

Finding a World of Opportunity in a World of Risks

An International Perspective on Due Diligence

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About RSM McGladrey (RSM)

RSM is the fifth largest accounting and consulting firm in the United States, and the largest focused on companies on the move. Through our national Private Equity Practice RSM provided due diligence on more than 150 engagements for more than 60 funds nationwide. We also audit more than 50 private equity funds and are the auditors for many private equity fund portfolio companies.

RSM McGladrey is the largest member firm of RSM International (RSMi), the world's sixth largest organization of accounting, tax and business consulting firms according to the International Accounting Bulletin. RSMi has office locations in more than 70 countries, including nearly all of the key markets of the world. We have more than 24,000 professional staff members and combined revenues in excess of \$2.7 billion. Through our unique International Office in Chicago, we have supported more than 1,200 international transactions in the last year alone.

Mention due diligence to most American business people, and they think of the traditional close examination of financial statements, projections and other representations involved in determining the appropriate purchase price for a target business.

While that examination remains vital in an international transaction, a much broader range of concerns must be addressed . . . starting with where those numbers come from to begin with.

In the U.S., transaction professionals are accustomed to accurate, transparent financial information governed by robust, mature accounting principles. That isn't the case everywhere in the world. Consider, for example, China, a key destination in today's global transaction marketplace.

While China has made tremendous progress in recent years in upgrading its accounting environment, the overall accuracy and reliability of financial statements in China is low. A recent article in the *Financial Times* points out that the Chinese Institute of Public Accountants has only 140,000 members. By most estimates, China needs at least 10 times as many trained accounting professionals. And it is still not unusual for a Chinese business to keep different sets of books for taxing authorities, investors, and its own management.

Nor is China alone in that regard. In developing countries the consistent application of financial regulations and accounting policies is an area that is still developing. Companies considering deals in such climates need to do considerable work to ensure the accuracy of financial statements before they even begin the type of financial due diligence that would characterize a deal with an American target.

Nor are financial statements the only areas that need more scrutiny. So, too, do the owners and managers of target companies or potential partners.

In the U.S. you can learn a tremendous amount about anyone involved in a deal in a few minutes. Credit history, criminal history, civil judgments, and bankruptcies—all are just a few clicks away. Not so in China. The personal reputations and histories of those with whom you will be doing business are vital. Professionals who have been reading up on business in China have all reviewed the stories of lower-level plant managers' living lifestyles far beyond the means afforded them by their salaries. While the Chinese government is taking steps to try to rein in corruption and fraud, the legal environment in China is still at an early stage of development when compared to the U.S.

Nor is bad news all you should look for. In any market, and especially in China, having connected business partners is vital. Guanxi, the Chinese version of networking, is vital to success in China. Part of the investigation of potential partners, investors or managers involved in a deal in China should be to establish and verify their connections within the business community and with any appropriate governmental entities. Those connections can be crucial to the success of your deal.

Be aware, however, that business traditions and ethics in China can be different from our own. While you want well-connected partners, you don't want partners engaged in activity that will run afoul of the Foreign Corrupt Practices Act. That caveat applies to your business relationships anywhere overseas, not just in China. And corruption isn't the only issue. With international terrorism a concern, capital flowing into the wrong hands could have your enterprise running afoul of the USA Patriot Act.

The human factor isn't all that needs to be examined; human resources should be closely taken into account as well.

Consider the following scenario: An American business spots a European company with similar products and markets but suffering from poor results due to overstaffing and other inefficiencies. The American business plan? Buy the company, take advantage of operational synergies to reduce the workforce, close a few locations, and use the new, leaner European operation to break into the EU market.

While it sounds like a solid strategy and models an approach successful in the U.S., a variety of labor law concerns will make it far more expensive in most locations of Europe than in the U.S.

For example, many European countries require severance packages by statute, and these packages are often tied to longevity. In France labor laws make it more difficult to lay off more senior workers than more junior employees regardless of performance levels. Labor laws also may have strict rules about exactly how layoffs are conducted. If your restructuring plans are leaked during negotiations, you could run afoul of those rules and end up with legal liabilities before you've even closed your deal.

Some European countries also have state-mandated pension plans. Depending on the details of those plans and the demographics of a target company's workforce and retiree population, pension obligations could be a significant factor or even a deal-breaker for a cross-border transaction.

Even in locations without mandated pensions or onerous employment laws, there may be other employment-related expenses that could trip up companies which fail to investigate local practices. In China, for instance, companies are sometimes required to provide housing, transportation, even food, for their workforces. While China is attractive for its low labor costs, understanding exactly what

those costs are, including any non-payroll expenses, is important to gaining an accurate economic picture of any deal.

The due diligence implication? Investigate local labor laws and practices to quantify their potential economic impact and to negotiate an appropriate purchase price.

Any cross-border transaction raises issues related to effective local tax compliance, appropriate deal structuring and efficient global strategies to best take advantage of tax laws and regulations in both the U.S. and the target company's country. Other concerns, such as transfer pricing, also may be an issue. It is impossible here to provide specifics, which vary with each location and each deal. The important thing is to work with advisers who have a comprehensive tax knowledge and breadth of experience necessary to transform local knowledge into an appropriate, cohesive global tax strategy.

International differences can affect deals in a variety of other unexpected ways. For example, when buying a privately held company, U.S. companies are used to structuring deals in ways that would most benefit a business owner in the U.S. Yet those same

structures may not be as beneficial in other countries that may have more paternalistic attitudes toward employees. A U.S. buyer pushing to close a deal quickly may alienate such an owner, who is waiting to get a better feel for the new management team that he is entrusting with his people.

The key to effectively addressing the numerous issues that make the difference between a successful international deal and a financial black hole is effective advice from professionals. Seek out those experienced in working on cross-border transactions who have direct access to foreign experts well-versed in the full range of issues that can affect your deal.

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