

# Forensic due diligence: Another tick in the box?

According to Refinitiv, a financial market data provider, the overall value of mergers and acquisitions in India amounted to US\$41.6 billion in the first half of 2019.<sup>1</sup> Furthermore, given the Indian Government has eased Foreign Direct Investment norms, with the aim to entice heavy foreign investments, and is looking at market growth in the interest of the buyers who are consolidating businesses, India will remain a lucrative investment destination in the coming years. There are multiple steps which investors undertake to ensure a profitable return on their investment – due diligence being one of the steps.



Investors often face the dilemma of how much diligence is needed before investing in a business. Some of the parameters which an investor needs to weigh are:

- Financial viability and forecasts
- Risk associated with the geography where the investment is made
- Geo-political risks
- Company and promoter reputation
- Taxation
- Regulatory and legal risks

Furthermore, the depth of diligence is also influenced by a number of factors including the value of investments, type of business, timelines and competitive biddings amongst others.

So, how much diligence is adequate? There is no straight answer to this question. In this article, we highlight some key areas to be evaluated, and the possible repercussions of undertaking inadequate due diligence.

While most investors carry out financial and legal due diligence, forensic due diligence is, perhaps, less common. A failure to conduct in depth forensic due diligence may result in financial loss, as well as other exposure, since certain inherent risks are likely not to be detected.

Broadly, forensic due diligence aims to address the following concerns:

- Authenticity of the reported financial numbers
- Existence and background of key suppliers, employees and customers
- Adverse issues surrounding the promoters or key management personnel
- Political connections and impact on business activities
- Undisclosed related parties and transactions
- Undisclosed liabilities or potential claims and litigations
- Exposure to bribery and corruption

While financial due diligence, a critical step in any transaction, gives the investor a broad overview of the trends and sustainability of a business based on a macro-level data set, forensic due diligence delves into the transactional-level data to find anomalies and irregularities.

### Key differences between a financial due diligence and a forensic due diligence

FINANCIAL DUE DILIGENCE	FORENSIC DUE DILIGENCE
Top-down approach	Bottom-up approach
Macro level data analysis	Transactional level data analysis
Focus on trends and fluctuations	Focus on fictitious and dubious transactions
Looks into unusual or non-recurring expenses	Looks into fabricated expenses
Addresses application/usage of funds in true nature of business	Addresses diversion of funds

Failure by an investor to undertake sufficient forensic due diligence, may result in the emergence of unforeseen issues and risks post-investment.

For example, during our experience of working with a retail giant, the investor was initially reluctant to conduct forensic due diligence, as there were no major concerns highlighted in the financial due diligence report. However, after a little hesitance, the investor agreed to move forward with the exercise.

Our team of experts, using hands-on forensic accounting skills and modernised data analytics tools identified purchases from undisclosed related parties at higher than market prices, exorbitant expenses incurred outside the ordinary course of business and potential bribes being paid to various local authorities disguised as normal business expenses. Such issues were enough for the investor to expunge the deal.

Another instance which highlights the importance of forensic due diligence was encountered when we were hired by a multinational media house to conduct a pre-acquisition due diligence on the target company. Numerous red flags were identified such as bribes to local politicians and government officials to obtain licenses and broadcast rights which led to the deal being called off.

Forensic due diligence helps to mitigate risks and threats with the support of analytics and financial analysis which goes beyond analysing and reviewing books of accounts. Transactional-level data can be deeply scrutinised to raise red flags in relation to unusual and suspicious entries.

Another key area of conducting forensic due diligence is to review the target’s involvement in any unlawful or unethical practices which might pose a threat to the prospective buyer by bringing the target under the scrutiny of regulators.

In yet another example, a German investor was looking at acquiring a logistics company in India. Forensic due diligence involving the review of the financial statements, invoices and supporting documents such as gate registers and delivery letters, indicated that the sales were fraudulent. In collusion with the debtor, the logistics company had the fraudulent transactions financed

through a bank. This revelation not only reduced the valuation to one fourth, it would eventually bring the German investor under scrutiny of regulators. Realising the grave issues uncovered during the forensic due diligence, the German investor called off the deal.

*The views expressed herein are those of the author(s) and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates, or its other professionals.*

<sup>1</sup> <https://www.livemint.com/companies/start-ups/m-a-deals-more-than-half-to-41-6-bn-in-january-june-1562091912050.html>

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