

VentureBeat

GUEST COLUMNIST

Due diligence, recession style

Justin Hibbard | November 4th, 2008



[Editor's Note: One little-discussed byproduct of the economic downturn may be a bump in cases of corporate corruption and financial fraud. Not because companies are under more pressure to hit their targets, but rather because VCs -- jolted awake by losses -- are suddenly aware of situations they overlooked during fatter times. Below, Silicon Valley investigator Justin Hibbard explains how due diligence on all sides of funding deals can help prevent sticky situations going forward.]

When fear of recession crept into the venture and startup worlds, commentators predicted that VCs and entrepreneurs would start paying more attention to due diligence. Their forecasts are probably accurate, since historically investors and beneficiaries have tended to clamp down when the economy has soured.

As an investigator specializing in due diligence, I believe it's always a good time to make diligence

a high priority — not just because it helps my business, but because I've seen people get burned under all economic conditions. [In October, federal prosecutors filed a complaint against the former chief executive and chief financial officer of Entellium](#), a private CRM software company in Seattle that had raised over \$50 million from VC firms like Ignition Partners and Sigma Partners. The complaint charged the executives with wire fraud and alleged that they had deliberately overstated annual revenue to the board and investors for nearly five years. In one case, they allegedly reported that the company booked \$3.9 million in 2006 revenue when the actual figure was \$582,079 — an overstatement of 589 percent.

The Entellium case is reminiscent of fictitious-revenue schemes revealed in 2000 and 2001 at software companies like MicroStrategy, Critical Path, and Lernout & Hauspie. Similarly, those cases came to light at the onset of an economic downturn, and the allegations concerned events that happened during a recently-ended economic expansion.

Intuitively, one might think that financial-statement fraud increases during recessions as management teams grow ever-more desperate to make their numbers. Not so. [A recent study at the University of Minnesota's Carlson School of Management found that financial-statement fraud is most likely to occur in relatively good times](#). Think, for example, of the real-estate boom of the 1980s, which was followed by the S&L crisis and revelations that rampant fraud had occurred during the go-go period at institutions like Lincoln Savings and Loan. Or, more recently, recall the stock-market bubble of the late 1990s; not until the bust of the early 2000s did prosecutors discover the shenanigans that Worldcom and Enron had pulled at the market's peak.

Now, cast your mind back to 2003. The U.S. economy was recovering from the recession and terrorist attacks of 2001, and the tech industry was just getting over its worst meltdown since the bursting of the PC bubble in the 1980s. Suddenly, the stock market sprang back to life. Record low interest rates enabled condo flippers to quadruple their net worth faster than '90s dot-commers. Venture capital started flowing again. And "Web 2.0" was on everyone's lips.

It was under these conditions in 2004 that Entellium's management raised \$4 million in venture capital, allegedly by presenting phony numbers. I'm not privy to the due diligence that was conducted or whether anything could have detected such a fabrication. But a cursory database search from my office today revealed that in 2004 the IRS slapped Entellium's former CFO with a \$117,690 tax lien — not a good sign for the executive overseeing your company's accounting (the lien was released in 2007). I don't know whether anyone followed up on that detail. As the University of Minnesota researchers found, investors are more likely to overlook warning signals

during buoyant periods like the post-2001 recovery.

That's why in a recession VCs should examine not only current financial statements but also those that were reported — and contracts that were executed — during the most recent economic expansion (if the company's history extends that far). Even if fraud isn't apparent in past documents, prospective investors may find that management made assumptions and estimates during happier times that didn't account for how drastically conditions could change. Assumptions may be found, for example, in lease, employment or financing agreements contingent upon achieving improbable milestones.



VCs often rely on the due diligence of colleagues at other VC firms when they look at deals on referral, participate in syndicated investments or provide follow-on financing. Avoiding duplication makes sense, but the risk profile, objectives and procedures of VC firms can vary significantly. They should never assume that their brethren have performed the same type or degree of diligence that they would perform. When relying on second-hand diligence, VCs should always assess the level of risk independently and, based on their conclusions, decide whether additional diligence is warranted — especially if prior research was conducted in a bull market.

Many of these imperatives apply to entrepreneurs, too. VCs build their reputations largely during prosperous times. When their portfolio companies go public or are acquired at attractive multiples they look like prescient geniuses. But VCs prove their true mettle when they shepherd companies through economic downturns and inhospitable financing environments without resorting to desperate measures. A smart entrepreneur who is conducting diligence on a VC firm should scrutinize how the partners behaved and how their investments fared during previous recessions.

Company founders should also inquire about the financial stability of limited partners, especially those of relatively new VC firms. During the dot-com bust of the early 2000s, young VC firms that had raised funds from newly-minted Internet millionaires suddenly found that their **limited partners were having trouble making capital calls as their paper fortunes dwindled**. I predict that in the coming months more than one institution with heavy exposure to securitized mortgages, credit-default swaps or money markets will be unable to supply the cash it promised to VC funds.

Also check whether a VC firm will be able to raise new funds. Entrepreneurs want investors that will

be around for the long haul to participate in follow-on financings. Many pension funds and endowments are currently struggling to liquidate distressed investments and can't imagine committing additional capital to yet another illiquid 10-year venture fund. For all but the top 1 percent of VC firms, this will lengthen the time it takes to raise funds and may cause some firms without glowing track records to throw in the towel.

Finally, remember that just as no two deals are alike, no two due diligence projects should be alike. Too often people take a cookie-cutter approach to the process, dutifully slogging through the same checklist in every instance. They search the web, run some database reports, call former associates to press for candid comments, and call it a day. Sometimes their intent is not to discover anything, but simply to document that diligence was done — always a mistake.

Every diligence project should have its own plan based on the unique risk level and circumstances involved. If you were loaning \$100 to a long-time friend, you wouldn't spend much time researching her ability to repay. But if you were putting \$10 million in the hands of a stranger who promised to double your money in a month, you would want to learn as much as you could about him and his methods. Lesson one: Let the amount of risk determine the scope of your due diligence.

The Internet makes so much information readily accessible that people often try to conduct all of their due diligence by themselves. That may work for small, low-risk deals. But remember the adage about people who try to act as their own attorney: They have fools for clients. Any manager with an MBA can analyze financial statements. However, a major diligence project requires specialized research skills, interviewing skills, and covert investigation skills that aren't taught in business schools. Even an experienced auditor may miss certain red flags because she's trained to render an opinion on the fairness and presentation of financial statements, not to detect fraud.

Serious due diligence requires expertise. For a large-scale project, you'll want accounting specialists combing financial statements for glitches, legal specialists scrutinizing contracts and intellectual property for hidden liabilities, and investigative specialists checking backgrounds for past problems and conflicts of interest. In addition, you may want a technical expert to examine the viability of a company's proprietary technology or information systems. To find these experts you can ask reputable law firms, investment banks, or professional services firms for referrals.

Economic crises can make even the most cold-blooded capitalists prone to overreaction and susceptible to misinformation. As the recession deepens, don't expect a tsunami of scandals to crash down on the VC and technology industries as it did in the post-dot-com era (unless your

industry is somehow joined at the hip with the financial sector). Just remember as you conduct your diligence that if recently-concluded good times seemed a little too good, they probably were.

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