<u>Did You Incorporate FCPA Risk Into Your Model?</u>

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This is the second in a series of posts that review certain ingredients that are essential for an acquirer to successfully execute on its business plan after closing a deal.

In today's deal environment, no responsible board of directors will permit their company to make an acquisition, or in some cases, even submit a bid, until they are satisfied that the deal team has done the requisite level of FCPA diligence.

Although a great deal has been written about the appropriate scope of FCPA diligence that an acquirer should perform to shield itself from successor liability, little has been written about what an acquirer should do with the FCPA risk information that it gathers to improve the fidelity of its financial projections. This piece focuses on the need for buyers to adjust their financial models to comprehensively incorporate the information that their FCPA diligence teams learn during their investigation of the target. This opportunity for an acquirer to improve on the fidelity of its financial model of course assumes that its FCPA diligence team has not uncovered any "show-stoppers".

Every organization has its own system for performing diligence in an M&A deal and the level and frequency of communication among the various subject matter experts varies widely. Very often the lion's share of the diligence performed to make an FCPA risk assessment is carried out by outside counsel and accountants rather than by in-house team members. Frequently this exercise is performed in a silo and the details of the results are mistakenly not integrated with the rest of the business diligence efforts.

This lack of communication may happen for a variety of reasons. Sometimes it happens because the intended audience for the FCPA diligence results is the board of directors rather than the commercial team focusing on the financial assumptions included in the model. Sometimes it occurs because the deal team views the results of the investigation as binary (i.e. either everything is fine and we do the deal, or there is a problem and we do not do the deal). Other times the FCPA compliance review is simply considered part of the legal review and mistakenly deemed not to have any impact on the financial assumptions behind the projections.

To properly reflect discoveries made during FCPA diligence an astute buyer should consider making three types of adjustments to its financial model. The first adjustment that should be considered is increasing SG&A to reflect the ongoing costs associated with hiring additional compliance personnel and implementing systems. As described above, in almost every acquisition the acquirer will consider its own FCPA compliance policies and procedures to be superior to those of the target. Bringing the target's policies and procedures up to the standards of the acquirer will always result in higher ongoing costs. The second type of adjustment that should be considered is to include a contingency expense to reflect event risk if a problem is

discovered post-closing. It is not unusual for an acquirer to find potential compliance issues when it is integrating the target. If these matters are serious enough the acquirer will need to incur expenses for outside counsel and accountants to conduct an internal investigation to determine if an FCPA violation has in fact occurred. Even if it is determined that there was no violation, the costs associated with these types of investigations can easily exceed $1 million. Finally, if the internal investigation uncovers a violation not only will additional professional fees be expended to deal with the SEC or DOJ but there may also be material costs associated with a fine or settlement. Adjustments to the financial model to reflect such eventualities can only be made properly if there is open dialogue between the FCPA diligence team and the team controlling the financial model so that the likelihood and magnitude of any potential issues can be discussed and quantified in a reasonable manner.

The third category of adjustment, a potential loss of sales, is the one that buyers most frequently overlook. It is also the one that can have the most material impact on the accuracy of the acquirer's projections. As mentioned above, almost every buyer will implement its own FCPA compliance program after closing and in the vast majority of cases it will be more stringent than what the target had in place. Such changes will likely impact marketing methods, sales distribution channels and the target's travel as well as gifts & entertainment policies. A buyer should assume that sudden changes such as these will have a negative impact on the target's sales. Below are some specific examples of how implementation of a stricter FCPA compliance policy can lead to lower sales levels than may have been reflected in buyer's initial projections prior to completing its FCPA diligence.

If a target has had a high percentage of sales to foreign governments and SOEs, part of its success may have been driven by its liberal FCPA compliance program. Implementation of a stricter program that decreases the costs and frequency of meals and entertainment may lead to a drop in sales. This drop may, or may not be temporary. If the target's business plan contemplates growth from sales to additional foreign governments and SOEs the impact of these changes to the target's FCPA compliance program on sales projections could be even greater.

A buyer should also expect to see a significant decrease in sales if the target uses a significant number of agents abroad and the acquirer has a policy against the use of agents, as many companies do. The discontinuation of the target's use of agents will likely result not only in termination costs, but also in lower sales, particularly in the first few years after these agents have been terminated.

An acquirer's unwillingness to sell into certain markets based on its FCPA policy could also require a need for revised projections. For example, if the target's projections rely heavily on growth in countries with a reputation for corruption such as Nigeria, Angola, Uzbekistan or Russia and the acquirer as a matter of policy avoids doing business in one or more of these jurisdictions any sales in the projections that are contemplated to come from those countries will need to be adjusted.

The magnitude of these types of adjustments will of course depend on a variety of factors including the volume of foreign sales, the percentage of customers who are governments or SOEs and the growth-drivers of the business.

The most accurate financial models incorporate as much information as possible. Acquirers should take advantage of every piece of information they learn about a target and not compartmentalize the results. For acquirers to make the most of the information that they learn about a target's FCPA risks and create the most accurate financial projections they should use a cross functional team that includes representatives from the FCPA diligence team, the revenue diligence team and the modelling team to review the results of the FCPA risk assessment and incorporate them into the assumptions underlying the model.

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