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CULTURAL DUE DILIGENCE AS COMPETITIVE ADVANTAGE IN CROSS-BORDER MERGERS AND ACQUISITIONS

BY

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Abstract. During the last decades, the corporate world has witnessed a significant rise in the number of cross border mergers and acquisitions (M&As). The aim of these complex processes is to gain access to new markets, create cost advantages provided by foreign resources and achieve synergies. In cross border M&As, not only different corporate cultures collide, but also different national cultures. Notorious cases like Daimler-Chrysler, Hoogovens–British Steel, or Alitalia-KLM have shown that managing cultural differences can be decisive in M&As. A Cultural Due Diligence (CDD) process aims at identifying the relevant cultural differences and similarities of the companies involved in mergers or acquisitions. The purpose is to get a coherent image of the intercultural challenges of the M&A in order to be aware of the intercultural risks and opportunities.

In this article, we aim to underscore how cultural due diligence influences the companies' integration and post M&A performance. Our goal is, also to highlight the lack of consensus about cultural due diligence content and about the depth of this process.

Key words: mergers and acquisitions (M&As); cultural due diligence; cultural differences; integration.

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1. Introduction

Mergers and acquisitions (M&As) have become a characteristic mode of growth, enabling companies to rapidly increase their market share, enter into new countries, and acquire new know-how.

Managing a merger or an acquisition starts at the beginning of the business relationship, in the pre-merger stage. Both planning and due diligence are vital to determine the fit of the companies and the hidden risks associated with the M&A. Top management of the involved companies must assess their goals and evaluate whether the M&A is the best option to achieve the goals.

Cultural and linguistic barriers make it difficult to evaluate potential M&As developments. Therefore, one of the key issues in research on mergers and acquisitions is the role of cultural differences.

The significant rise in the number of cross border mergers and acquisitions require considerable reflection, planning and accurate due diligence. Due diligence has been an essential constituent for mergers and acquisitions for decades. Due diligence is connected with managers' efforts to evaluate the performance of a target company and reduce the associated risks.

Due diligence is a comprehensive appraisal of a business undertaken by a prospective buyer, especially to establish its assets and liabilities and evaluate its commercial potential. A "classical" due diligence process would start with commercial due diligence, then continue with operational due diligence and legal review, and end with accounting compliance review and financial due diligence.

Some authors analyse the success factors for both cross border and domestic M&As (Calipha *et al.*, 2010). They consider that many companies fail to capture the much anticipated added value from M&A deals. When asked to draw on their recent experience to pinpoint the critical elements of a successful cross border M&A transaction, respondents most often cited "orchestrating and executing the integration process" (47% of respondents), conducting due diligence (43%), and energizing the organization and understanding cultural issues (40%).

In cross-border M&A, culture is even more complicated to integrate since the two companies are constrained to combine not only unlike organizational cultures but also various national cultures. Cross-border M&As are more complex because of different languages, values, beliefs and traditions which can cause many unexpected problems.

Intercultural conflicts and misunderstandings are major indicators of failure in cross-border M&A and the companies involved in M&A deals should always be aware of the intercultural danger and prepare their managers to cope with these challenges.

Companies involved in M&As that have antagonistic cultures due to their management practices and values risk loss of key personnel, a difficult

integration stage and finally, failure of merger or acquisition. One of the largest and most often neglected risks for integration and long-term performance in M&As is organizational cultures conflict. Many mergers and acquisitions that looked good after a “classical” due diligence process were doomed to failure due to cultural clashes.

Cultural differences can result in clashes in management style, norms, values and beliefs. The executive team must combine the positive features of the two companies’ cultures, adding value and increasing synergy.

Cultural Due Diligence (CDD) is a diagnostic process conducted to ascertain the degree of cultural alignment or compatibility between companies that are party to a merger or acquisition. It provides data at a sufficient level of detail to determine potential areas of culture clash and the level of difficulty these areas represent, and it is used to develop an effective integration/alignment plan to deal with the impact of organizational culture on the merger or acquisition

This high-level assessment should provide:

- Culture analysis;
- A complete risk assessment;
- An overview of the organization/people-related risks;
- A culture alignment plan for the areas of divergence.

One of the most important challenges related to M&As is that in these complex processes, one team of managers plans a merger, and another team implements the merger. Under these conditions, division of tasks, it is to be expected a shortage of necessary cultural awareness during the implementation stage.

Another factor affecting the success of mergers is the differing goals of the companies and teams involved. For example, the purpose of the finance team would be to determine the financial performance of the merger. Typically, this team would not envisage any cultural differences they discovered during the due diligence process due to their belief that cultural differences do not affect their target directly.

The goal of the cultural due diligence is to identify the cultural factors that are crucial for the integration of the organizational and national cultures involved. The results of this stage help in a systematic analysis of both the national cultures and the corporate cultures involved in M&As and to develop strategies for preventing conflict and assuring collaboration and cultural integration in the post-investment stage. Otherwise, the merger or acquisition might fail to achieve the expected performance and might finally develop into a failure.

2. Why is Due Diligence Important?

Trompenaars and Asser (2010) point out that business is increasingly pursuing mergers, acquisitions and strategic alliances, not only to implement globalization strategies and necessary restructuring, but as a consequence of

political, monetary and regulatory convergence. The authors consider that a few global companies like P&G, J&J, IBM, GE, Pfizer and Cisco but also Tata & Sons, Mahindra & Mahindra, Haier, Lenovo, HSBC, and others all have an M&A strategy coupled with an organic growth strategy, enhancing growth and managing risk at the same time. The conclusion reached by the authors is that realizing the business benefits and creating wealth in an integration process is not a straightforward procedure. Although success rates of mergers and acquisitions are difficult to compare, as surveys in the area use a variety of assessment metrics, most point to a success rate of about one third, while some have found that only 20% of mergers and acquisitions are ultimately successful.

Today's M&A success rate hovers around 30 to 40 percent, with clashing cultures cited as at least a contributing factor in most cases. And yet, despite the lessons of history, many due diligence teams glance past the topic, preferring instead to focus on items that can be easily quantified (Recardo & Toterhi, 2014).

It is generally believed that culture plays a determinant role in investments. Zait *et al.* (2014) remark that in such operations, meeting among businessmen, managers and other professionals in the field is, first of all, meeting in specific circumstances, among more or less different cultures.

DePamphilis (2011) posits that although some degree of protection is achieved through a well-written contract, legal documents should never be viewed as a substitute for conducting formal due diligence. While most often performed by the buyer on the seller, the seller also may be well advised to perform due diligence on both itself and the buyer. Finally, lenders also are likely to perform due diligence on the target company if that firm's assets are going to be used to collateralize loans made to the acquirer.

A similar opinion (Rosenbloom, 2002) highlights that in order to make sure two companies in a cross-border deal can achieve and maintain strategic alignment, exhaustive strategic due diligence must be conducted. Often called "commercial assessment" or "commercial review," strategic due diligence begins with a company's corporate, or strategic, planning.

In the same direction, Trompenaars and Asser (2010) point out that due diligence is of fundamental importance to the non-operational pre-deal activities. It enables the acquirers to focus their attention upon market reviews, risk assessments, management competencies, and synergies to support the operational impact. It generally doesn't involve a full review of the (corporate) cultures of the two companies, but traditionally stays solely within the realm of financial measurement and reporting tools.

A cross-functional approach to due diligence, employing a single team of dedicated professionals from different disciplines to collaborate to arrive at a holistic picture of the organization that makes sense is suggested by Boyle and Winter (2010). The authors consider that a team of finance, operational, HR, environmental, and legal professionals, for example, can each look at the

company through a different prism and, by comparing notes, will uncover more information than individual visits. The company can thus be more thoroughly valued and understood. In addition, the cross-functional approach is less disruptive, as the time it takes to complete the diligence process is greatly reduced.

Reed-Lajoux and Elson (2010) show that the mathematics of due diligence is not pure; it is applied. Although financial statement analysis forms a large part of due diligence, the most important part of due diligence is conducted “live” through interviews and on-site visits. Such interviews should not neglect “soft” information such as conflict and culture.

An interesting point of view is expressed by Recardo and Toterhi (2014). They show that regardless of team makeup, it is important that all parties be briefed at the start of the due diligence process on the following:

- Overview of target–company history, size, structure, etc.;
- Deal drivers and expected synergies;
- Nature of transaction;
- Receptiveness of management and
- Intended level of integration/integration strategy.

Gole and Hilger (2009) mention that typically, in the course of due diligence, exposures of various types and magnitudes are identified, and the prospective acquirer must address the more significant ones at some point. The nature of each due diligence finding dictates whether it is best addressed before or after the closing. For example, some findings may alter pre-established assumptions about future growth and profitability prospects and therefore affect the perceived value of the target business. Similarly, other issues might involve the discovery of legal or regulatory concerns that place the target business at risk for future liability. Issues such as these may result in the need to renegotiate the value, structure, or terms of the acquisition transaction. They would be assigned to the team charged with negotiating the definitive purchase agreements, which must obviously address them prior to the closing. Other issues, alternatively, may flag potential risks to the combination of the acquiring and acquired businesses. Those issues should be considered by a separate team tasked with the post-acquisition integration and contingency planning.

Both M&A researchers and practitioners alike agree that deal-makers must make certain that the people in charge of the integration are fully-aware of the information uncovered during due diligence which can impact integration and ultimately deliver success, such as, cultural fit, strategic fit, key talent and so forth, as Gleich *et al.* (2010) mention.

Our findings reveal that, although most of the researchers point to the importance of due diligence in M&A, in many cases there is not an appropriate practical approach.

We can state that M&A research has underestimated the roles of individual managers and employees. Individuals’ mind-sets and interests

influence the due diligence, negotiation, decision processes and the integration of the companies.

We'd like also to emphasise that due diligence's importance lies in determining the acceptable level of change within a company.

3. Why Should Cultural Due Diligence (CDD) be Conducted?

Stachowicz-Stanusch (2009) mentions that "Cultural due diligence" is a term borrowed from the financial due diligence that is part of any merger or acquisition, when the acquiring firm pores over the books and balance sheets of the company it is acquiring to assess its financial health. No one would ever think of moving forward with a merger without this detailed financial check, but if it did the same for assessing a partner's business culture, it would get to examine factors that often loom far larger in the success of a new partnership.

On the basis of his studies, Carleton (1997) showed that the point of cultural due diligence is not to discourage mergers between companies whose cultures happen to differ- most culture- clash problems can be (and have been) handled successfully. Rather, the point is to have a plan to manage these differences, just as companies do with divergent financial procedures or information systems.

Berkman (2013) contends that in the context of a merger of two businesses, one of the intangible issues directly affecting the success of the transaction down the road is whether the business cultures mesh well. The due diligence process is not only about obtaining confidence in the financial and legal aspects of the business, but also in management, its ability to run the company, and whether there is a common mind-set or a clash of business cultures that could jeopardize the success of the posttransaction business. Incompatible business cultures can be a recipe for a merger disaster.

Carleton and Lineberry (2004) consider that Cultural Due Diligence (CDD) is a diagnostic process conducted to ascertain the degree of cultural alignment or compatibility between companies that are party to a merger or acquisition. It provides data at a sufficient level of detail to determine potential areas of culture clash and the level of difficulty these areas represent, and it is used to develop an effective integration/alignment plan to deal with the impact of organizational culture on the merger or acquisition. CDD should be viewed as a mandatory step to maximize post-merger or acquisition organizational effectiveness and profitability.

A similar view (Rosenbloom, 2002) reveals that different styles of doing business often make a market for the same product vary from country to country. Also, cultural peculiarities often dictate the organizational structure of the target company (such as hierarchical organizational structures in Japan). Some cultural differences can be overcome; others cannot. Due diligence can determine the extent to which change can or cannot occur smoothly within a firm or market.

An interesting point of view on due diligence in M&As belongs to Trompenaars and Asser (2010). The authors consider that organizations are often acquired on the basis of their inherent valuation (shareholder value) rather than with the intention of achieving full integration of all human capabilities. A wider range of other expected benefits might include synergistic values (e.g., cross-selling, supply chain consolidation and economies of scale) or more direct strategic values (becoming market leaders, penetrating a ready-made customer base, etc.). However, the pre- and post-deal management too often focuses on the rapid exploitation of new opportunities within a mechanistic or financial due diligence mindset, on the assumption that delivering benefits simply requires the alignment of technical, operational and financial organizational systems and market approaches. In contrast, the human relationships part of the merger is generally underestimated and few due diligence methods assess the value of power and trust or adequately map out the new and old stakeholder relationship management processes, either inside or outside the newly created company structure. The authors appreciate that this trend may change as talent management teams take on more global roles and have their strategic growth goals linked to expansion and integration targets.

Another paper focused on due-diligence (Boyle & Winter, 2010) shows that prior to spending considerable resources on putting together meaningful due diligence, it is imperative to ask ourselves some major questions regarding the decision under consideration. The authors continue with some questions: What, explicitly, do we hope to achieve by the transaction? What is the end game and what are the alternatives? Why is the deal better than a greenfield operation or some other business arrangement? If the transaction is to be a joint venture, are you merely paying tuition for a formidable competitor?

Other authors (Reed-Lajoux & Elson, 2010) also support the need for CDD. They reveal that “Cultural due diligence” includes research into what the people in an organization routinely believe, think, and do, including attitudes and mental processes (how people feel and think), behavior (what actions get performed and rewarded), functions (how people do things), norms (what rules get enforced), structures (how the above are organized and repeated), symbols (what images and phrases have special meaning), and history (what stories and traditions get passed on to future generations). All of these elements tend to be synchronized within a culture. So, for example, if attitudes are risk-averse, the behavior, functions, norms, structures, symbols, and history will also be risk-averse.

In a recent paper, Warter and Warter (2014a) consider that cultural diversity in organizations can be both an asset and a liability. Whether the losses associated with cultural diversity can be minimized and the gains be realized will depend likewise on the managers’ ability to manage the negotiations and due diligence processes in an effective manner.

In their comprehensive analysis, Gleich *et al.* (2010) posit that that the due diligence process should extend far beyond the traditional financial and

legal investigations to incorporate organizational and cultural issues. Anecdotal evidence indicates that firms have been complacent in this regard and many failed takeovers could be attributed to such neglect. Further, acquirers should approach organizational and cultural due diligence with a dynamic attitude, being cognizant of the multi-dimensionality of the problem, to position the merged firm for an inevitable change that will occur in the business environment. Although we cannot predict with certainty the outcome of an M&A, done properly, strategic fit, organizational and cultural due diligence could, and should, be an effective insurance policy against failures that too often accompany M&As.

In his study, Carleton (1997) concludes that regardless of what models we choose or what methodology we employ, cultural due diligence is coming, and soon. It won't be accountants or lawyers who conduct the audits; it will be HR people. The question is: Will we be ready?

To sum up, Cultural Due Diligence (CDD) is necessary for providing data enough detailed to determine potential areas of culture clash and the level of difficulty these areas represent during the M&A process.

We consider that cultural diversity in organizations can be both an asset and a liability. The influence of cultural diversity depends on the managers' ability to manage the negotiations and due diligence processes in an effective manner. Our further research will aim to reveal how CDD influences post M&A performance.

4. The Content of Cultural Due Diligence (CDD)

Carleton and Lineberry (2004) describe in detail the content of CDD. They mention that, during the CDD process, qualitative methodology utilizes interviews, focus groups, workplace observations, and documentation review, with the researchers capturing the voice of the culture and the people through collecting verbatim responses and organizing the data either according to predetermined cultural attributes or according to the areas in which the cultural behaviors are exhibited. Quantitative methods utilized are informed by and based on early capture of high-level qualitative data by means of CEO/Executive interviews, workplace observation, and documentation review. An initial web-based CDD survey is developed and administered to a sample of the total population of the two organizations engaged in the merger to develop high-level cultural profiles of each organization.

The survey data is then used to plan and conduct a subsequent round of interviews and focus groups with a weighted sample of managers across the business units and geography of both organizations. A subsequent web-based CDD survey is developed based on this and the initial survey data, and the survey is administered to everyone in the combined organizations if desired.

Ultimately, in addition to the CDD surveys, will be interviewed key managers, starting with the CEOs, executive teams, and all essential senior managers, moving on to a targeted sample of middle managers and supervisors. Selected focus groups, workplace observations, and documentation review will supplement this.

In a guide to mergers and acquisitions, Galpin and Herndon (2014) describe the process of cultural due-diligence. They point out that due diligence is a key ingredient both of successful negotiation and of post-deal integration. Most companies do a decent job of traditional financial due-diligence analysis but a dismal job of nontraditional human capital and cultural due diligence. Due diligence in the area of human capital and culture can provide a picture of where two companies converge or diverge on such aspects as leadership, communication, training, performance management, and so on. Instead of learning about such aspects of a partner or target company after the fact, you can learn a great deal during the due-diligence process.

Cultural outcome can be detrimental to an association, and discovering differences during the cultural due diligence process is necessary. Cultural differences can obstruct the post- merger integration, and therefore affect M&A success.

The post merger integration organization should consist of a management integration team (MIT) and a series of integration work teams, as DePamphilis (2012) concludes in a recent study. Each work team is focused on implementing a specific portion of the integration plan. The MIT consists of senior managers from the two merged organizations and is charged with implementing synergies identified during the preclosing due diligence. The use of senior managers from both firms not only enables the combined firms to capture the best talent from both organizations but also to give employees from both firms comfort in knowing that there are decision makers who understand their respective situations.

Other authors (Reed-Lajoux & Elson, 2010) show that approaches to cultural due diligence fall into four general categories:

- ✓ Integrating cultural criteria into the earliest merger discussions;
- ✓ Staffing and preparing the due diligence team with an eye toward cultural criteria;
- ✓ Adding cultural criteria to due diligence data collection;
- ✓ Using formal tools to assess culture fit.

Focusing on the practical approach to cultural due diligence, Warter and Warter (2014b) reveal that, although most of the researchers point to the importance of due diligence of M&A, in many cases there is not an appropriate practical approach.

To clearly define the CDD construct, Gleich *et al.* (2010) point out that cultural due diligence is a relatively new area of the due diligence process, as previously cultural issues had been neglected. In the facts-oriented world of

takeovers, culture seemed somewhat displaced and too soft for serious consideration. But these soft factors can deliver a hard punch when it comes to value creation, or conversely, destruction. Integration teams should invest time conducting a thorough due diligence on the other firm's culture and ways of doing business. However, integration due diligence should also involve investigating one's own firm, culture and processes in order to determine if the buyer fits the target's needs. This is especially true in situations where the value of both companies resides in specific organizational capabilities, intellectual assets or human capital, which is often observable in professional-service industries, such as consulting, law or advertising.

Our findings show a lack of consensus about cultural due diligence content and about the depth of this process. We can remark, though, that the overall opinion is that cultural due diligence has a strong influence on M&A performance.

5. Conclusions

If we accept that the goal of any cultural due diligence process is a successful post-deal integration and that what the acquiring company ultimately needs is a clear picture on such aspects as cultural compatibility, the outcome of the merger or acquisition will be a success. Based on precise data on cultural compatibility, the leaders should take radical measures, in extreme cases, they might cancel the deal.

Companies that choose to grow by merging with or acquiring another organization must systematically address the cultural due diligence phase of the process. In particular, their leaders must focus on the key cultural issues affecting the acquired organization's operations and strategies. These include functions, norms, attitudes and mental processes, behaviour, structures and symbols. To sum up, the merging of two companies requires an understanding of opposing cultures and the differences in individuals.

The outcome of a cultural due diligence is usually less "awful" and gives information to changing the management practices that produce cultural conflict. The top management of the merging companies has to focus on integration structure and opportunities, making culture easier to define, identify, and handle.

Nevertheless, often companies involved in M&As approach culture as a separate, HR-driven integration activity. This routinely makes key managers be resistant to cultural integration efforts, perceiving them as a disturbance from the real, "classical" work of integration. The conclusion is that cultural interventions must be woven into the larger integration process.

When analyzing the "classical" due diligence processes, we distinguish that some of the problems detected do not receive adequate consideration. Consequently, we believe that exploration into traditional issues (*e.g.*, profit, cost, marketing etc.) can aid in identifying the possible impact of cultural issues.

Cultural due diligence is a tool that offers a systematic way to diagnose and address intercultural issues in a merger or acquisition. Key managers need to use this tool in order to understand the cultural compatibility of companies planning to merge because every integration step has impact on corporate culture and hence value.

In other words, the aim of a cultural due diligence process is to synchronize some important elements within a culture. These elements are related to people: how people feel and think, what actions do they completed, how people do tasks, what rules get imposed, and what images and phrases have significant sense.

The cultural due diligence is necessary to examine our own cultural identities as well as others' cultural beliefs, traditions and values to gain a better insight of their "truths". This process involves applying non-attachment to our emotional reverberations when we recognize that other cultural points of view may differ entirely from our own. We therefore suggest eradicating the "us vs. them" mentality in order to recognize everyone contribution to the goal of merger or acquisition.

Cultural due diligence can determine the degree to which change can or cannot occur smoothly within the companies involved in M&As due to the fact that some cultural differences can be overcome; others cannot. This is the reason why cultural due diligence is of central importance to the non-operational pre-merger activities.

Understanding cultural differences helps top management involved in cross-border M&As to successfully ameliorate processes, procedures and profits. The existing literature concerns about the causes and effects of not understanding and integrating cultural differences during mergers or acquisitions. In the era of globalisation, top managers must be able to coordinate people who have different values, beliefs, and experiences.

The key managers must promote new capabilities in intercultural relationships and use such capabilities to ameliorate the efficiency and effectiveness of the merged companies. National culture differences affect the efficacy of an organization, and the behavior of persons from different cultures straightly affects the organization.

In this concluding section, we would like to remark that the shortage of communication channels or the amateurish use of communications can become a barrier in negotiation, decision-making, and planning. Hence, members of the due diligence team should uncover the formal and informal channels of communication.

The top managers involved in M&As have to insure that the key people responsible of the integration are well-informed of the details uncovered during cultural due diligence which can impact integration and finally improve the merger or acquisition performance.

Most of M&A research has underestimated the roles played by middle managers and employees. Their individuals' mind-sets, opinions and interests affect the negotiation, decision making, due diligence procedures and, ultimately, the integration of the companies.

Our study also reveals that identifying why key leaders are not taking the steps necessary during due diligence to consider, comprehend, and integrate the national and organizational cultures of their companies involved in M&As is an essential problem. We therefore posit that the lack of attention to the integration of culture often results in the downtrend of M&A performance.

The influence of cultural diversity depends on the managers' ability to manage the negotiations and due diligence processes, in the area of human capital and culture, in a beneficial way. The cultural due diligence process influences the ability to run the merged companies in order to improve the post merger performance.

Achieving success in M&As requires strong capabilities in leadership, communication, training, performance management etc. Two aspects of cultural due diligence present challenges for even the most experienced companies: integrating cultural criteria into the earliest merger negotiations and the due diligence evaluation team.

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DUE DILIGENCE CULTURAL CA AVANTAJ COMPETITIV ÎN FUZIUNI ȘI ACHIZIȚII TRANSFRONTALIERE

(Rezumat)

În ultimele decenii, lumea corporativă a cunoscut o creștere semnificativă a numărului de fuziuni și achiziții transfrontaliere (M&A). Scopul acestor procese complexe este de a avea acces la noi piețe, de a crea avantaje de cost oferite de resurse externe și de a crea sinergii. În fuziunile și achizițiile transfrontaliere, nu numai diferite culturi corporatiste se ciocnesc, dar și diferite culturi naționale. Cazuri notorii, cum ar fi Daimler-Chrysler, Hoogovens-British Steel sau Alitalia-KLM au arătat că administrarea diferențele culturale poate fi decisivă în M&A. Un proces de due diligence cultural (CDD) are drept scop identificarea diferențelor și asemănărilor culturale relevante ale companiilor implicate în fuziuni sau achiziții. Scopul este de a obține o imagine coerentă a provocărilor interculturale ale fuziunilor și achizițiilor, pentru a fi conștienți de riscurile și oportunitățile interculturale.

În acest articol, ne propunem să subliniem cum due diligence cultural influențează integrarea companiilor și performanța post M&A. Scopul nostru este, de asemenea, de a sublinia lipsa de consens cu privire la conținutul due diligence cultural și la profunzimea acestui proces.