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TOWARD A NEW GENERATION DUE DILIGENCE: SHIFT IN THE CORNERSTONES OF TRADITION

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YENİ NESİL AYRINTILI İNCELEMeye DOĞRU: GELENEĞİN TEMELLERİNDE DEĞİŞİM

Abstract

Mergers and acquisitions have been the focus of business agenda since thousands of companies preferred them as a new route to expand market share, increase profitability, lessen costs, gain competitive advantage, etc. Due diligence, the investigation of the target company with its financial, legal, operating background has been the basic procedure in realizing mergers and acquisitions. However, since majority of transactions fail, there seems a necessity to create a new vision for due diligence process. This paper searches to present a draft framework for building a broader structure for the process in two dimensions: scope and approach by putting forth the underpinnings of human resources due diligence, discussing common mistakes in the process and suggesting various amendments to the classical perspective of due diligence.

Keywords: due diligence, merger, acquisition, downsizing, human resources

Özet

İřletmelerin pazar paylarını genişletmek, karlılıklarını artırmak, maliyetlerini düşürmek ve rekabetçi avantaj elde etmek için sıklıkla başvurdukları yollardan biri olan birleşme ya da satınalmalar, özellikle son yıllarda Dünya iş gündemindeki yerlerini yoğunlaştırmaktadır. Hedef işletmenin mali, yasal ve faaliyet altyapısını incelemek amacıyla “ayrıntılı inceleme” adı altında yürütölen süreç, bu işlemlerin başarısını etkileyen kritik bir aşamadır. Ancak, birleşme ve satınalmalarda yaşanan başarısızlık ayrıntılı incelemenin yeniden şekillendirilmesini gerektirmektedir. Bu çalışma, ayrıntılı inceleme çalışmalarına ‘kapsam’ ve ‘yaklaşım’ açısından yeni ve daha geniş bir boyut getirmeyi amaç edinerek bir takım önerileri tartışmaya açmak istemektedir. Bu amaçla çalışma, insan kaynakları ayrıntılı incelemesinin temellerini belirlemekte, yapılan hataları incelemekte ve başarılı bir örgütsel değişim süreci için ayrıntılı inceleme anlayışında yapılabilecek değişiklikleri tartışmaktadır.

Anahtar Kelimeler: ayrıntılı inceleme, birleşme, satınalma, örgütsel küçülme, insan kaynakları

1. Introduction

The changing nature of economic activities leads firms to adjust their organizational structures accordingly. Global competition and soaring foreign direct investments, shifted firms' vision toward alliances, mergers and acquisitions. These domestic and cross-border deals have become so widespread that, even many firms from diverse industries from various geographical regions combined together to form new companies. In 2005, the estimated total volume of mergers and acquisitions rose to 2.86 Trillion US Dollars (Pasha, 2005). Same year, deal volume in Turkey reached to a historical record of 12 Billion US Dollars (ISI Emerging Markets, 2006). Despite these amazing statistics, failure in mergers and acquisitions is so common that it cannot be neglected.

The scope of this paper is due diligence, one and possibly the most critical phase of a deal, which is a key element in success of mergers and acquisitions. After depicting a general view on recent economic developments, the paper will focus on success of mergers, examine and criticize due diligence practices and finally will suggest a new due diligence framework for ensuring a better integration process.

The aim of the paper is to question the traditional due diligence practices and to bring forward a more comprehensive understanding of company investigation from all business aspects. Considering the scarcity of studies in this field this paper aims to deal with a remarkable problem in mergers and acquisitions and to come up with answers to the following questions:

- Why do some mergers fail?
- What is to role of due diligence in mergers, acquisitions and does it have adequate mechanisms in supporting the success of deals?
- Which new components can be inserted to the scope of due diligence?

2. A Broad Look At The World Economy, Mergers And Acquisitons

Twentieth century has witnessed two world wars in military base and has been the starting era of the still lasting trend of struggle in economic terms. Today, world nations, most of which are belonging third world group, combat for surviving in this milieu of economic endeavor.

World's gross domestic product proliferated many times, however so has uneven income distribution. Certain countries became richer while some others have got poorer. Investment regimes were hanged in favor of multinationals, particularly beginning from the second half of twentieth century. As time passed, foreign investors captured greater roles in national legislation and execution, which provided them more operation facility and generate ample benefits. Today, companies settled in Western Europe, Northern America manage portfolios worldwide, bigger than GDPs of many developing countries. World trade and international investments boosted as legal amendments were fostered. Companies, as the agents of multinational dependency among world nations, and national economies get accustomed to the conditions of the overwhelming wave of change by time.

Major changes in business environment during the last few decades of the twentieth century can be summarized as follows: trade volume increased, commodities were varied, specialization became a necessity, production of commodities and services required high-technology processes, global economic, political and technological transformations became the major variables of operation planning of enterprises, internationalization became widespread, strategies and practices were started to consider globally, companies obtained more grounds on influencing governmental policies that is, they participate directly in economic and business policies and finally interdependence rose among countries, both politically and economically. To become clearer on the outcomes of this cluster of changes, one may refer foreign direct investment statistics.

Multilateral wave of reduction in tariffs and releasing transaction barriers to foreign investors, especially after 1990, led to a considerable increase in foreign direct investments (FDI), which reached up to \$865 Billion in 1999. In fourteen years from 1987 to 2000, FDI grew nearly five times to \$1Trillion. Mergers and acquisitions had a major impact in this trend. In 1999, mergers and acquisitions created 83% of FDI, which is \$720 Billion. As the world's GDP has doubled during the last twenty

years, global production and sales of cross-border mergers have proliferated by 3.5 times (UNCTAD, 2000).

From 1987 till 2000 volume of mergers and acquisitions expanded by 730 percent. These operations have been widely accepted as frontiers of change in conducting business. They need particular attention in terms of human dimension since they create thousands of redundant employees and their success is broadly related to human related issues. Due to mergers or just for the sake of restructuring many firms choose downsizing as a goal to operate more efficiently (Cascio, 1993). AT&T trimmed its workforce by cutting 123.000; IBM by 122.000, GM by 99.400 and Boeing by 61.000 in previous years. Nevertheless, the term of “organizational restructuring” was often considered as “trimming the workforce” and many firms chose layoffs as a primary cure for costs and competition. Many articles and survey reports have touched failure in mergers and acquisitions. A survey published in Fortune magazine in 1986 (Veninga, 1990), one by Acquisition Horizons and one by KPMG (1999) came out with failure in mergers and acquisitions. These are a few examples that verify the problem. However, true attention should be granted to the underpinnings of the failure in mergers.

3. Success Of Mergers And Acquisitions

Success of a merger can be measured by assessing economic value added, more efficient use of resources and harmonization of organizational cultures (Birkinshaw, Bresman and Hakanson, 2000). Available data proves that many deals cannot create additional value for combined companies. Given these, one should come up with the inevitable question: “Why do mergers fail?”

Not many pieces are required to complete the puzzle accurately, indeed. Some articles and surveys have repeatedly disclosed explicit problems: “Not enough diligence is devoted to the participation of human resources department into the deal, inadequate due diligence is performed in organizational and cultural terms”. This diagnosis is in line with Bramson’s (2000) thesis, that is; organizational and cultural problems are more likely to derail a merger than financial factors are.

Success of broad changes, like mergers, acquisitions and downsizing, is limited. Failure in change can be tied up to unpreparedness of an organization to change, lack of motivation and commitment of managers and employees who are responsible of managing change (Devos and others, 2002:3), lack of concern to human resources (Labib and Appelbaum, 1994), costs of change, failure in

determining the priorities of change, focusing on short-term targets rather than following an extensive strategy (Mirvis, 1997:46). Likewise, some point a strong correlation among organizational behavior, change and emotions (Huy, 1999: 325). Thus, if employees do not support planned change, they would not show commitment to change. However, executers insistently tend to ignore the cure. Occasionally, top managers ignore to share information with or distribute tasks to middle managers. Even this weakens the commitment of those managers to the organization and undermines their morale and productivity (Karake, 1998).

Meanwhile, as Faulkner and others, in their 2002 article on international mergers, posited that human resources management strategies can be significant control mechanisms for companies wishing to integrate. An acquirer's human resources management policies may have strong effect on its ability to get the best results from its new subsidiary. The way it treats its employees will affect their motivation and the attitude that employees bring to their work.

At this stage of the problem, there seems a consensus among the sides towards a possible solution: "Companies need systemic planning and intense endeavor for integrating their production systems and cultures" and this should begin with the due diligence process.

4. Due Diligence: The Corporate Inquiry

The basic function of due diligence is to assess the benefits and liabilities of a proposed acquisition by inquiring into all relevant aspects of the past, present and predictable future of the business to be purchased (Reed and Reed-Lajoux, 1999: 347). This definition reflects a narrow view and can be characterized as conventional. A different and a wider definition has been offered by International Business Standards Association: "Due diligence is an investigative process of collecting and analyzing appropriate, relevant data before reaching a decision with a goal of understanding the advantages, disadvantages and risks associated with the decision". In the concept if mergers and acquisitions, due diligence refers to the investigation and examination of target company with its financial, legal and human resources background, each requiring special expertise. The human resources due diligence can also be classified as cultural, legal and financial human resources due diligence.

The results of Watson Wyatt 1999 Survey on mergers and acquisitions in Europe revealed the fact that companies spend enough and proportional attention neither to due diligence process itself nor to the fundamentals of the concept. Human resources, for example, held the

fifth rank in due diligence and the sixth in integration processes. Communication, as well, has not gained fair concern and has been the last item in the list of priorities in due diligence and integration phases. Same survey disclosed that the involvement of human resources department in deals was low in those phases. The weak participation of human resources department gives rise to ambiguity which is a major threat to organizational change.

Given the failure in mergers, data turns the focus to the lack of human resources due diligence and participation. People, rightfully, need to realize whether the forthcoming change would be an opportunity or a threat for them. Downsizing, mergers and acquisitions have the potential to create a risk for employees in terms of losing their jobs. In line with this, Devos and others (2002) uncovered that emotions of employees affect their commitment to change. Eby and others (2000) also defended that trust to managers; skillfulness, participation and teamwork fortify the ability to perform change. Lastly, Keiselbach and Mader (2002), from the University of Bremen, uttered that employees more readily accept decisions when they feel that the decisions made or procedures implemented are fair. Therefore, the greater job insecurity is perceived, the greater the intention to seek a new job, the lower the organizational commitment, the lower the trust in the organization and the lower the job satisfaction.

A SHRM survey in 2001 revealed the consequences of layoffs as decline in morale, commitment, increase in gossip and resignations. CIPD's Redundancy Survey Report has found similar results in 2002 as decline in morale and trust, loss of skills and experience, increased turnover.

Dennison (1990), in his book on corporate culture, suggested integrated mechanisms of organizational culture that may influence its performance. These are organizational direction and shared purpose, early employee involvement, consistency, the impact of a strong culture on firm performance, and integration of norms and expectations. Human resources department is an intrinsic element of the integration team in a merger because of its ability to evaluate the compatibility of corporate cultures and different options for combining enterprises (Bramson, 2000: 59) and therefore its early and full involvement, which may start up with the due diligence process, is a critical decision in managing organizational change process.

Top management should be aware that, although it is recognized as pre-deal process, due diligence possesses crucial significance on policies

to be applied to survivors as well, since attaining goals depends on post-merger or post-downsizing performance of these employees (Doherty, Horsted, 1995; Nelson, 1997). After a merger, acquisition, restructuring or delayering program, survivors may be subjected to a mixed psychological case, the survivor syndrome, which has symptoms like decline in morale, motivation, performance, organizational commitment, trust to managers and increase in stress, anxiety (Doherty and others, 1996; Appelbaum and Donia, 2000) that may lead to loss of planned savings to be earned from the change. This is particularly important when considering the concrete outcomes.

In practice, studies show that survivors' performance after downsizing does not soar but descends (Zeffane and Mayo, 1994; Vahtera and Kivimaki, 1997). However, according to the theory of justice, positive injustice intensifies the feeling of guilt and therefore motivates survivors to be more industrious, raise their performance in both psychological and behavioral aspects. Even if survivors feel as the firm has more equally treated them, their feeling of guilt would get stronger. In that case, there seems a contradiction between the theory of justice and the arguments above. However, the increase in performance could be due to the tendency of suppressing job insecurity as well as to the feeling of guilt (Leung and Chang, 2002). Indeed Brockner pointed out, in his article in 1992, that there is an increase in performance until a certain degree of job insecurity, yet it descends after a critical point. For Hitt and others (1994), even if survivors' performance augments in the short run, it declines due to stress and lack of equipment, especially in cases where survivors have not been integrated into decision making processes, in the long run. This is clearly a sign of failure that is, today's understanding of performing critical changes is out of date.

Beyond layoffs, volunteer leaving may bring about harmful outcomes to the organization. The symptoms of survivor syndrome also may lead survivors to leave the firm. This, in turn, may stimulate them to seek for new jobs. Leaders of this tendency are generally the key employees (Latack and Dozier, 1986; Shaw and Barrett-Power, 1997). Two broad categories of factors influence survivors' reactions. These are justice related factors (Was downsizing really inevitable? Has advance notice been given? Have the causes and necessities of downsizing been pronounced effectively? Has downsizing been applied to all organizational ranks, especially top management, equally? Did top management use reasonable criteria to select who would be laid-off?) and changing working conditions (Will the nature of work change? What will be the new challenges, tasks and responsibilities? Will remuneration

policy change? Will lay-offs continue?) (Brockner and others, 1986, Appelbaum and Donia, 2000).

Although lay-offs are a medium of cost reduction, they can also lessen the ability to respond new opportunities and risks, diminish innovation capacity. Lay-offs, early retirements and resignations due to redundancy could have negative effects on organizational activities, trim intellectual capital, augment the costs and incur a loss in its competitive strength (Pamenter, 1994; Flude, 1994; Band and Tustin, 1995). In Du Pont, for example, where early retirements and resignations were encouraged, twice as many employees left as was anticipated. In this context, due diligence team and human resources department should prepare a detailed action plan to retain the key staff in an organization. There should be training and support programs not only for redundant employees but also for survivors (Kinnie and others, 1998), as the latter are going to compensate extra work load and meet talent requirements (London, 1996; Zeffane and Mayo, 1994). Additionally, the due diligence team should look after the interest of key employees. To begin with, the team, accompanied with human resources department, should find out the key talent, and then create a retention plan for each employee to protect intellectual capital. Each role and employee in the organization should be examined and right people to right positions should be delegated. Therefore another task of human resources due diligence should be the organization of work distribution. Certainly, these are to be carried out in cooperation with human resources department.

Not merely in due diligence but also during the integration process, firms should insert human resources department into the negotiations. A so-called ‘post-merger’ or ‘integration’ plan should be prepared by gathering all relevant aspects of the deal. This plan should be consist of three fundamental elements: the goals of the new company, the way the integration of resources, systems and responsibilities will support these goals, and the timetable for the integration (Reed and Reed-Lajoux, 1999). Since organizations may have different cultures, integrating them would be hard. The more dissimilar the cultures, the harder would be to integrate them. Employees should be involved in organizational, cultural and human resources integration plans, future goals of the new structure and new roles of employees should be clearly articulated, an effective communication system should be developed, trust to top management and commitment to organization should be reinforced for a healthy manner of change during a merger (Horwitz and others, 2001).

5. Toward A New Approach In Due Diligence

Data, relating merger failures prove that traditional due diligence systems cannot boast much success (Bacon, 2001). According to Horwitz and others (2001), failed mergers often reflect ‘sloppy’ due diligence, by which companies may intend to minimize legal and financial conflicts. However, beyond avoiding these predicaments, due diligence in human dimension should shelter broader aspects, not only defensive but also synergetic.

Although they may have similar organizational structures and produce similar goods in equivalent markets, firms may have diverse remuneration systems, union policies, fringe benefits, training systems, communication manners, promotion and rewarding methods, decision-making processes. Therefore we need a new, comprehensive vision and a due diligence understanding for integrating two unlike organisms.

During a due diligence inquiry, for a better pace of integration, organizational strategies, environmental and organizational characteristics and capabilities (that are consistent within their own organizational system) of each firm should be investigated. Human resources strategies should be determined in accordance with the features cited above. Firm strategies, since they may imply totally diverse human resources sub-strategies, possess more vital importance in harmonizing them. Consider a firm that adopts Porter’s cost leadership strategy and another that adopts differentiation. The former entails narrow job descriptions, tight task and responsibility, performance appraisals as means of control as human resources policies. However the latter entails innovative force, flexibility, openness to contrast ideas, loose job descriptions, teamwork and performance appraisals as means of development (Schuler, 1998). Similar contradictions may be envisaged for Miles&Snow’s generic strategies. Therefore, in case of mergers, firstly, these ought to be harmonized for both companies and then effort ought to be spent for making them consistent with human resources strategies. This, indeed, is far from the context of conventional due diligence understanding.

Strategic convergence and cultural harmonization, especially in human resource management, may entail a full-time endeavor. From this perspective, due diligence is a group task and that needs a permanent full-time manager. Beyond the conventional perspective, a co-manager from the acquired company can be appointed to assist the manager and fulfill the tasks at the employer organization more efficiently. Here, the critical point is that the co-manager should be a believer of the merger or

acquisition and should be the one that would dedicate all necessary efforts to the success of process. As long as the gathered information ought to be mixed and interrelated critical factors ought to be determined, cooperation of members of the due diligence team from both organizations are vital. Because such a team would have a matrix structure, issues related to these structures should be taken in consideration and other departments must support the effort.

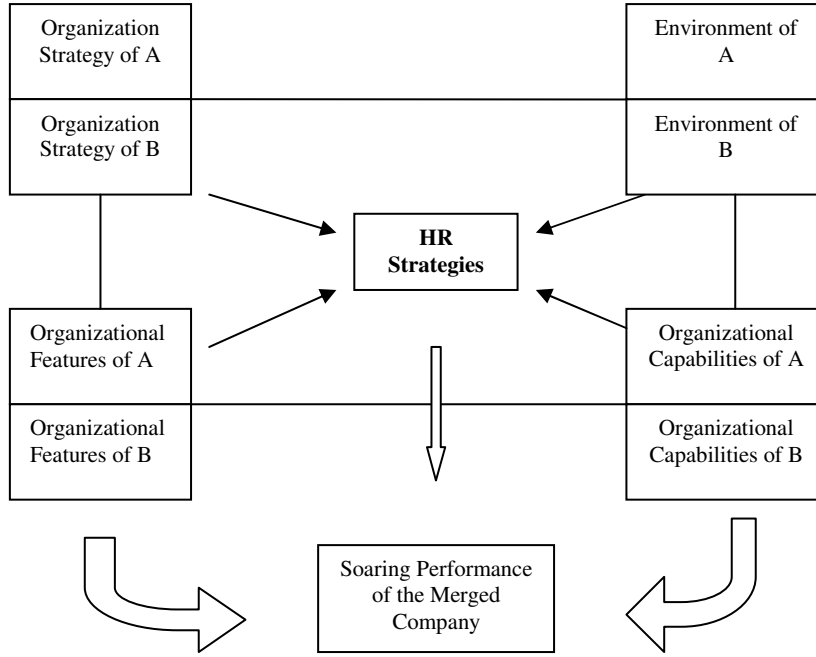


Figure 1: Creating HR Strategies for Merging Companies

Source: Derived from the figure in: Schuler, R. (1998), *Managing Human Resources*, 6th Ed., Cincinnati: International Thompson Publishing, 42.

Due diligence should be far from being just an investigative and preventive set of actions. It should also possess a stimulating dimension. That is, it may insert in external consultancy for some tasks in case of necessity. Tasks of a due diligence team should include measures to reduce costs, elimination of ineffective systems, improvement of new systems, risk reduction, documentation and communication (Bacon, 2001), assistance for preparing an integration plan and aligning corporate cultures, detecting which employees could participate in which decision

making processes and encouraging the company to involve them in decision making. For accomplishing such due diligence, teams should definitely involve specialists for cultural integration, human resources, finance and accounting, sales and marketing, information technology and legal issues. Another vital focus point of due diligence may be communication. After completing the work, copies of each report, except confidential information, should be distributed to relevant parties involved in due diligence (IBSA, 2003).

Due diligence team, and especially the team manager as the head of the team, is responsible for the sufficiency of data that is presented. Since due diligence is one of the most indispensable determinants of a deal, team leader occupies a crucial role in prosperity of the merger. Thus, if due diligence is a map, team leader would be the cartographer. Any mistake or lack of information in the report would derail the deal. That is why the process requires crucial planning, implementation and control.

Conventional due diligence has focused primarily on financial, strategic aspects of deals and has ignored cultural integration and human resource alignment of organizations. Human resource issues tend to be considered only when financial and legal matters have been finalized (Horwitz and others, 2001; Bramson, 2000). A new due diligence system necessitates more than reviewing data at the detail level (Bacon, 2001) which should possess a proactive vision. If conventional due diligence x-rays the organizations, the new one should perform the function of magnetic resonance, should impose preventive measures and suggest improvable aspects. Despite IBSA's argument, today's due diligence should also include a risk management perspective as well. Hence, we propose a model where due diligence team is a permanent unit of a firm not presenting data only before a merger or an acquisition, but for all critical decision that are relevant with a firm's operations.

6. Conclusion

Not only mergers but also almost all broad changes are destined to failure. Although concrete issues are considered elaborately, firms ignore to examine human resources, communication with employees and cultural integration. Today, traditional due diligence system seems insufficient to meet the requirements of the challenging business transactions, both with its scope and approach. In order to overcome these drawbacks, a new way of handling the due diligence process would be helpful. Under this framework, proactive approach replaces reactive approach which envisages creating a permanent department for

conducting due diligence. As for its scope, the new system would be put into force not only in case of mergers or acquisitions but also for almost all critical decisions, assisting to take preventive measures and suggest improvable aspects.

As a conclusion, this paper suggests the following steps for building a new due diligence concept. Firstly, change is a permanent process and each organization should seek the ways of adjustments to the change. In this view, due diligence may be the key that would open the locks. Thus, firms should consider it as a group task that needs a permanent full-time manager and staff. Secondly, because each company is a unique entity, organizational strategies, environmental, organizational characteristics and capabilities of merging companies should be examined elaborately as well as the financial characteristics, by the due diligence team. Thirdly, the due diligence team should be empowered to get involved into implementing the measures such as reducing costs, eliminating ineffective systems, improving new systems, reanalyzing jobs, redistribution of jobs, employee training, communication systems, preparing the integration plan and aligning corporate cultures.

Many studies have been dedicated to the failure in mergers and acquisitions. However, many of them are far from suggesting measures relating the due diligence process which seems to be a critical reason of failure. This paper may trigger a discussion in repositioning due diligence within the process of a merger or acquisition. However, further effort should be spent and research should be made on developing a new generation due diligence.

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