



HANDLING OF MERGERS AND ACQUISITIONS RISK WITH DUE DILIGENCE IN EMERGING MARKETS – COMPARISON OF SCIENTIFIC STATE OF RESEARCH AND PRACTICAL POINT OF VIEW

Alen Sacek, University of Applied Sciences Kufstein, Austria¹

Abstract. The obviously ever increasing number of corporate mergers and acquisitions (M&As) in recent decades has widened and improved the general knowledge and awareness of due diligence for both the industry and research. In the current financial crisis, M&A transactions face higher degree of risk profiles, especially in the emerging markets. The greater the uncertainty, the more diligence is due. A number of globally active consulting companies performed surveys and got results which differ from the state of the scientific economic research to this topic. Companies investing in firms in those markets believe the risk assessment they do before investing in the lesser-known environment of emerging markets, needs to be enhanced. The problem is that common risk assessment approaches consider financial, legal, commercial, and other issues – but they are not discrete areas in emerging markets, because there is overlap between the public and private sector in these regions, information is unreliable and regulation unpredictable. As the surveys show, e.g. state intervention, political instability and litigation history are both commercial and reputational issues in emerging markets. Thus more integrated approach to due diligence is required in these regions than in developed markets. This paper focuses on a practitioner's experience with M&A due diligence and how the current state of research efforts in M&As due diligence fits to this experience. The comparison calls for a different, more integrated system of due diligence and shows the research deficit.

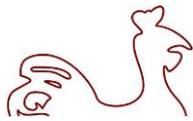
Key words: *due diligence, emerging markets, mergers and acquisitions, risk, investment*

JEL code: G 34

Introduction

Global mergers and acquisitions (M&As) activity in 2012 is down on last year, with volume falling 12% compared to 2011, while the total value of deals fell by 8% as macro-economic concerns, including the ongoing Eurozone crisis and the impending “fiscal cliff” in the US, restricted corporates in the developed markets from committing to acquisitions (Rodwell/Parker, 2013). The M&As in Central and Eastern Europe decreased merely by 40%. M&A activity is predicted to remain low in 2013, with the intention to acquire among large global corporate's falling. A growing number of global executives looking to make an acquisition see the gap between their valuation of potential assets and the prices sought by sellers as the main reason not to do a deal in 2013 (Rodwell, H., Parker, 2013). Historically,

¹ Corresponding author – e-mail address: alen.sacek@fh-kufstein.ac.at



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M&A activity levels have tracked equity prices in many developed markets – such as the US and UK – but in recent years there is a gap in those prices and M&A activity (Rothenbuecher/Hoyningen-Huene, 2007). According to this observations of the practitioners, in such an environment, the quality of assessing the potential risks in M&As prior to concluding the transactions becomes crucial. In a broad based survey at the Annual Due Diligence Conference, the symposium said weak due diligence was the main reason that many mergers collapsed within few years (Morrison et al, 2008). In an effort to examine the current state of due diligence this paper reviews the traditional approach conducting due diligence M&As in Emerging Markets, especially in the Central and Eastern Europe region. In the second step author researches the understanding of due diligence proceeds in current publications and surveys of M&A practitioners and figures out the gap between the traditional and practitioners' approach. The literature review considers all, at my best knowledge, current scientific papers about risk assessment via due diligence and deals with M&As, even if they do not concentrate on due diligence as the risk assessment tool.

Due Diligence

Due diligence is generally accepted method of risk assessment in the M&A world. The nature of due diligence is that it is used across all industries and business activities such as M&As but also in case of initial public offerings, real estate transactions, venturing technology firms, HR topics, supplier identification etc.. Due diligence is also known as “due care”, and used essentially to prevent damages and/or possible harm to either party involved in transaction or business decision (Angwin, 2001, Belian, 2011, Meier, 2011). In general, the core point of due diligence is to provide an acquirer with enough basic information about a target to pave the way for an informed decision about whether to pursue the M&A transaction and to at what price and other terms. The acquirer can make a better risk assessment about the economic benefits of a potential M&A, when there are more precise private information. "The basic function of M&A due diligence is to assess the benefits and the liabilities of a proposed acquisition by inquiring into all relevant aspects of the past, present, and predictable future of the business to be purchased. Those making this assessment should focus on risk" (Lajoux/Reed, 2011). In a M&A transaction, due diligence means carrying out an investigation or audit of a potential investment serving as a confirmation of all material circumstances related to a transaction. The final purpose is to give confidence to the acquirer that they fully understand the value and risks of associated with the target company (Angwin, 2001, Belian, 2011, Meier, 2010).

Since the 1980s, a lot of research has been done on due diligence methods covering mostly the factors of the realm of the economy and finance (Firstbrook, 2007) and the number of factors to be addressed increases steadily. Due diligence practices are not uniformed around the world, but they are roughly categorized in two forms in the literature. Rosenbloom (2002) differs between “Anglo-Saxon” and the “Non-Western” due diligence. The Anglo-Saxon practice involve legal and financial due diligence and significant disclosure prior to signing the acquisition agreement. The Non-Western approach involves broad preliminary legal and financial due diligence procedures with more limited disclosure. The areas examined are the targets company's (Angwin, 2001):

- industry and how it is affected by macroeconomic factors,
- the current competitor analysis in terms how the target company competes against current and potential competitors,
- historical picture and development,
- commercial situation in terms of products and services and their position in the market,
- management and personnel quality and capabilities,
- financial performance over time,



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- asset valuations,
- accounts and the accounting policy and
- information systems.

The main challenge for the acquiring firm is not obtaining adequate information about the target company's business. This problem is known in the business as the information risk problem (Wangerin, 2011). In line with the literature, I use the term information risk to describe the uncertainty surrounding information relevant to the acquirers valuations and expectations for future economic development (Wangerin, 2011). Information risk also arises due to uncertainty about how the combined entity will generate future cash flows after the acquisition is completed. Other common and more general risks relate to the existence and valuation of the assets and liabilities in the financial statement and litigation and claims against the target company. Table 1 summarizes these risk assessment factors relevant for the acquirer that are addressed within the due diligence inquiry (Lajoux/Elson, 2000).

Table 1

Summary of due diligence inquiry areas and mergers and acquisitions risk factors

Risk Type	Area of Inquiry	Risk factors related to the acquisition
Information Risk	Financial Statement Review	<ul style="list-style-type: none"> • compliance of financial statements with GAAP • existence and valuation of assets/liabilities • identification of undisclosed contingencies and liabilities • assessment of internal accounting policies • taxation issues • effectiveness of internal control and accounting information systems
Operating Risk	Operations review	<ul style="list-style-type: none"> • operational performance and efficiency • condition of the productive assets and infrastructure • post-acquisition integration strategies • evaluation of management control systems • key customer and supplier relationships
Litigation Risk	Litigation review	<ul style="list-style-type: none"> • compliance with relevant laws and regulations • contractual rights and obligations • exposure to antitrust litigation • intellectual property protection and litigation risk • assess risk under consumer protection law • assess risk under environmental law • assess risk under employment law • negligence • improper disclosure

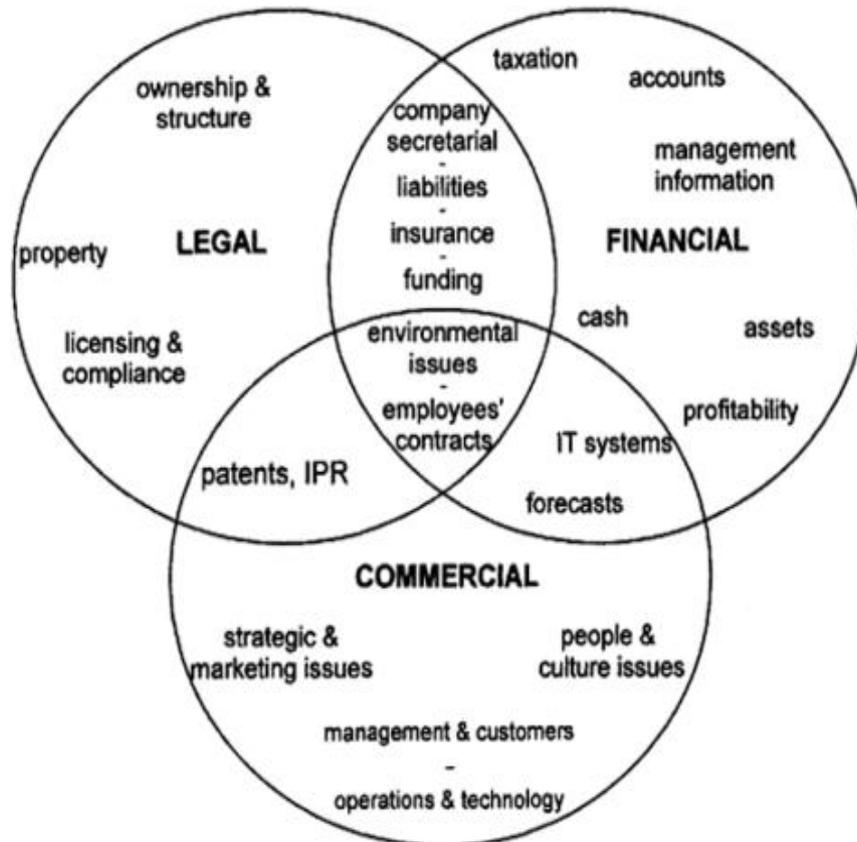
Source: Authors table, based on Lajoux/Elson 2000

The cross-border M&As include as greatest risks cultural, regulatory or risks in the competitive environment in the target market (Firstbrook, 2007), but concrete scientific research on this issue, with exception of the cultural aspects, is still rare.



The traditional approach

In general, the traditional due diligence approach considers legal, financial and commercial issues and is carried out by legal and accounting advisors (Angwin, 2001, Belian, 2011, Meier, 2011). There is an interconnecting idea between these three issues graphically visualized in Fig. 1 (Blayney, 2007).



Source: Blayney, 2007

Fig. 1. Traditional Approach Due Diligence

Berens/Brauner/Strauch (2011) also theoretically consider further topics than the traditional approach but the additional areas are all combined with the financial and legal outcome without considering the critical areas which often led to failure of the M&As.

The traditional due diligence process has been primarily focused on tangible assets or documents relative to the operations of the company (Harvey/Lusch, 1995). Harvey/Lusch (1995) divide the due diligence proceedings in risk assessment separated in intangible and tangible assets as they consider the traditional due diligence approach as a “mechanical verification” of legal, accounting, and tax matters. Their research includes the secondary consideration of intangible assets resulting from a survey of members of due diligence practitioners. Especially beyond the tangible matters, they recommend to include audits of macro-environment, production, management, marketing, and information systems in due diligence proceedings as shown in Figure 2 and 3.



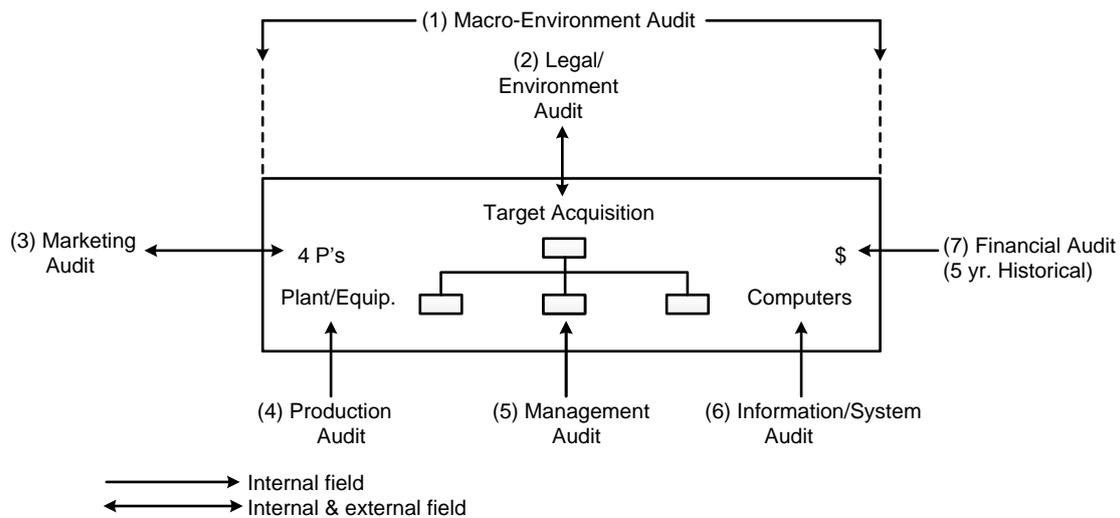
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Internal Environment	External Environment
Tangible <ul style="list-style-type: none"> • cash • plant equipment • accounts receivable • patents/trademarks • technology • inventory 	Tangible <ul style="list-style-type: none"> • share of market • supplier/distributor contracts • physical location
Intangible <ul style="list-style-type: none"> • quality of leadership • training of personnel • corporate culture • quality of infor./analysis operating system • loyalty of personnel • trade secrets • data bases • personal/professional networks 	Intangible <ul style="list-style-type: none"> • brand product awareness • customer loyalty • competitive positioning

Source: Harvey/Lusch 1995

Fig. 1. Tangible und Intangible assets approach by Harvey/Lusch (1995)



Source: Harvey/Lusch 1995

Fig. 3. Due Diligence Requirements

In the past four years there have been few theoretical research articles about operational due diligence. This kind of risk assessment concentrates mainly on the target company's operational elements. Namely, the operational complexity in companies increased – such as the need for integrated supply chain management systems, logistics operations which must work real-time and across the borders, the extensive use of subcontracting and manufacturing, etc. (Knecht & Calenbuhr 2007). Other authors, e.g. McGrady (2005), name merely the same area of “typical due diligence considerations” and argues that the guidelines and best practice vary but that they appear to be comprehensive. As long time the approach consisted exclusively of financial and legal issues, the newer scientific work includes employees, benefits, environment and intellectual property are signs of a broadening of scope in the due diligence process (Mcgrady, 2005).



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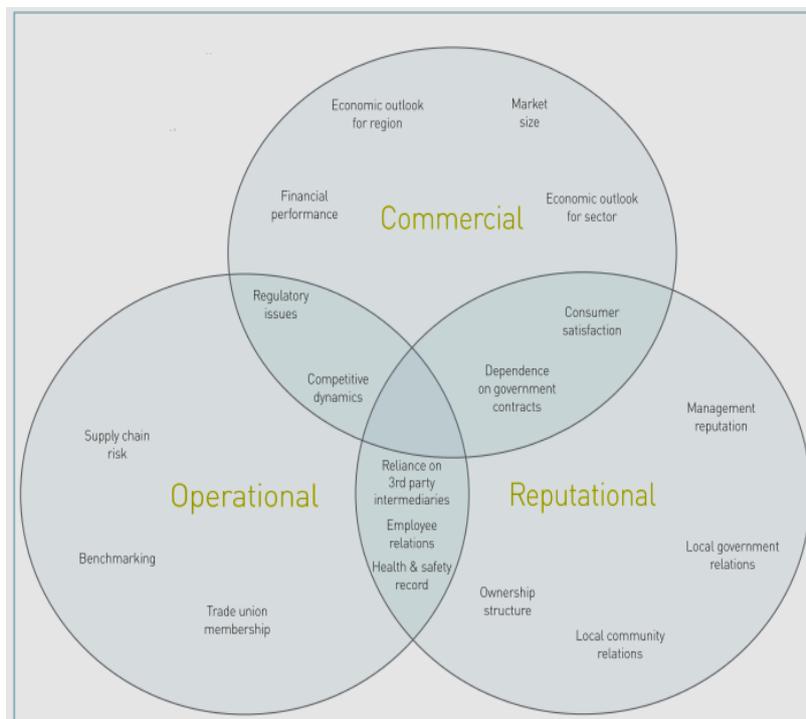
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There seems to be a pattern emerging from both research and experience that intangible issues such as culture and change are critical to success. Some research even identifies “irrational” influences on post-merger integration. However, the predominant focus of due diligence remains financial and legal although the track record of M&A deals points to shortcomings in the traditional due-diligence approach (Morrison et al., 2008 and McGrady, 2005).

Practical point of view

In general, the potential rewards from acquiring in emerging markets are undeniable, but the risk profile of such M&As is higher than in domestic transactions. One of the difference is the information risk on a higher level than in developed countries, as the acquirer does not get reliable information about the target company. The M&A practitioners still search for the best practice standards. This research paper considers three market surveys that were carried out by renowned advisors of multinational companies when they acquire M&A targets in the emerging markets: Kroll Advisors, AT Kearney (Emerging Markets), Deloitte (Emerging Markets, Central and Eastern Europe). Kroll Advisors interviewed 50 practitioners with broad experience in M&As in emerging markets (Glaption 2012). Deloitte surveys also consist of numerous expert interviews.

Kroll Advisors – Due Diligence in Emerging Markets (2012)



Source: Kroll Advisors, Glaption, 2012

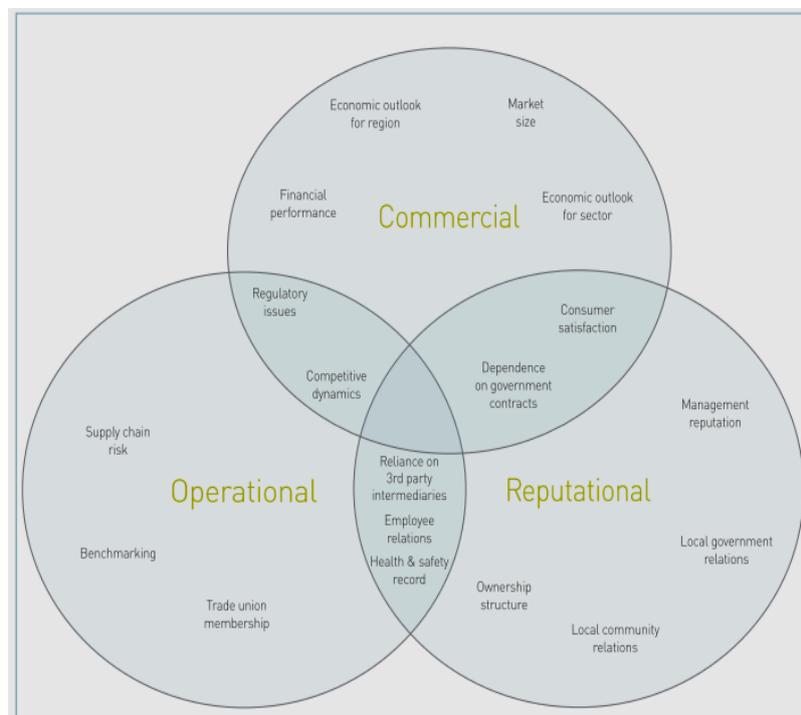
Fig. 4. Due Diligence in developed markets



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The study concludes that conducting due diligence on targets in emerging markets requires a different approach and that the acquirers have adapted their approach to emerging & frontier markets, opting instead to increase the traditional approach with concentrating on legal and tax issues. The main hurdle identified is the connectivity and overlaps between commercial and reputational dynamics, as illustrated in the Fig. 4 and 5. when addressing the risk assessment challenges in the pre-acquisition phase (Glaption, 2012). In the focus of the Kroll's survey stands the inter-play between commercial and reputational issues and their implications on the M&As in emerging markets. This is especially the case in jurisdictions and sectors where the government involvement in its role as a regulator, undisclosed ultimate beneficial owner in the target company, a client or a supplier, a provider of infrastructure or a competitor.



Source: Kroll Advisors, Glaption 2012

Fig. 5. Due Diligence in Emerging Markets

Deloitte Study – Emerging Markets (2012) and Central and Eastern Europe (2009)

The survey from Deloitte also investigated that managing compliance and integrity-related risks in emerging markets is a major concern for many companies as over 70 per cent of the executives are extremely concerned about this fact and over 70 per cent of the executives believed compliance and integrity-related risks in emerging markets had increased over the last two years (Deloitte 2012). Their most concerned topic is commercial bribery and kickback-payments. The survey participants report of the need to more thoroughly analyze to gain real insight into the political and regulatory environment, as well as its impact on to operation's and financial issues. A special topic are related with corruption, bribery and fraud, changeable regulatory situation as well as the implications of interaction with state-owned or state-controlled entities. As the most promising emerging markets are the countries of CEE (Glaption,



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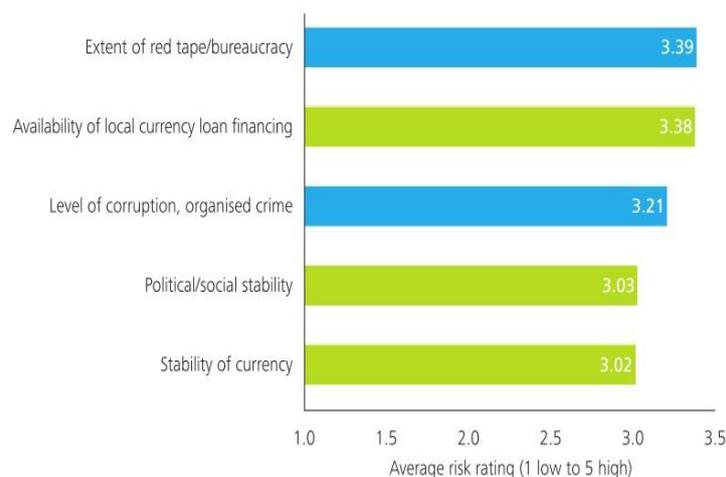
2012). However, the challenge remains because of the fact that emerging market countries are often found in the upper level of the Transparency International Corruption Perceptions index, which ranks countries based on how corrupt their public sector is perceived to be (van Dijk/Griek/Jensen, 2012). This implicates a different investigation questions than those found in the traditional due diligence approach:

- impact of the regulatory changes on commercial success of the business,
- level of government interference or influence on the business,
- conflict of interests in the supply chain,
- steering board and their political career or exposure,
- appetite for bribery in this region/sector and the compliance issues with prevailing legislation and the acquirers reputation.

More than a half of the survey participants' companies reported conducting extremely or very extensive due diligence before conducting M&As in emerging markets (Deloitte 2012). Furthermore, the political uncertainty is named as important factor to be considered, as the politics are associated with adverse changes in market policies, uncontrollable inflation and changing laws regarding labor and resource utilization (Glaption, 2012). This implicates further investigation needs than those found in the traditional view and these uncertainties demand a thorough approach to scenario planning and the acquisition needs to be stress-tested for i.e. changes in political leadership, or the withdrawal of government subsidies. Further issue is the weak discipline in documentation and creating reliable financial statement. This implicates the that an thorough examination of a company's financial and operational state are difficult to perform and often only within a longer time period feasible.

Compared to the traditional view of conducting due diligence, the survey from the M&A practitioners points to the fact that the due diligence approach needs to be suited to the dynamics of the markets. Summarized, for example (Glaption, 2012):

- overlap between public and private sector requires combined commercial and reputational due diligence in order to uncover potential implications of the interconnections,
- questionable information quality need to be supplemented with "on-the-ground" research,
- ambiguous regulatory environment or lack of legal framework require plan scenarios for unforeseen events.



Source: Deloitte, 2009

Fig. 6. Top Five Risks in M&As in the emerging markets 2009



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In the survey from Kroll (2012) participants have pointed out that the most important issue to be examined are the relationships. Especially the relationships in the supply chain, i.e. to customers and suppliers, third party agents, are seen crucial in the examination (Deloitte 2012), but only 30 per cent of the of the acquiring companies do really conduct due diligence on this matter. Also important relationship are the ties to the political community. The concerns about transparency are widespread as target company's in emerging markets lack transparency in sense of corporate governance. Thus, considering studying all stakeholders of the target and internal controls must be tested to a greater extent in order to mitigate risk and/or fraud (Glaption, 2012).

Deloitte study proved the level of due diligence when conducting mergers and acquisitions in emerging markets and found out that due diligence into specific risks is often not extensive. Despite the fact that bribery of government officials and commercial bribery or kickbacks were ranked as the top risks, only little more than a half of executives said their company conducts an extremely assessment of those issues when considering M&As. The typical risks in M&As in the emerging markets, regionally focused on the Central and Eastern European market, show the currency and financing concerns as well as worries about political stability as the top five risks as shown in Figure 6.

Only about the half of the executives conducts an extensive assessment during due diligence of bribery, kickbacks and other violations of economic and trade sanctions. This risk assessment might be challenging but the avoidance to do so when engaging with third parties in emerging markets leaves the company vulnerable to significant reputational risks (Deloitte 2012).

A.T. Kearney Study

In the study of the A.T. Kearney points out that M&As involving companies from emerging markets at different stages of economic development bear unique challenges for acquirers, and require “redesign and expansion of their M&A skills” (Rothenbucher/Hoyningen-Huene, 2011). There are specific success factors in terms of target selection, due diligence, closing and integration. I. e. the data and information collection is weak and these markets lack transparency in relational aspects. Thus, the acquirer must spend more time and money in assessing the risk profiles of target companies. Among the practitioners, there also due diligence professionals who are still pinned to the traditional view of risk assessment. One of the biggest legal M&A advising companies in the world, Clifford Chance points out in their publication on cross-border M&As, that the due diligence process comprises of “thorough picture of historic financial accounts and cash flows and challenge of the financial forecasting...” and “legal due diligence as the most critical cornerstone in risk assessment of M&A valuation issues” (Layton, M., 2013).

Digesting the study results

Summing up, the surveys show a gap between due diligence scope in the practical and scientific approach. The gap arises from historical experiences in the M&A, new risk potentials arising from the regulatory field and from the political risks. Further aspect is the assessment of economic and political framework of the host country and the probability of changes in that environment. As the political institutions tend to be weak in emerging markets, and power often lies in the hands of an elite. thus, the acquirer may face a changeable and unpredictable operating environment. All these aspects are intangible and mostly difficult to measure but were named by the practitioners as unavoidable to assess in the pre-acquisition phase.

The reputational risk is also not a topic at all in the traditional view of due diligence (Morrison et al., 2008). But in the newer literature about this topic we find research of reputational issues within integrity due diligence that assesses critical integrity risks arising from money laundering, hidden interests, conflict of interest or business relationships. By identifying such kind of risks which could



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negatively impact the overall evaluation, the acquirer can manage the risk and mitigate its overall impact (Hanley-Giersch, 2011).

The level of due diligence is being impacted by variety of issues conducted during the acquisition process. Harvey/Lusch (1995) categorize the issues in as time restrictions, cost constraints, and situational factors. Under time restriction it is often the case that the effective examination of the target acquisition – beyond the major financial, legal, tax and future sales projections – does not occur. An further aspect of not performing an full scope due diligence are the cost constraints as it is been viewed as to expensive to bring in experts in each functional area. Finally, situational factors for performing a limited due diligence is most notably with cross-border acquisitions and hostile takeovers because the competitive nature of bidding for a company has required or has not allowed full scope due diligence.

Conclusion

Due diligence is the cornerstone of successfully executing M&A transaction, either in developed or emerging markets. When such a transaction is being contemplated, a whole new range of decisions must be made that do not have a domestic or developed markets equivalent. At that point, the traditional, in the literature mostly researched due diligence approach falls short as it concentrates largely on very tangible risks i.e. as the financial, legal or operational issues. The traditional due diligence approach found in the current literature shows partial insufficiency in covering the current necessary pre-acquisition needs of the acquirer, as the risk profile of target company in emerging market differs from the target company in developed markets, however, requires awareness of additional points.

As the considered surveys show, acquirer need to consider using consistent and scalable process for assessing such typical risks across acquiring in the emerging markets. That means placing the same importance to reputational due diligence as on legal, financial, operational, and other traditional due diligence. The move to the next level of performing due diligence requires more enhancing than replacing traditional due diligence activities. The due diligence scope will be longer but they will be forward-looking and more post merger oriented. On the other side, the “new” risk fields are almost all non-quantifiable and the more they have been assessed, the more difficult is to determine the quantitative impact. However, each M&A has own “personality” and thus, the applicability of the expanded due diligence process may vary from one situation to the next. In phase of competitive bidding process there is a lack of time to institute full blown due diligence proceedings. The same is applicable for small volume M&As as an expanded due diligence is very costly.

According to the scientific matter, the transfer from the best practice to the scientific work seems to be an area where a need for further scientific research exists. As it is often difficult to ensure the transfer from the practical to theoretical knowledge and vice versa, an integrated approach is likely to develop with a growing amount of experience in growing frequency of M&As in the emerging markets. An important factor for proving the hypothesis is the input from experienced executives from acquirers and their advisers in M&As in emerging markets. In brief, the nature and scope of the due diligence process need to be examined in light of these new trends. This will help to ensure that the M&As deal intelligence gets wider scope of the risk assessment methods and finally improve the success rates in M&As either in developed or emerging markets.

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