

## Cultural Due Diligence: Upping the Likelihood of Merger and Acquisition Success

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Financial, operational, and technical due diligence are routine undertakings before companies consummate a merger or acquisition. However, what spells trouble most often in mergers and acquisitions is cultural incompatibility. Through cultural due diligence, the human side of these transactions can be given the same scrutiny that has traditionally been applied to the more quantitative assets of companies.

In 1998, worldwide merger and acquisition transactions totaled more than \$2.4 trillion across nearly 23,000 deals. According to Mergerstat, 7,700 deals involved U.S. companies and totaled \$1.2 trillion. Yet, despite the time and money invested in merger and acquisition deals, many failed. Indeed, recent studies estimate the failure rate of mergers at close to 75 percent. This statistic begs the question: Why do so many mergers and acquisitions fail to achieve their intended results?

Remarkably, the high failure rate has less to do with paying too high a purchase price or making a poor strategic fit than one would think. Rather, many failed organizational marriages are the result of companies' failing to critically examine the ramifications of cultural differences on post-combination success. Just as two individuals with differing values and beliefs will not co-exist for long, unsuitable organizational marriages won't last either. Thus, many companies include cultural assessment as part of their due diligence to discern, prior to the altar, if the cultural differences can be managed post-merger.

### ***Why is Organizational Culture Important?***

Organizational culture can be thought of as the "basic assumptions and beliefs that are shared by members of an organization, that operate unconsciously, and that define in a basic 'take it for granted' fashion an organization's view of itself and its environment."<sup>1</sup> Organizational culture is important because it has been shown to have a significant impact on organizational performance. Cultures that support the mission, goals, and strategy of an organization serve to ease communication and coordination and provide a means for dealing with change and conflict when they arise.

The impact of organizational culture on company performance cannot be overstated. The Wall Street Journal reported that 57% of mergers had financial returns below their industry averages three years after the transaction, the leading cause of failure being attributed to culture incompatibility.<sup>2</sup> Researchers have also found that firms with cultures that emphasize key managerial constituencies (e.g., customers, employees, stockholders) and leadership outperformed companies that do not possess these attributes. According to this research, the companies with strong leadership cultures increased revenues an average of 682 percent over an 11-year period, while those with weak leadership cultures increased only 166 percent. Furthermore, firms whose cultures were not aligned with firm strategy

often fail to adapt to changing environments, resulting in their inability to survive and prosper.<sup>3</sup>

Because culture represents shared beliefs, assumptions, and values, it is not readily observable. Indeed, an organization's culture often only becomes obvious when contrasted with the culture of another organization, such as in the case of the merger of two firms. When two organizations unite, the combination inevitably results in some form of culture shock. The extent of culture shock can range from slightly unpleasant to exceptionally distressing, depending on how employees in each organization evaluate the attractiveness of the other culture in regard to their own. Generally, the greater the cultural dissimilarity, the greater the culture shock. The exception to this rule occurs when employees in one organization consider their own culture to be unsuccessful or oppressive. In this instance, employees may be willing to abandon their own culture in favor of a more attractive one.

Culture clashes can be the result of several factors, including ignorance (i.e., lack of understanding of another's culture), disrespect for another company's norms, and arrogance (i.e., a belief that one culture is superior). Consider the case of a partnership between American and Brazilian chemical-products manufacturers. Negotiations were immediately tainted when, on their first day of meetings in Rio de Janeiro, American executives insisted that the meetings commence with a working breakfast session. The Brazilians, who are unaccustomed to discussing business over a meal, found this practice objectionable and were deeply offended by the idea.<sup>4</sup>

Though a seemingly innocent misunderstanding, such occurrences frequently result in failed organizational marriages. Consequently, companies have begun to acknowledge the existence of divergent cultures, identify cultural components that potentially hinder successful combination, and prioritize the cultural dimensions believed to be most important for a successful combination. This process of analyzing the fit between two independent organizations is known as "cultural due diligence."

Until very recently, there was no systematic model for performing cultural due diligence. There was no overall conceptual model, let alone a defined process and analytical tools. Now, techniques are available that can be applied at any stage of a merger or acquisition to provide data that can help managers decide to move forward with a merger, anticipate significant problems as the merger is completed, and deal effectively with problems post-merger.

### ***Why Culture is Overlooked***

Indeed, the rationale underlying mergers and acquisitions is typically based upon various types of business performance metrics, including size and growth, economies of scale, profitability, and increases in market share.<sup>5</sup> In addition, heavy emphasis on merger and acquisition technical issues may occur because they are generally more concrete and quantifiable. Thus, executives may feel more comfortable focusing on these issues rather than cultural issues, which are more difficult to effectively measure in quantitative terms.

Undeniably, the extent to which legal and financial due diligence are performed competently plays a significant role in determining the successful integration of two companies. Exclusively focusing on these concerns, however, understates the reality that the merger of two companies figuratively amounts to the marriage of two people with very different personalities. Potential problems associated with

mixing together two organizational cultures warrants that attention be shifted to a deeper understanding of the human side of merger and acquisition activities, including the cultural implications on post-combination success of such activity.

### ***Undertaking a Cultural Audit***

The first step in managing the human aspects of a merger or acquisition requires undertaking a cultural audit in order to develop an understanding of each company's culture and how the combining of cultures affects the success of the merger or acquisition.

Cultural audits help to determine the extent to which a company's current culture aligns with the type of culture required for success in the future. When done properly, information from a cultural audit will highlight similarities, as well as significant differences, between the cultures in question. Cultural disparities, even those that are significant, do not necessarily jeopardize merger and acquisition activities. Indeed, in many instances it is precisely the cultural difference that attracts companies to one another. Nonetheless, it is imperative that those involved in merger and acquisition discussions have reliable information at their disposal regarding cultural similarities and differences so they can make informed decisions on how to best combine the cultures.

Though cultural audits can be accomplished in many different ways, one of the most cost-effective methods is to conduct a survey in each organization. Through the use of systematic, research-based surveys, decision makers can collect critical information on relevant cultural elements. With this information in hand, the management team can develop plans to facilitate the integration of people and operations.

At the very least, such surveys should solicit feedback regarding:

- organizational structure
- core values and philosophy
- commitment to vision and strategy
- leadership practices
- respondents' desired culture
- organizational norms such as methods of communication, decision-making, etc.

For example, questions such as: "Is management hierarchical or decentralized?" "Do leaders encourage teamwork or employee competition?" "Is the organization averse to change or does it embrace it?" can provide vital data on the compatibility of merging companies by highlighting potential "cultural gaps." This information is invaluable for estimating the likelihood of successful integration, as well as how much disruption will accompany merger and acquisition activities.

### ***Conclusion***

Organizational culture issues are responsible for a significant amount of failures in merger and acquisition transactions. Up until recently, most due diligence activities have focused on aligning the technical, operational, and financial systems of the combining organizations. Reconciling these processes is undoubtedly imperative for successful integration, but considerably more attention and resources need to be devoted to managing the cultural differences between the new partners.

Using the cultural due diligence technique provides an operational framework to manage cultural differences by accentuating potential pitfalls and their implications

prior to completing a deal. Though cultural due diligence often uncovers significant differences in organizational practices among merging companies, the intent of the process is not to discourage integration. Rather, cultural due diligence is meant to alert stakeholders to potential differences in the human side of the merger equation so that plans to manage these disparities can be developed. In some instances, cultural differences may be too intransigent to bridge. However, with information derived from a cultural audit, decision-makers can systematically address potential hazards and take the necessary steps to overcome them before they severely impede the transition.

### **Notes**

1. Edgar Schein. (1985). *Organizational Culture and Leadership*. San Francisco: Jossey-Bass, p. 6.
2. *Wall Street Journal* (2/14/97).
3. John P. Kotter and J. L. Heskett. (1992). *Corporate Culture and Performance*. New York: Free Press.
4. Mitchell Lee Marks and Philip H. Mirvis. (1998). *Joining Forces*. San Francisco: Jossey-Bass.
5. W. H. Goldberg. (1983). *Mergers: Motives, Modes, and Methods*. Aldershot, UK: Gower.