CULTURAL DUE DILIGENCE AS A PROACTIVE STRATEGY OF ORGANISATIONAL CHANGE: AN EMPIRICAL ANALYSIS

MARIO PEZZILLO IACONO

Abstract
This paper focuses on cultural due diligence as a tool to handle the changes related to a merger and acquisition process. The main goal is to provide a framework to handle the whole merger process in a proactive perspective to managing changing. For a due diligence to be strategic in the decision-making process, it must be related to the ability of evaluating its actual success: the identification of potential problems of culture clash and the anticipated management of the post-merger integration process define a proactive logic of change management, rather than a reactive strategy or an adjustment strategy. Cultural change should occur in all the companies involved and begin as soon as the deal is considered, rather than when due diligence is completed: cultural due diligence helps anticipate the demands of integration. When preliminarily considering cultural characteristics, the acquirer's executives can be prepared to articulate a cultural "end state" for the combined organization; decisions can be made to retain a degree of cultural autonomy in the target or to approach the work of fully assimilating the acquired culture. For the purposes, I examine the use of a professional advisor - NM Rothschild & Sons - in particular. The study is
carried out by means of the behaviour analysis of the "due diligence teams" made up of the advisor in the framework of four cross-border merger operations, carried out in the banking sector in particular.

Keywords: Organizational Change, Due Diligence, Culture Clash, Mergers and acquisitions

1. Introduction and focusing

Mergers and acquisitions (M&As) have long been a popular strategy for firms and represent an important alternative for strategic expansion. While the majority of M&As involve two firms within the same country, over 40% of the M&As that were completed between 2005-2007 involved firms headquartered in two different countries (Thomson Financial, 2007).

A race for global M&A continues to drive transactions to new record-breaking highs in volumes and size of deal. Technological development and globalization have vastly contributed to the popularity of M&As and cross-border M&As. The total number of worldwide M&As has been increasing recently at a rapid rate: according to Thomson Financial (2007), the deal value rose 56% in 2007 to hit a new record of $1.48 trillion. The dynamics of cross-border M&As are largely similar to those of domestic M&As (Shimizu et al, 2004).

It is traditional to assume that acquisitions fail. Many M&As have failed to achieve their objectives owing to questionable acquisition motives, problems regarding valuation and premiums paid, and especially difficulties in the post-acquisition integration process (Koob, 2006).

Recent evidence suggests that they are not highly successful. For instance, a study by KPMG Corporate Finance (2004), found that only 30% of cross-border acquisitions created shareholder value, while 55% destroyed it. Another survey,
this one made by McKinsey & Co., is that 88 percent fail (Kazara Software Corporation, 2003).

M&As pose tremendous challenges, in particular, at the post-acquisition stage (Child et al., 2001): the success or failure of a merged corporation often depends on its ability to integrate effectively the two previously independent organizations and to operate as a coherent entity. However, due to their international nature, cross-border M&As also involve unique challenges, as countries have different economic, institutional (i.e., regulatory), and cultural structures (Hofstede, 1980; House et al., 2002).

The impact of corporate culture on the success or failure of a merger or acquisition is of paramount importance. Culture clash afflicts every corporate combination. By their very nature, mergers and acquisitions produce a "we versus they" relationship, and there is a natural tendency for people to exaggerate the differences, as opposed to similarities, between the two companies.

Different social and cultural environments affect the way in which buyers perceive opportunities and the actual and potential value of target businesses. Indeed, while cultural difference between merging firms often is the most cause of post-deal problems and regret, it's seldom examined correctly in the run-up to the purchase agreement and closure. This particular dimension, however, rarely comes into play in the analytical framework used by the companies themselves, or by the investment bankers or the corporate lawyers who are brought in as counsel or who conceive of the deal in the first place.

The objective of this paper is to provide a framework to handle the whole merger process in a proactive perspective. This paper is focused on cultural due diligence, as a tool to handle the changes related to a merger process.

For a due diligence to be strategic in the decision-making process, it must be related to the ability of evaluating its actual success: the identification of potential problems of culture clash and the anticipated management of the post-merger integration process define a proactive logic of change management, rather than a reactive strategy or an adjustment strategy.
2. The cultural due diligence process in cross-border M&As

There are multiple processes involved in M&As, such as due diligence, negotiation, and integration. In this paper, I consider these three steps in a complex, interdependent perspective.

All pre and post-acquisition processes are dynamic and involve learning. In fact, in each of them, the acquirer should improve its knowledge of how to use each of the processes to reach a successful conclusion.

Due diligence is a complex process in all M&As (Hitt et al., 2001); it is intended to be an objective, independent examination of the acquisition target. In particular, it focuses upon financials, tax matters, asset valuation, operations, the valuation of a business, and providing assurances to the lenders and advisors in the transaction as well as the acquirer’s management team (Angwin, 2001).

The process is often preoccupied with financial issues, sales and revenue forecasting, and technology sharing, leaving cultural differences as an afterthought (Koob, 2006); however the due diligence process should go beyond the mere examination of the financial health of the target firm, providing a thorough analysis of its intangible assets and resources. It is complicated by a few elements that appear even more crucial in cross-border M&As. Differences in the national cultures, for instance, largely imply different individual values, risk propensity, acceptance of uncertainty, etc., while differences in corporate cultures suggest different organizational routines, managerial practices and styles, communication systems, etc. These elements include the different institutional environments between the two firms’ home countries and their two different cultures (either at national and corporate levels). Firms are embedded in a system of social and cultural norms that often affect the processes and outcomes of cross-border M&As. In general, differences in the institutional environments may be based on different regulations, accounting standards, value systems, etc.

The objective of cultural due diligence is not to eliminate culture clash in a combination. While too wide a gap in underlying values and ways of approaching work is unhealthy, the best mergers and acquisitions occur when a fair amount of culture clash prompts positive debate about what is best for the combined organization.
Therefore culture due diligence should help buyers spot likely people problems at a target and determine whether potential clashes might sink the deal. People don't regularly notice their corporate culture, but when thrust into a combination, employees become aware of how their ways of doing things differ from those of the other side: they also feel a sense of vulnerability and fear over losing their accustomed ways of doing business (Marks, 1999).

Cultural change should occur in all of the companies involved and begin as soon as the deal is considered, rather than when due diligence is completed: cultural due diligence helps anticipate the demands of integration.

Despite the importance and complexity involved in a cultural due diligence process in cross border M&As, research on this phenomenon is limited. By considering cultural characteristics early on, the acquirer's executives can be prepared to articulate a cultural "end state" for the combined organization; decisions can be made to retain a degree of cultural autonomy in the target or to approach the work of fully assimilating the acquired culture.

3. Theoretical Framework

3.1 Organizational change

The theoretical framework of the paper is focus on a process perspective: this perspective attempts to combine pre-merger fit with post-merger integration (Hasepilagh and Jemison 1991), highlighting a process-based contingency theory (Hunt 1990) in which “organizational culture” played a central role.

This framework is consistent with the Van de Ven and Pool’s definition of “process study of organizing”. It corresponds to the “strong” process approach described by Tsoukas (2005) and Chia and Langley (2004). It presumes the world is composed of processes, and applies the process research approach. On this view, an organization is a reification of a set of processes that maintain the organization by continuously structuring it and maintaining its boundaries in a field of other processes that are continuously breaking down the organization and its boundaries. In this view, stability and change are explained in the same terms: stability is due to processes that maintain the organization so that it can be reified as the same thing by some observer(s), while change occurs when the processes
operate in a manner that is reified by observer(s) as changing the organization. In both instances, stability or change are judgments, not real things, because the organization is a process that is continuously being constituted and reconstituted (Rescher 1996).

The process research approach explanation include both an account of how one event leads to and influences subsequent events and an explication of the overall pattern that generates the series.

3.1 Organizational culture

Organisational culture has been identified as an important element of organisational change (Pettigrew et al., 1992). According to Schein, we cannot understand organizational learning, development and planned change unless we consider culture as the primary source of resistance to change. This conceptualization entered into discussions of mergers in the mid-1980s (e.g. Buono and Bowditch 1989; Marks and Mirvis 1998; Walter 1985) and it has become a popular topic in mergers, one that is now accorded central relevance in both academic and organizational settings. Overall, most merger authors operate from the assumption that “organizational culture” is essential to the creation of value. Yet, they forewarn of the immediate concern: that the interaction of the two organizational cultures could result in a loss rather than a creation of value (Haspeslagh and Jemison 1991).

Within the rational fit approach to mergers (e.g. Chatterjee 1986), interest turned to ‘culture fit’ (Olie 1994) as a component in pre-merger prescriptions (e.g. Cartwright and Cooper 1993). Building their study on a theoretical framework based on national cultural differences and the potential fit between the characteristics of the two cultures, Weber et al. (1996) found that differentials in corporate culture affected the cooperation between the two firms’ top managers. As such, they found negative attitudes toward the merger when there were greater differences in corporate culture.

A number of scholars have developed integrative frameworks of organizational culture (Allaire and Firsio0tu 1984; Hatch 1993; Martin 1992; Schein 1985, 1990), but little consensus exists with regard to a general theory. Because culture is a
complex phenomenon, ranging from underlying beliefs and assumptions to visible structures and practices, some observers question whether culture can actually be “measured” in a comparative sense.

Most of these authors suggest that corporate culture can be viewed as “the DNA of an organization” (Marshall, 2000). An organization’s culture reflects how managers and employees relate to each other, how decisions are made, and how work is accomplished. Organizational culture is a pattern of beliefs and behaviours, assumptions and routines, which are distributed and used by the people within the firm. Culture encompasses the way the organization “ticks” as well as its corporate values, philosophies, and ethics. In most organizations, culture is so well established as a property of a firm that hardly a day goes by without reference to it, either overtly or subtly.

Kotter and Heskett (1992) expanded on this by exploring the importance of adaptability and the fit between an organization and its environment. Management is embedded in a wider societal setting, and is heavily influenced by historical and cultural norms, indeed there are significant social pressures to conform to local forms of rationality (DiMaggio & Powell, 1983). As Whittington (1993) observes, business strategies may be the product of very particular historical and social circumstances.

The problem of integrating cultures at a double level is referred by Barkema et al. (1996) as “double-layered acculturation”. Of course, the potential for conflict on cultural bases depends on the degree of integration required (Nahavandi and Malekzadeh, 1988): the greater the integration, the coordination necessary to implement it successfully and, therefore, the greater the importance of cultural differences. Overall, most merger authors now operate from the normative assumption that “organizational culture” is essential to the creation of value (Riad, 2005).

Recently, more attention has been paid to post-acquisition issues such as integration processes (Child et al., 2001; Inkpen et al., 2000; Lubatkin et al., 1998), integration processes from an employee viewpoint (Risberg, 2001) and post-acquisition turnover of acquired firm executive.
However, different social and cultural environments affect also the way in which acquirers perceive opportunities and the actual and potential value of target businesses. In terms of the due diligence process, these perceptions may also show in variations among the issues that appear to be of most importance to the acquiring company.

4. Case study

4.1 Method

The study involved a case study (Yin 1984, Eisenhardt 1989) of a merchant bank advisor, N M Rothschild & Sons. NM Rothschild & Sons (Rothschild) is an investment bank company and a financial advisor; it is a global firm with over 40 offices in more than 30 countries, from the Americas through Europe to Australia. Rothschild operates through three divisions: Investment banking, Corporate banking, Private banking and trust. Rothschild Investment Banking in particular provides financial advice and execution expertise, encompassing Mergers & Acquisitions, Restructuring, Private Placements, Privatisations, and Equity Capital Markets.

The firm is consistently in the top 10 global investment banks for M&A advisory. According to Thomson Financial data, in 2007 Rothschild announced 390 deals worth a total of $566bn, giving it 12.6% market share. The firm is particularly strong in Europe, especially in the UK, France, Germany, Italy, and the Benelux countries, in each of which Rothschild consistently holds a top league table position. Rothschild has received several awards in recognition of its M&A positions in various countries from Acquisitions Monthly, Financial Times Merger market, Financial News, and Euromoney. Awards include Rothschild being named as Best UK M&A House, Best European M&A House, and Corporate Finance Advisor of the Year in 2006 as well as M&A Bank of the Year in 2007.

The analysis is focused on Rothschild UK Investment Banking in particular. The study is carried out by means of the behaviour analysis of the "due diligence teams" made up of two advisors in the framework of four fusion operations (carried out in the banking sector in particular).
The method of data collection is participant observation (Wax, 1968): I became participant, as observer, in the activity of the due diligence teams. Miles and Huberman (1994) suggested that researchers should use qualitative research designs when there is a clear need for deep understanding, local contextualization and exposing the points of view of the people under study. The arguments seem clearly demonstrate that these needs apply in the case of studying M&As in banking industry (Schweizer, 2005). In earlier research, Larsson (1990) argued that case studies (Yin, 1993) are particularly appropriate for the study of M&A integration, given the need for detailed, contextual descriptions of very sensitive data. The use of case studies in the context of M&As is also in line with the recommendations of Javidan et al. (2004) and Napier (1989). The ethnographic fieldwork including (Van Maanen 1988):

- observation at integration meetings with advisor’s team;
- conversations with various members of the advisors before and after meetings;
- interviews: focus group interviews with people within their original team structure and individual interviews;
- internal document collection (including integration plans, emails, minutes of all the meetings, newsletters).

Researchers’ impressions are kept separate from the interviewees’ impressions, and all data are included in the write-ups even when not specifically requested in the interview guide (Yin 1993). This analysis (Knights and Morgan, 1991) is focused on identifying:

- subject positions in knowledge relations involving “organizational culture”;
- which are the cultural criteria to data collection;
- tools (formal and/or informal tools) applied to analyze “organizational culture”;
which are the specific forms of knowledge (on “organizational culture”) that are deployed to shape the conduct of others — i.e. the practices through which power is rendered operable;

- differences between formal organizational culture and subjugated culture.

4.2 Discussion

The department “Investment Bank” of Rothschild UK is, as regards the number of people employed, the most important in Europe: it has over 500 people.

The case study is about four processes of due diligence regarding as many operations of M&A in the bank sector: in particular the analysis was about two “acquisitions in a narrow sense” and two “mergers of equals”\(^1\). All were cases of “friendly take over” (a situation in which a target company’s management and board of directors agree to a merger or acquisition by another company).

For every operation of M&A in Rothschild, UK project teams “ad hoc” are created for the realization of the due diligence. The structure of the project team is quite stable as compared with the sector in which the operation of acquisition is realized (banking, insurance, institutions, etc).

The size of the project teams in these cases was variable, as requested by the complexity of the operation: from 20 units in the case of the most important merger of equals (in relation to value) to 7 units in the simplest case of acquisition. The duration of due diligence too was extremely variable: from 7 days (in the simplest case) to 30 days (in the most complex case).

In all the cases the work groups identified two main objectives: the “analysis of potential synergies” between the companies and the “analysis of organisational structures”; in the case of the two mergers of equals the teams were subdivided into two groups, each of them focusing on one of the objectives. The members of

---

\(^1\) Merger and Acquisition mean slightly different things. When one company takes over another and clearly established itself as the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist, the buyer “swallows” the business and the buyer's stock continues to be traded.

In the pure sense of the term, a merger happens when two firms, often of about the same size, agree to go forward as a single new company rather than remain separately owned and operated. This kind of action is more precisely referred to as a “merger of equals”. Both companies' stocks are surrendered and new company stock is issued in its place. So a merger of equals is the most accurate definition of a merger.
the two subgroups were chosen by the leader with reference to their professional competence; the leader appointed the person in charge of the two subgroups. Consistently with the objectives of the paper, the activity of “analysis of the structures” was mainly taken into consideration. In particular as regards the analysis of the cultural compatibility of the companies involved in the merger:

1. No process of formal due diligence was started in any of the cases under analysis; the analyses on these aspects were fragmented both in terms of time and of dedicated competences.

2. The analysis was partially developed only in the case of the mergers of equals and never in the case of acquisitions; the time devoted to the cultural analysis was estimated to be in a range of 3% - 5% in the acquisitions in a narrow sense and of 5% - 10% in the mergers of equals; the range is associated with the (broader or narrower) concept of activity of cultural due diligence.

3. It had as its main goal the evaluation of two essential elements: the level of cultural homogeneity of the organisation in the pre-merger phase and the level of organisational flexibility. In particular the approach adopted by the due diligence teams could be associated with Reigle’s approach (2001), according to whom the concepts of “contingency” matrix of organic and mechanical organisation, formulated by Burns and Stalker (1961), could be profitably used for the analysis of the company culture, also in a cultural due diligence. The characteristics of an organic organisation, the emphasis on the empowerment, on the work flexibility, on the side communications, seem to indicate that this type of enterprise is characterized by a stronger adaptability to changes. Under this respect, the organic enterprise is identifiable as a “target” which is connected with more chances of success as compared with a mechanical organisation, typically characterised by a very rigid and formal line of command, a system of communication that prefers vertical lines, a top-down decisional process. In other words in the cases we are analysing the level of adaptability of the company culture was identified as a positive criterion (Nelson, Quick, 1997; Daft, 2003); this criterion can be considered as an
explorative dimension in a cultural due diligence if we consider that it is possible to find out a positive connection between adaptability and aptitude of human resources to support the integration process.

4. The analysis has never involved a strategy of post-merger integration.

5. It had as a reference frame the analysis of organisational cultures by means of different levels of search; this operational approach is close to Schein’s theoretic approach. According to Schein (1985), culture is the most difficult organisational attribute to change, outlasting organisational products, services, founders and leadership and all other physical attributes of the organisation. His organisational model illuminates culture from the observer’s standpoint, described by three cognitive levels of organisational culture. The weakness of this approach is that it considers culture in a holistic, homogeneous sense, as opposed to Martin’s or Kunda’s more subjective views or to Weick’s relativistic view.

The due diligence team’s pattern consist of six analytical dimension (to analyze organizational culture): Basic Driving Force of Business, Operating environment, Life Style Indicators, Organization structure, Interpersonal Style, Reward & Recognition. The pattern is summarized below:

1. Basic driving force of business: a) for example, but not limited to technology, research, marketing, service, finance, other; b) are there Corporate values and what are they?; c) what is vision/strategic intent? d) are their values reflected/contradicted in their compensation system.

2. Operating environment: a) short/long term orientation; b) degree of entrepreneurialism; c) how far along are they in TQM initiatives?; d) level of competition (how competitive in the market); e) extent of competitive advantages; f) how structured is decision-making process?; g) degree of complexity of company (example: conglomerate, global, different business); h) commitment to employee health and safety; i) employee involvement; j) risk taking atmosphere; k) degree of accountability and responsibility given employees at different levels; l) concern of social responsibility; m) Labor relations philosophy.
3. Life style indicators: a) travel and entertainment practices; b) working environment; c) company car practices; d) management perquisites; e) distinctions between levels of management.

4. Organization structure: a) flat/hierarchical team/empowerment practices; b) centralized/decentralized; c) formalized leadership development/succession planning; d) turnover/senior management and key employees; e) time in position / senior managers; f) recruitment practices - internal & external; g) profile of human resources; h) degree of computerization; i) paternalistic versus low involvement; j) task versus people oriented; k) bureaucratic versus informal; l) generalist versus specialist; m) composition of board; n) procedures used in employee selection; o) promote from within versus hire from outside; p) long service versus up and out; q) degree of diversity

5. Interpersonal style: a) formal/informal; b) leadership styles; c) communication approaches (bulletin board/ TV/ newsletters, MBWA/annual reports, d) employee morale indicators (demeanor of employees, for example); e) "chemistry" between current company leadership team and target team

6. Reward & Recognition: a) fixed/variable compensation; b) compensation policy & practice; c) equity position of senior/key managers; d) celebration of success; e) Promotion criteria.

These factors are not measured using a numerical scale, but are described in specific and precise phrases. To summarise, according to the due diligence team leaders, the main elements which were taken into consideration in order to evaluate and analyse the gap between the companies involved in the merger are the following (listed in order of decreasing relevance for the due diligence teams):

- board composition;
- compensation structure;
- mission;
- marketplace reputation;
- internal and external recruitment practices;
As said by team leaders, the following areas be considered in performing pre-combination “cultural due diligence” work: business philosophies; critical success factors and measurements; leadership/management styles; organizational structure; workflow/practices; perceptions/expectations; customs/artifacts; and facilities/work environment.

At national and industry levels in particular, the Rothschild due diligence process (merger of equals) provided an understanding of the institutional environment in which the target firm is located, such as government regulations, to effectively respond to potential local constraints.

The analyses of cultural compatibility were mainly based:
1. on the analysis of internal documents (company mission / vision / strategic intent statements, strategic plan, value statements, human resources statements on mission / vision/ intent, recruitment literature, job evaluation system, leadership and succession planning descriptions/plans, human resources policy manual, performance review forms, dress code, TQM literature, training guides/records, organisation charts, employee publications, suggestion system);
2. on a limited number of interviews to the top management team of the banks involved in the merger of equals. In no case there were interviews with a higher number of employees and/or external stakeholders.

5. Summary and conclusions
The managerial and organisational literature has widely demonstrated how the precise awareness of the cultural differences among the organisations and the planning of the necessary adaptations in order to reach a unifying culture, are significant factors for a successful integrative process of the joined firms: in a
significant number of cases, in fact, the variance between the results expected at the moment of the strategic resolution and the ones resulting from the concentration (Mintzberg, 1979), is connected with the poor planning attention to the level of cultural and ethical compatibility of the companies involved in the transaction, as well as to the problems of “cultural stress”, connected with the management of the process of cultural integration.

The conditionings related with the organisational culture should therefore be considered as critical variables underlying the decisional process which have an impact on the strategic behaviour form and on the actual feasibility of the choices made. Coherently with this logic, the analysis of the possible inelasticity and resistance connected with the “culture clash” should be appropriately taken into consideration in the activities of target selection and of integration planning and should be a parameter of auditing and evaluation of the process of due diligence, which has by definition the objective of favouring informed decisions about the opportunity of the acquisition as well as of maximising the value of the transaction.

The starting point of the developed analysis is that the centrality of the cultural due diligence in the process of strategic decision making identifies a proactive logic of change management which increases the opportunities of success of the acquisition or of the merger operations even if it does not eliminate the danger of failure.

In the cases of due diligence being analysed, a strong tendency to the analysis of the level of cultural adaptability was pointed out. The hypothesis at the base of this model is that the tendency to an adaptive culture (in policies tending to promote trust and risk in the workers, in a management group that operates as an agent of change and focuses on the needs of all the groups of stakeholders, both internal and external) implies the capacity and the tendency of the organisation to reaction as well as to change development.

Rothschild’s view of the due diligence teams can be seen in the positive value given by the teams to such factors as innovation, creativity and workers’ assumption of responsibility. In this sense an attitude to investigate the ability of the companies object of M&A to react quickly to changes as well as to create
changes has been pointed out. The hypothesis at the base is that a non adaptive company characterised by a more cautious attitude and high bureaucratisation of the procedures has a physiologic tendency to keeping the status quo, and to path dependency.

The case under analysis leaves however many unanswered questions:

- is the model of analysis of company cultures really able to supply information on the exploitation of the possible synergies in the integration phase?
- are the instruments used in the due diligence efficient? Should the analysis of cultures require a thorough investigation of informal elements unlikely to be found in internal documents?
- is the capacity of managing the cultural integration always linked with the cultural likeness of the involved organisations?
- The organisational culture is analysed by the due diligence teams in a homogeneous way; could a better approach be found in a subjective view of organisational culture especially in the case of large and complex organisations?

6. References


collaborazione, in Boari, C. (a cura di) Dinamiche evolutive nei cluster geografici di imprese, Il Mulino, Bologna


Martinez M., De Marco M., (2005) I criteri di scelta delle metodologie di IS Development: un contributo dalle teorie di progettazione organizzativa, Sinergie; ISSN 0393-5108; CUEIM. Consorzio universitario economia industriale e manageriale; Vol. 19


Moschera, L., (2000), L’efficacia organizzativa, capitolo 8, in Mercurio R. e Testa F., Organizzazione. Assetto e relazioni nel sistema di business, Giappichelli, Torino;


Piscopo G., 2010. “L’impatto dello stile di leadership sul clima organizzativo: due indagini empiriche”. In Mecosan, n. 73;