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DUE DILIGENCE AS A KEY SUCCESS FACTOR OF MERGERS AND ACQUISITIONS

This study analyses due diligence as a key success factor of M&A. Previous research has shown that more than half of M&A transactions fail to achieve the desired goals. Attempting to discover reasons and find solutions to this problem, some studies emphasized the importance of due diligence for successful M&A. Due diligence represents a detailed scan of various aspects of a target company. The purpose of such investigation is to provide the buying company, their advisers and creditors with a comprehensive grasp of value and risks pertaining to target company. Due diligence is a process which identifies, approves or denies business reasons for proposed M&A transactions. After general presentation of the process of due diligence, its phases and different areas of research, the study analyses the role of due diligence in alleviating risks associated with takeover process. Finally, a review of existing empirical research which proves the importance of due diligence for success of M&A is presented.

Keywords: *mergers and acquisitions, due diligence, target company, M&A success factors.*

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ФІНАНСОВА ЕКСПЕРТИЗА ЯК КЛЮЧОВИЙ ЧИННИК УСПІХУ ЗЛИТТІВ І ПОГЛИНАНЬ

У статті обгрунтовано фінансову експертизу як ключовий чинник успіху процесів злиття і поглинання. Попередні дослідження показали, що більше половини подібних операцій не дають бажаних результатів, і підкреслили важливість фінансової експертизи для успішних злиттів і поглинань. Фінансова експертиза є детальною перевіркою різних аспектів діяльності компанії. Мета такого розслідування — забезпечення сторони-покупця, її радників і кредиторів повною інформацією про цінності і ризики, що відносяться до цільової компанії. Фінансова експертиза є процесом визначення, схвалення або відмови від пропонованих операцій. Після загального представлення процесу фінансової експертизи, її різних фаз і областей дослідження проаналізовано роль фінансової експертизи в боротьбі з ризиками, пов'язаними з процесом приєднання. Представлено огляд існуючих емпіричних досліджень, які доводять важливість фінансової експертизи для успіху злиттів і поглинань.

Ключові слова: *злиття і поглинання, фінансова експертиза, цільова компанія, чинники успіху злиттів і поглинань.*

Табл. 3. Рис. 2. Літ. 24.

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ФИНАНСОВАЯ ЭКСПЕРТИЗА КАК КЛЮЧЕВОЙ ФАКТОР УСПЕХА СЛИЯНИЙ И ПОГЛОЩЕНИЙ

В статье обоснована финансовая экспертиза как ключевой фактор успеха процессов слияния и поглощения. Предыдущие исследования показали, что более половины подобных операций не дают желаемых результатов, и подчеркнули важность финансовой экспертизы для успешных слияний и поглощений. Финансовая экспертиза представляет собой подробную проверку различных аспектов деятельности компании. Цель такого расследования — обеспечение приобретающей стороны, ее советников и кредиторов полной информацией о ценностях и рисках, относящиеся к целевой компании. Финансовая

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экспертиза представляет собой процесс определения, одобрения или отказа от предлагаемых сделок. После общего представления процесса финансовой экспертизы, ее различных фаз и областей исследования проанализирована роль финансовой экспертизы в борьбе с рисками, связанными с процессом присоединения. Представлен обзор существующих эмпирических исследований, которые доказывают важность финансовой экспертизы для успеха слияний и поглощений.

Ключевые слова: *слияния и поглощения, финансовая экспертиза, целевая компания, факторы успеха слияний и поглощений.*

1. Introduction. Many companies regard M&A as a superior way of strategic, production and market expansion in order to improve competitive advantages. However, achieving M&A success presents serious challenges to management. Although expectations regarding the results are optimistic, research shows that M&A usually do not achieve the desired goals. Many studies (Schuler and Jackson, 2001; Epstein, 2005; KPMG, 1999; AIM M&A, 2009) have come to the same conclusion that due diligence in the preparation phase of a transaction represents one of the key success factors of M&A.

This study explores due diligence as one of the possibly most critical phases of the M&A processes. Due diligence is the process of investigating all aspects of a target company, including finances, production and technology, legal, IT, human resources and culture, to perceive whether initial impressions of this company were accurate, and in order to make the decision whether to go on with the acquisition process and at which price. Due diligence estimates how acquisition will affect the efficiency of internal business processes and creation of new capabilities, thus providing realization of those acquisitions which can contribute to realization of strategic goals of a company, and increase its value for shareholders. Despite general consensus of managers, accountants and bankers regarding the importance of due diligence, this aspect of M&A process is relatively unexplored in literature.

2. Due Diligence: Corporate Investigation. Preparation and organization of a company for efficient M&A presents an important precondition for its successful implementation, because it facilitates a professional investigation of the possibilities for added value creation. Anyone who intends to acquire another company should try to obtain as much information as possible regarding a target company and its assets, in order to be able to make the correct decision on investing in it. The process which deals with investigation and collection of necessary information on a target company is called due diligence.

Due diligence represents a thorough analysis of target company operations; its strengths and weaknesses, its strategic and competitive position within the industry (Angwin, 2001). It is the process of collecting and verifying information designed to support the valuation of a target company, its resources and liabilities. It involves deep scanning and reviewing all aspects of a company, including production, technology, marketing, sales, finance, regulatory framework, human resources and others. Through this process acquiring companies receive and verify accuracy of public and private information regarding the target company. Obtaining better quality information through the process of due diligence may lead to improved identification and valuation of assets and liabilities intended to be acquired (Wangerin, 2010).

Due diligence should include a quick but rigorous examination of the target company, evaluate business infrastructure and assess the performance of key business processes; analyzing the operational efficiency of the target company and identifying potential opportunities for achieving financial savings, improved productivity and improved quality of products and services (Robin, 2002). The basic function of due diligence is to assess the benefits and constraints of the proposed acquisition by examining all the relevant aspects of past, present and predicting future functioning of the business to be purchased. This definition reflects the narrow view which can be described as conventional. Different and broader definition is offered by International Business Standards Association: "Due diligence is the investigative process of collecting and analyzing adequate, relevant data before making a decision, with the aim of understanding advantages, disadvantages and risks associated with a decision." (Arslan, 2009).

Due diligence as a process of systematic check of truth and fairness, as well as of management behavior concerning risk and utilization of resources, represents a necessary preparatory stage in the process of acquiring companies. Effective due diligence should discover the questions which can stop negotiations, lead to termination of the transaction or even cause prolonged lawsuits (Savovic, 2009). Costs of such actions often exceed investments necessary to conduct due diligence prior to acquisition. Another important argument in favor of due diligence lies in the fact that in an increasingly complex economy, the impact of corporate acquisitions and strategic and financial business policies of the potential target are not transparent to the investor without a comprehensive and detailed analysis, even if the target is from the same industry as the acquirer. Detailed and comprehensive analysis is thus an absolute precondition for securing the transparency required to make a purchase decision (Kuhlwein, 2006).

Purpose of due diligence is to provide support to the valuation process, negotiation process as well as to planning and post-acquisition integration (Bruner, 2004, p. 211). Due diligence activities are focused on investigating value of target company by identifying and determining value drivers, as well as on considerations why combination of 2 businesses may be unsuccessful. Due diligence also seeks to assess the possibility of target company to comply with the global structure of the acquiring company and whether desired synergies can be achieved. In this way, due diligence refers not only to financial and legal considerations, but also includes operational and strategic aspects.

2. The Process of Due Diligence. Due diligence represents one of the most important stages of the M&A process, as it provides the buying company with means to better control the involved risks and to achieve the goals of the acquisition. It is ideal to begin the due diligence process while transaction is being prepared, when publicly available information can be used. Sequential phases of the due diligence process are: (a) preliminary due diligence, (b) due diligence review and (c) transactional due diligence.

During preliminary due diligence, potential benefits of the acquisition are reviewed, and publicly available information on target company is collected and estimated. For target companies which are publicly listed, this means reviewing financial statements and other information. Public information regarding target company can be gathered during preliminary due diligence from other sources as well, including analyst reports, business magazines and non-financial information disclosed by the company in other ways (material available on corporate web sites, product brochures). Managers of the acquiring company become more informed on target company during preliminary due diligence, but no more than other market participants who are aware of the publicly available information.

Due diligence review begins when participants begin the negotiations process and sign the confidentiality agreement. The objective of this phase of the due diligence process is to obtain and evaluate private information on target company which will be useful for: 1) deciding whether to execute the acquisition and if so, 2) negotiating the terms of acquisition. Information and litigation risks encourage the acquiring company to obtain private information from the target company during the due diligence review, while target company has incentive to disclose private information to maximize the purchase price and increase the probability of reaching agreement between participants.

During transactional due diligence acquiring company continues to gather private information and performs procedures to verify accuracy of the information collected during due diligence process. Acquisition agreements are designed to facilitate verification function of the transactional due diligence by incorporating statements and guarantees. The acquiring company can obtain the most valuable and precise information during transactional due diligence in order to evaluate fair value of the acquired net assets. Transactional due diligence provides the company with the final opportunity to check what is being purchased prior to assuming the risk of ownership. At the end of transactional due diligence, company assumes ownership and control over the target company.

There are different types of due diligence. Table 1 shows 3 major areas of due diligence, while Table 2 shows other areas which are investigated during due diligence.

Table 1. **The main due diligence topics**

DUE DILIGENCE TOPIC	*FOCUS OF ENQUIRIES*	*RESULTS SOUGHT*
Financial	Validation of historical information, review of management and systems	Confirmation underlying profit. Providing basis for valuation
Legal	Contractual agreements, problem-spotting	Warranties and indemnities, validation of all existing contracts, sale and purchase agreement
Commercial	Market dynamics, target's competitive position, target's commercial prospects	Sustainability of future profits, formulation of strategy for the combined business, input to valuation

Source: Howson, Peter, (2003) *Due Diligence: The Critical Stage in Acquisitions and Mergers*, Gower Publishing Limited, p. 8.

The objective of financial due diligence is to investigate financial performance of the target company in the past, present and future, and thus represents a key point in assessing the financial state of the given company. However, the analysis of the target company should not be reduced to financial analysis; rather it should involve a range of different areas. As each transaction is unique, the acquiring company should consider the acquisition by taking into account the type of activity and whether the transaction will be profitable and will contribute to realization of benefits. Having that in mind, a company should think strategically, depending on the nature of the target company as well as its initial goals.

Table 2. **The other due diligence disciplines**

DUE DILIGENCE TOPIC	*FOCUS OF ENQUIRIES*	*RESULTS SOUGHT*
Human Resource and Culture	Contents of the workforce, terms and conditions of employment, level of commitment and motivation, organizational culture	Uncovering employment liabilities, assessing potential human resources costs and risks of the deal, prioritizing the HR issues that need to be dealt with during integration, assessing cultural fit, costing and planning the post-deal HR changes
Management	Management quality, organizational structure	Identification of key integration issue, outline of new structure for combined businesses
Pension	Various pension plans and plan valuations	Minimization the risks of under-funding
Tax	Existing tax levels, liabilities and arrangements	Avoiding any unforeseen tax liabilities, opportunities to optimize position of combined business
Environmental	Liabilities arising from sites and processes, compliance with regulations	Potential liabilities, nature and cost of actions to limit them
IT	Performance, ownership and adequacy of current systems	Feasibility of integrating systems; associated costs. IT plans for operational efficiency and competitive advantage
Technical	Performance, ownerships and adequacy of current systems	Value and sustainability of product technology
Operational	Production techniques, validity of current technology	Technical threats; sustainability of current methods; opportunities for improvement; investment requirements
Intellectual Property Rights (IPRs)	Validity, duration and protection of patents and other IPRs	Expiration; impact and cost
Property	Deeds, land registry records and lease agreements	Confirmation of title. Valuation and costs/potential of property assets
Antitrust	Various national filing requirements (some of which can be expensive if not complied with); degree of market/information sharing with competitors	Merger control filings and clearance; an assessment of any antitrust risks posed by the target's activities; an assessment of the enforceability of the target's contracts
Insurance/Risk	Present, future and, most importantly, past exposures of the business. The structure and cost of the existing programme	The costs and benefits of retaining risk versus transferring it

Source: Howson, Peter, (2003) *Due Diligence: The Critical Stage in Acquisitions and Mergers*, Gower Publishing Limited, p. 8

Traditionally, due diligence has been focused on the examination of material property of the company. Financial and legal experts attempted to perceive potential obstacles or scenarios of future growth after the acquisition. The attention of auditors, attorneys and accountants was primarily focused on verifying historical data and evaluating material property of the company. However, constraining the process to evaluation of financial statements and physical property has serious weaknesses. It is of essential importance that due diligence goes beyond prior analyses and includes a detailed analysis of own strengths and weaknesses, as well as opportunities and threats which exist in the environment (Lebedow, 1999). Also, information which historically has not been included in due diligence process pertains to immaterial property of the company. "Soft" property such as the quality of management and employees, corporate culture and loyalty of buyers present crucial elements of future success or failure of the acquisition. It is therefore necessary to evaluate the intangible assets, such as: 1) intellectual property rights, 2) business secrets, 3) contracts and licenses, 4) databases, 5) employee and organizational networks, 6) organizational culture and 7) know-how of employees and management and their impact on the future. Besides standard due diligence, companies should conduct also organizational due diligence, focused on examining strategy, culture, leadership, competences, organizational structure etc. The most important reason for implementing organizational due diligence is to set the best strategies in order to achieve desired business results, as well as ensuring the best alignment of 2 company cultures (Harvey and Lusch, 1995).

Particularly highlighted is the importance of the cultural due diligence which relates to determining cultural compatibilities of international acquisitions. Implementing cultural due diligence prior to the acquisition can help the acquiring company to assess whether combination of different cultures at the post-acquisition stage can be successful. Research shows that cultural analyses were ignored by many companies, which can cause failure of the acquisition transactions. Angwin (2001) in the study on 142 cross-border acquisitions reached a conclusion that majority of the acquiring companies paid little attention to assessment of culture compatibility during due diligence process.

In recent times, more attention is paid to strategic due diligence which adds an important filter for target company scanning. Managers must be convinced not only that potential value of integrated entities justifies the investment, but also whether future business will be capable to realize this value. Rational evaluation should help determining the purchase price, taking into account that price be in line with the level of integration risk. Focus of strategic due diligence is determining the exact possibilities for creation of value of each transaction (Adolph et al., 2006).

3. The Role of Due Diligence in Mitigating Acquisition-Related risks. The role of due diligence is reflected in assisting companies that intend to carry out acquisitions to understand and evaluate future transactions, to identify potential risks, and strengthen their bargaining position. The objective of due diligence is to identify business problems, particularly detecting issues which can halt the negotiations, produce unexpected future liabilities or cause failure of the acquisition during the post-acquisition phase. Adequate understanding of the target company requires a combination of financial, legal and commercial due diligence, as well as other types of due diligence, in order to provide important inputs for valuation of the target company, provide the best possible negotiating position for the buyer, facilitate integration after the acquisition and minimize possible risks.

Managers of acquiring companies face ex-ante information problem prior to completion of M&A transactions concerning the uncertainty of adequate valuation of the target company. This ex-ante information problem exists for two reasons. First, managers of the acquiring company are at a disadvantage because managers of target company hold valuable private information. Second, managers of the acquiring company face informational uncertainty regarding expected future cash flows to be generated after the acquisition. Information asymmetry between managers of the target company and acquiring company combined with information uncertainty regarding future cash flow create information risk.

Besides information risk, other possible risks faced by acquiring companies include:

- First, whether there are restrictions in sale of stock or assets (licenses, joint venture or shareholder agreement etc.);

- Second, acquisitions rarely involve only investing in a profit-making company. Their purpose usually involves making presence on a new market, expanding operations base (through vertical or horizontal integration), acquisition of new technologies or intellectual property or strengthening competitive position. In these cases, buyer risks failure in accomplishing internal acquisition objectives. For example, acquiring company may wish for the target company to become a distributor of its products on their territory. Target company may, on the other side, have a signed contract with a competitor which limits the possibility of accomplishing desired goal.

- Third, buyer must be certain of the capability of the target company to continue its operations after the acquisition. This risk is the most realistic in the cases when assets are acquired and entity operations are changed, where it is necessary to facilitate extension of existing business contracts, re-licensing and approvals. Acquiring shares often poses similar risks, if institutions in charge can discontinue or withhold licenses or if suppliers or buyers have the right to terminate contracts.

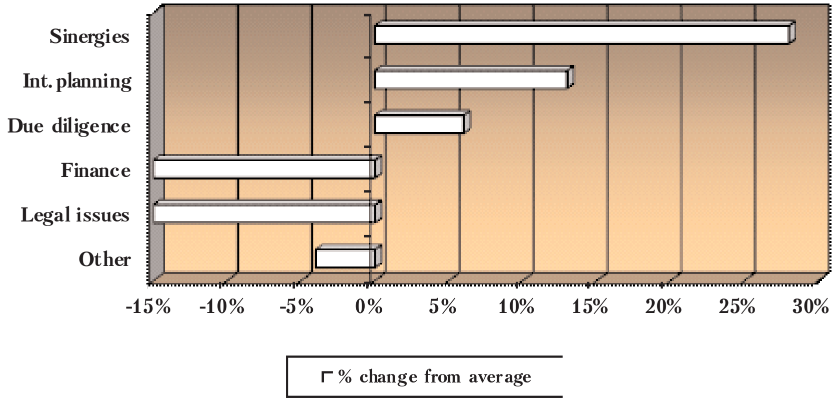
- Fourth, buyer must be certain of its capability to integrate and than manage and control the target company and maintain its goodwill. The risk that may arise here is that employees of the target company refuse to accept management style or method of the acquirer, or that buyers or essential suppliers (including lenders) discontinue support to company operations (Bhavri and Bajaj, 2008).

Possible risks are also related to lack of strategic alignment, redundant assets or employees, incompatible corporate cultures, technology, vague and imprecisely defined liabilities etc. In international M&A, companies face graver risks and uncertainties compared to domestic M&A. International transactions are much more complex because, besides general risks, they include a number of unique risks or challenges. Due diligence should be understood as a continuous process tailored to deal with practical needs of each transaction, thus helping to identify, prevent and manage material risks and increasing the probability of long-term success of M&A.

4. Due diligence. One of the Key Success Factors of M&A. For years scientific and professional community has attempted to explain the high rate of failure of M&A. Obviously, no one attempting an acquisition intends to lose value for shareholders, but rather has optimistic expectations regarding results and competitive advantage, which in reality is often not realized (Pokrajcic, Savovic, 2010). According to Schuler and Jackson (2001) key success factors of M&A are: well defined objectives and tasks, due diligence, good management by the acquisition team, successful learning based on previous experience, integrated planning, keeping key talent, widely present and timely communication with all stakeholders.

According to Epstein (2005) determinants of merger success are: strategic vision and alignment, structure of M&A transaction, due diligence, pre-merger planning, post-merger integration and external factors. Duncan et al. stated the following key factors: previous experience in acquiring companies, strategic compatibility, focus on key business activity, cultural alignment and integration process. As organizational due diligence, among other things, deals with issues of strategic and organizational compatibility, there is no doubt that these authors have pointed out the importance of due diligence. Jemison and Sitkin (1986) also stressed the importance of strategic and organizational alignment for the importance of M&A. Datta (1991) specifically emphasized the importance of organizational alignment, which affects the ease with which two organizations can merge on different dimensions after M&A.

KPMG (1999) lists 6 factors that successful companies use to create value and groups them into two categories: 1) hard factors, related to the activities which have direct impact on financial performance and; 2) soft factors, which refer to human aspects. Hard factors include assessment of synergy, planning integration and due diligence, and soft factors include selecting management team, understanding cultural differences and communications. Companies which prioritized on due diligence, according to the research, had 6% more successful transactions than the average (Graph 1).

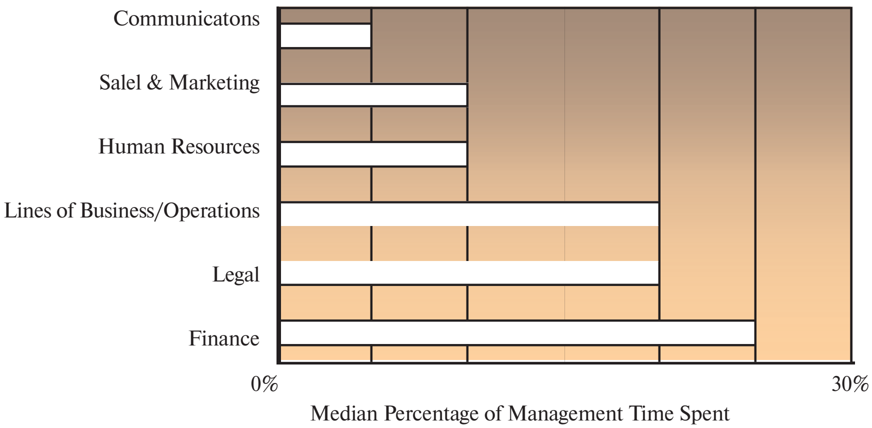


Source: Kelly J., C.Cook, D.Spitzer, Mergers & Acquisitions: Global Research Report (1999), pp.1-21, http://www.kpmg.co.uk.

Graph 1. **The impact of hard factors on M&A success**

The report "Making Acquisitions Work: Capturing Value After the Deal" of the consulting firm "Booz Allen & Hamilton" emphasizes that the success of M&A depends on the ability to integrate 2 companies, planning details from the beginning, identifying the sources of value and ways of capturing it (within strategic due diligence), where it is important to manage inevitable challenges of cultural change and provide expert leadership (Harbison et al., 1999).

Perry and Herd (2004) emphasize that in circumstances when M&A are becoming more complex, due diligence becomes more important than ever, as the best way to mitigate the risks companies face during M&A activity. Moeller believes that carrying out detailed due diligence is the best way to increase the success of M&A. Graph 2 shows the total management time spent on function during due diligence according to survey Hewitt Associates (2009).



Source: M&A Transactions and the Human Capital Key to Success- Global Report (2009) Hewitt Associates LLC, http://aon.com/attachments/thought-leadership/Hewitt_Global_MandA_Survey_Findings.pdf 29.05.2012.

Graph 2. **Total Management Time Spent on Function during Due Diligence**

AIM M&A Survey (2009) aimed at identifying and evaluating the importance of factors affecting M&A success by questioning board level executives. The importance of each factor was scaled from (1) "irrelevant" to (5) "of key importance". 18 M&A success factors ranked by importance are: post-acquisition integration, due diligence, non-financial due diligence, managing relations with existing clients and relatedness of M&A strategy to corporate strategy and so on. Factors of due diligence and non-financial due diligence are ranked as the most important factors for the post-merger integration, with average grades of 4.47 and 4.43 respectively (Table 3).

Summarizing the results of empirical research and relevant literature, undoubted importance of due diligence for success of M&A is evidenced. Due diligence should address not only financial, legal and operational issues, but also the issues dealing with organizational values, aspirations and culture. Due diligence should provide insights not only whether the potential value of integrated entities justifies significant investment, but also whether business is able to realize this value.

Conclusion. Despite the efforts to improve competitive advantage and create value for shareholders through M&A, studies continuously indicate that many mergers fail, instigating search for answers why it is so. Among the factors discovered by authors, important place is reserved for the due diligence process, which is recognized as one of the key factors determining the success of M&A. Due diligence is the process of thorough, detailed and comprehensive investigation of financial and market performances of selected target companies, which aims to collect and process relevant information which can be of essential importance for final decision in choosing the target company.

Table 3. **AIM M&A success factor rankings**

RANKING	SUCCESS FACTOR	WEIGHTED AVERAGE
1	Post-merger integration	4.56
2	Due diligence	4.47
3	Non-financial due diligence	4.43
4	Maintaining existing client relationships	4.42
5	Linking M&A and corporate strategy	4.37
6	Leadership	4.34
7	Communication (internal & external)	4.19
8	Method of financing	3.94
9	Speed of integration	3.94
10	Managing cultural issues	3.94
11	Managing human resource issues	3.84
12	Recommended (i.e. not hostile) deals	3.80
13	Prior M&A experience of the directors	3.67
14	Acquire related M&A targets	3.57
15	Minimizing employee turnover	3.54
16	Minimizing executive turnover	3.32
17	Planned rather than unplanned M&A	3.22
18	Prior M&A experience of the Company	2.85

Source: AIM M&A Survey, 2009, Daniel Stewart & Company, p. 14
http://www.danielstewart.co.uk/Assets/19314/aim%20m%26a%20survey%202009.pdf (30.03.2012)

Main types of due diligence are financial, legal and commercial. Besides traditional due diligence, which involves scrutinizing financial statements, attention is also paid to organizational due diligence, which focuses on examining strategy, culture, leadership, competences, organizational structure and processes. Special importance should be given to cultural due diligence, which is an important tool for identifying potential problems arising from cultural differences. Systematic cultural due diligence, conducted before the acquisition process can determine whether cultures of 2 organizations are compatible and how best to combine them. In recent years, importance of strategic due diligence is also stressed, which has the objective to investigate possibility of creating value from M&A transaction.

Due diligence provides necessary information to evaluate the target company, to facilitate negotiations and to carry out integration after the acquisition. It is a continuous process which should be adjusted to each particular transaction, with the aim to identify, prevent and minimize risks, which could arise after the acquisition process. Many studies have confirmed beyond doubt the importance of thoroughly conducted due diligence process for long term success of M&A.

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