecting the results?

Performing such data analysis and making comparisons to similar entities will help identify areas that warrant additional scrutiny during the due diligence. Whether numbers that look too good to be true are the result of (1) a truly outstanding organization, (2) poorly designed or implemented processes, or (3) intentional actions by that organization attempting to bolster its current position and fetch a higher price, the additional scrutiny can be valuable “insurance” for an acquirer. If these are identified by a target’s pre-deal diligence, as mentioned earlier, the information can help correct issues before en
tering the market, or the information will help to proactively address the issues with potential M&A partners and even show increased value warranting a higher price.

Experiences of comparable organizations

Paying attention to what similar organizations have gone through with fraud or compliance failures can provide insights into where risks may be. Not all organizations experience or are even susceptible to the same risks, but similar organizations (and employees of similar organizations) operating in the same or similar environment can face the same pressures and risks that lead to inadvertent or intentional missteps. Ignoring those realities can lead to a “head in the sand” mentality and needlessly overlook potential risks.

What to Include in Your Compliance and Fraud-Based Due Diligence Process

There are seven key steps to follow when looking for fraud or other inappropriate activities during the due diligence process.

1. Engage a third party

An experienced fraud expert brings valuable experience in knowing what to look for when it comes to fraud and other compliance risks. They also bring the independent and objective perspective that can be invaluable when considering what should potentially be included in the due diligence and evaluating the potential impact the items identified in the due diligence can have on both the acquirer and the target organization. This can also reduce or eliminate the concern that risks will be overlooked to “make the deal happen” or that unfounded risks will be used to scuttle a deal.

Additionally, as M&A activity continues at a rapid pace, a comprehensive due diligence process likely needs outside assistance to adequately address all aspects in a timely manner.

2. Go beyond standard due diligence

Fraud and compliance-based due diligence requires steps beyond standard due diligence, potentially including:

- Conducting background checks on and interviews with key executives and employees.
- Fully identifying the target’s jurisdictions and regulatory environment.
- Adequately reviewing the target’s business practices.
- Using technical skills such as data analytics to identify red flags and uncover issues.
- Reviewing the target’s third-party relationships.
- Examining relevant key policies and procedures.
- Identifying areas that may require including representations or warranties in the final agreement.
- Monitoring the target’s business activities until the transaction is finalized.

3. Conduct a risk assessment

Explained earlier in this article was the fraud and compliance risk assessment and why performing one is so valuable. Its importance is reiterated here to emphasize how vital of a step it is in the comprehensive due diligence process. A fraud and compliance risk assessment should be significantly more in-depth than a general due diligence report. The format of a formal risk assessment also allows the assessment to be tailored to the specific type, industry, services and/or products, and practices of each organization.

The fraud and compliance risk assessment may indicate red flags in areas such as changes in reimbursement; relationships between physicians, hospitals, vendors, and clinics; or data privacy and cybersecurity. It can also be used to highlight employee-based issues or deficiencies in internal control procedures that would not otherwise be evident in traditional financial due diligence.

4. Review the target company’s relevant fraud and compliance-related programs

Does the target organization have a robust fraud and compliance program and department? Does that include an anti-corruption program? If so, understand the intended scope, the intended and actual controls and effectiveness, and then identify any gaps. In addition, make sure to review the results of prior fraud or compliance issues uncovered, the organization’s response(s), and the residual risks, if any, to the organization.

5. Review prior internal audit findings (and other self-assessments)

Does the target organization have a robust internal audit department? Has it performed in-depth analyses of key anti-fraud and compliance-related business processes? If so, these can be key sources of information both as to the past risks to the organization and potential future issues that may impact the value of the target.

Conversely, the failure of the target organization to have a robust internal audit department may portend previously unidentified issues, indicating that an even more robust due diligence plan is necessary.

In any event, it is important to look at internal audit findings and other self-assessment results as part of the due diligence process.

6. Evaluate corrective measures for previously identified issues

What did the organization do to correct previous issues? What was management’s response and approach? Did they bolster policies and procedures and provide training for staff? Did they regularly and effectively communicate to staff that they, and the organization, could be successful by “doing the right thing”? Did they monitor the ongoing effectiveness of remedial measures?

Understanding the organization’s response to previously identified issues can be an important indicator of potential future issues, and it also provides a way to understand the organization’s past approach to fraud and compliance-related issues, which can have a significant impact on the value or price of the proposed transaction.
7. Begin to develop plans for implementing additional compliance measures

Even the best organization can have unidentified or under-appreciated issues. If an acquirer is going to go through with an acquisition, developing and implementing a robust anti-fraud and compliance program to prevent future missteps is just as important as uncovering past issues. Utilize the results and findings identified during due diligence to develop plans to close the gap(s) post-transaction with appropriate anti-fraud and compliance programs.

Don’t Forget the International Aspect

The health care industry is composed of more than just medical practices, clinics, and hospitals in the U.S. The industry also encompasses entities that provide health care goods and products, such as pharmaceutical companies that produce drugs and manufacturers that produce gloves, surgical equipment, hospital beds, etc.; keep in mind that these pharmaceutical companies and manufacturers can also be deeply involved in business with other countries. For those targeted organizations involved in international trade, the acquirer must consider the potential for prior Foreign Corrupt Practices Act (FCPA) violations. For example, the acquirer could inherit liability from an organization that committed bribery overseas and be responsible for paying fines and even undergoing court-ordered monitoring to ensure future compliance.

If no FCPA violations have been identified, consider the risk environment(s) in which the target operates and then evaluate the adequacy of their compliance program, including the robustness of their FCPA compliance program and what actions they take to monitor compliance. Do no overlook third-party relationships, such as joint ventures, business partners, and sales relationships because responsibility for a target’s FCPA failures can be imputed to the domestic partner. All should be looked at during the due diligence process.

Potential FCPA liability can be particularly vexing if the acquiring entity is prevented from adequately assessing the FCPA and anti-corruption risk prior to the acquisition. In a 2008 Opinion Procedure Release, the Department of Justice (DOJ) addressed the issue, which was posed by Haliburton Company relating to its potential acquisition of an unidentified U.K. entity. The DOJ noted that it did not intend to take any enforcement action against the acquirer for pre-acquisition unlawful conduct of the target if the acquirer was unable to complete pre-closing due diligence due to the laws of the target’s jurisdiction and the pre-acquisition conduct was disclosed and halted within 180 days of the closing, or if the conduct could not be fully investigated within 180 days, the conduct does not continue beyond such time as it could—in the judgment of DOJ—be reasonably stopped.

Post-Acquisition Impact From M&A Due Diligence

As noted earlier, information identified during the due diligence, whether positive or not, provides valuable guidance for post-acquisition integration and remediation planning. Key post-acquisition considerations resulting from due diligence include:

- If the risks identified were not or could not be addressed before closing, what post-acquisition remediation needs to be completed, and what is the timeline?
- Are there pending legal or regulatory actions? If yes, what are the potential consequences, and how do those consequences affect the newly united organization? Can that impact be mitigated or managed?
- Do any of the identified issues potentially impact participation in federal or state programs? What actions are needed to avoid, minimize, and manage those impacts?

What to Do When Issues Are Discovered Post-M&A

Even the most well-planned due diligence can result in the development of post-M&A issues. Examples abound about organizations that acquired entities without incorporating a robust compliance or fraud element into their due diligence, only to discover issues after the M&A transaction was completed. Is it too late to take action? Is the acquirer about to experience an unwelcome financial or regulatory hit?

Not necessarily. Following are three actions to take when fraud or other compliance-based issues are discovered after an M&A transaction has been completed.

1. Implement an improved compliance program promptly

Businesses are becoming more complex all the time, and even an exceptional due diligence program may not identify every single issue prior to completion of the transaction. But once completed, what matters is how the organization addresses those previously unidentified issues.

Promptly implementing an improved compliance program immediately after discovering the issue is very important. Make improvements to policies, procedures, training, monitoring activity, etc. If the acquirer self-discloses or the issue is revealed another way, showing a robust response will help mitigate the potential impact.
2. Consider the risks and benefits to self-disclosure

These days, more organizations are determining that there are benefits to self-disclosing the identified misconduct to the appropriate regulatory body; however, disclosure brings its own risks, not the least of which can be increased scrutiny and the potential for litigation from relevant stakeholders at many levels.

To disclose or not disclose is a determination that must be carefully weighed based on the totality of the organization’s circumstances, including the particular inappropriate behavior, the actual impact of the inappropriate behavior, and potential impact going forward.

3. Cooperate in an investigation

When/if an investigation is launched, cooperation is key. Merely appearing to cooperate is not sufficient. Seasoned attorneys know how important it is for a health care organization’s legal counsel to work and cooperate with any government investigation. This can help lessen both the severity of the regulator’s response as well as any impact to the organization from third parties.

Post-transaction action, such as cooperation, self-disclosure, or changes to the anti-fraud and compliance environment, can have significant impact to the organization. A failure to act can open the door for a more severe response by the regulator or government.

Learn More About Fraud and Compliance-Based Due Diligence

Fraud-based due diligence is developed to identify potential fraud before a transaction and help a company proactively deal with issues before they evolve into bigger problems. Fraud-based due diligence requires a special knowledge of what to look for and how to uncover issues that are likely well hidden. To find the right professionals to help, seek individuals who are “Certified in Financial Forensics” or fraud. The American Institute of Certified Public Accountants issues the CFF (Certified in Financial Forensics) and the Association of Certified Fraud Examiners (ACFE) issues the Certified Fraud Examiners (CFE) certification. Look for these certifications when seeking professionals in fraud-based due diligence.

Authors

Marc Courey is Wipfli’s leader in Financial Forensics. Marc is a Certified Public Accountant, Certified in Financial Forensics, a Certified Fraud Examiner, and recovering attorney. Marc has also been adjunct professor of fraud examination and in the use of technology to uncover fraud. He has worked on many high-profile fraud cases in the Midwest.

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If you want to learn more about how to detect fraud—whether it’s through fraud risk assessments and data analytics or other tactics like benchmarking and horizontal and vertical analyses—contact Wipfli. Our seasoned CPAs, fraud examiners, data analytic experts, auditors, and compliance specialists can help health care entities uncover fraud and mitigate risks before a merger or acquisition is completed.

Endnotes

With Wipfli, you can hit the trifecta with your healthcare M&As:

- Maximize price
- Minimize taxes
- Ensure a smooth transition

Our team specializes in valuation, transitions, taxes and private equity.

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