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Financial Service Firms, Boom Goes The Balance Sheet

By L Burke Files, CDDP, President, Financial Examinations & Evaluations, Inc (01/10/2014)

There have been a series of recent acquisitions of second and third tier financial services firms. The firms have included different types of firms such as insurance, family business management, securities, trust and estate planning, and tax management. These hasty acquisitions and the misunderstood role of due diligence often failed to discover hidden balance sheet bombs of future liability.

These mergers and acquisitions are driven by the required economies of scale that are required to deal with the cost of regulatory compliance and the network of the professional service providers requirement to gain access to markets with ever wider opportunities as demanded by their clients. These firms must grow rapidly, stay lean on expenses, and eventually merge. Failing to do this they will stagnate or they will simply fail to thrive. We get that.

The due diligence on these financial service firms is as much an art as it is a science. The shortcomings we have been seeing have been that the acquirers have been very good at the accounting and the science – and woefully short on the art. The ability of one financial service firm to review and audit another firm's data and create stupendous spreadsheets leading to the justification of the acquisition value and high confidence future values... well, its breath taking. The charts, of profit and loss, savings from synergies, and the cone of confidence in projected growth produce very attractive polychromatic charts. But just because it is pretty and convincing does not mean it is either scientifically accurate or art. It is much like a good suit on a bad man.

In continuation of this theme on the art of acquisition of a financial service firm, audits of the company's financials while required, should not be relied upon. While you should have one, they are more like a documentary seat belt against liability. Like in a car wreck, a seat belt only reduces the damage – it does not prevent the wreck that an attentive driver would have otherwise avoided.

I am sure that those skilled at creating and selling complicated financial instruments may also excel in fiscal engineering of financial statements for maximum ascribable value. When it comes to maximum present value for one of these firms a key point is to show a rising growth rate in sales and profits as well as to obscure any and all inchoate liabilities. The object is simple, the buyer thinks they are getting a steal and the seller is pleased with the success of their fiscal engineering skills.

An inchoate liability is the domain of the balance sheet bombs. An inchoate liability is any liability that is not yet a liability as a certain set of circumstances has yet to occur to make the set of circumstances morph from an inchoate liability into a full blown balance sheet bomb.

While there are many different balance sheet bombs – the one we have continued to see is abusive sales practices.

For the fiscally adept managers of these firms to create an illusion of rapidly increasing

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sales they often choose to push the sales representatives to reach ever greater sales targets and encourage the sales force to employ more aggressive sales practices – or provide to the sales force with leads that have been obtained by deceptive/overly aggressive advertising and high pressure double response mechanisms.

The tells that this practice has been put into effect are subtle. Typically one might see a shift to a new venue for lead generation. The managers of the firm have chosen a new venue to generate the leads, often with an Internet based marketing firm. The cost of marketing per sale appears to drop, as the cost of marketing is often coded into two or three other categories to disguise the true cost of the marketing. So while the cost of the lead to sale does go up with more aggressive lead generation stratagems, one will need to look in other accounts to find the mis-coded and obscured expenses.

Management changes compensation plans and sales targets typically are made more aggressive. Minimum sales targets are raised, with commission for fewer sales cut and those with greater production bonused. You might also see the use of some very enticing reward packages such as lavish vacations, for sales people and managers.

One other maneuver I have seen is that the compliance department is either forced into a series of look backs to clean up old files and records before the sale or compliance is outsourced. The look back keeps compliance busy and not engaged in current sales practices and the outsourcing keep compliance from being onsite each and everyday. Compliance is kept away from the nature of the push for more sales.

These tactics are typically used from six to 18 months in front of a planned acquisition or sale. The inchoate liability is the lead generation mechanism and sales practices that are either overly aggressive or outright non-compliant. These practices come to light as clients become disenchanted with the over hyped products or services. The disgruntled customers can no longer be fobbed off and the victims resort to regulatory complaints and litigation, often class action litigation.

The defense is difficult to master as an art. One may be able to obtain histories of customer complaints. All firms have complaints. To assess the level of complaints one should chart over time the complaints against the sales. All complaints will have the initial sales date of the product or service. Plot these along with the sales and look for the patterns. Complaints can be found with business bureaus, regulators, and even in litigation records and newspaper stories.

It is worth interviewing current and past sales representatives and compliance personal about what changes they have seen in the last 18 months. Look for spikes in all expenses. We have even seen some marketing expenses plowed into a capital expenses account and coded as office furniture.

It serves anyone looking at acquiring a financial services company not only to look at the numbers but also to inspect the lead generation mechanisms, sales practices and to take time to consider what value impairments might exist. For due diligence sakes, it is best to employ a démineur before buying the farm.

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