10 key due diligence checks for organisations heading overseas

Brexit, sales growth, climate change and a host of other reasons may lead your board to decide to set up operations in new territories. Many chief audit executives will go through their careers having never to think about this. But for those who do, it can be daunting as internal audit is one of many specialisms that has a role within the project and due diligence process.

It is useful for CAEs to think about this topic, not least as many of the points are also relevant for managing risk in existing facilities. It is, likewise, a missed opportunity to simply add any new facility or operation to the audit plan once it is up and running.

In the following piece, we highlight 10 key due diligence checks for organisations heading overseas. In particular, we focus on setting up an overseas operation with a local branch staffed by one or more employees or a fully registered local subsidiary. Other options can include a joint venture partnership or simply trading at distance from the UK.

What are the 10 considerations?

Many of the risk considerations require specialist skills outside the remit of internal audit. The role of a CAE is to provide assurance that a comprehensive due diligence process is being undertaken by reviewing outputs, asking questions and challenging assumptions. This may be as an advisor on a project team or through more formal assurance depending on the requirements of the audit committee.

1. Strategy

The first question for any CAE to think about is an introspective one to help you decide how best to manage your relationship with key stakeholders.

Ask yourself whether your organisation has the capability to succeed overseas and/or whether it is ready to take on the challenge. How does the board handle planned change and crisis events? What level of risk maturity has the organisation achieved?

Discussions with your chief risk officer and board members, along with a review of the business case will help inform your thinking. In an ideal world, CAEs would have an advisory role in the strategic process but, in reality, they are often only involved after the decision has been made.

Internal audit has a unique, objective lens across its organisation, and a CAE may find themselves a lone voice of doubt in sensitive conversations with their audit committee chair about how best to provide assurance for the project.

Any overseas activity must be part of a sound strategic plan that outlines objectives, targets, costs structure and risks.

Within the structure, governance arrangements should be considered. This is a key area where internal audit can advise and the Chartered Governance Institute has a useful checklist for setting up a subsidiary, some of which will be relevant to other projects.

2. Regulations

The reporting requirements of a particular jurisdiction are an important consideration in setting up operations overseas. A study of rankings by the Observatory of Economic Complexity finds that some countries are more challenging than others such as Japan, Switzerland, Germany, Singapore and Sweden.

Anecdotally, some UK banks may want to put Germany at the top of that list as they grapple with BaFin regulations post-Brexit!

The TMF Group suggest that Ireland, the Netherlands, Luxembourg, Malta and Jersey are among the most attractive options for UK companies looking to establish a branch or entity with the EU.

From generic employee matters, to listing requirements, import and export regulations through to repatriation of profits, organisations must ensure they are fully aware of the rules in a jurisdiction.

CAEs may find their understanding of 1^{st} and 2^{nd} line assurance within the organisation are a valuable asset to any discussions; particularly if supported by an assurance map that could be compared and contrasted to any new jurisdiction requirements. Given the importance of cyber security, data movements between jurisdictions is one issue that CAEs should ensure is understood.

Think for a moment about existing overseas operations and the quality of the assurance provided. How do you know when there is a regulatory change? What assurance do you obtain over third-party operations?

The UK government provides information about things that could slow down, stop or raise costs for companies doing business in a specific country (a ‘trade barrier’).

3. Taxation

One key consideration for an organisation is its liabilities under the tax regime and, critically, whether there is a double taxation treaty in place between the UK and the country under consideration. There are thousands of treaties world-wide and the UK has one of the largest networks. Check out gov.uk for current information. Tax advice is a critical element of any decision to locate overseas.

4. Geography

In terms of priority, it is a difficult call as to whether regulations, taxation or climate considerations is the most important consideration. They are certainly all heavily weighted in decision making, but climate risk could be a game changer.

Rising sea level predictions change the dynamics for coastal cities such as Rotterdam, Amsterdam, Hong Kong, New York, Vancouver and London. Coastal communities in parts of Asia are already being forced to relocate - the potential for more frequent extreme weather events such as flooding, wildfires and drought should also be a consideration together with the robustness of local infrastructures to maintain water quality, limit power outages and provide transport networks.

Relocating or establishing an organisational presence overseas is a longer-term investment.

Has your organisation sought specialist advice and addressed climate risk in its due diligence?

Forecasts indicate that global warming, even within targets levels of the Paris Agreement, could make parts of the world where commerce currently takes place uninhabitable. Organisations need to consider physical climate risk not only from a resilience perspective but also in terms of contributing to the issue.

5. People

People are often quoted as the most important asset to an organisation.

Not all countries offer the same level of access to skilled labour, so your organisation needs to research the availability of the skills needed to be successful.

In addition to general skills, organisations also need to think about their competitive edge and burgeoning new talent. Everyone knows that Silicon Valley is awash with tech talent but what about Hyderabad in India, or the automotive innovation in Chennai, India and Chengdu, China?

6. Culture

Understanding how business is conducted in a country is essential to understanding market risks and opportunities. In some cases, it can be the difference between success or failure in contract negotiations. Think about the people involved in the project; is there a need for subtle internal audit consultancy advice to enhance what are in effect subjective controls?

An organisation is part of a community and cultivating local relationships early in the process demonstrates integrity. Is this an area that has been included or overlooked?

Language is rarely a barrier in today's world with so many translation options and the prevalence of English.

7. Property

In the UK, we have business rates which add considerable cost over and above rent rates. Your organisation would not want to be caught out by something like this in another country as it would impact viability modelling.

Has your organisation sought specialist advice to fully understand the commercial property market?

Another consideration is the handling of deposits: are these refundable, held in Escrow or even payable to a government rather than a landlord? In locations where bribery and corruption remain commonplace, all parties should be vigilant to avoid illegal activities.

8. Currency risk

Currency fluctuations are complex and uncertain. Organisations operating in multiple currencies are vulnerable to currency risk. There are fintech companies that specialise in international money transfer and offshore accounting. Think about the treasury risk management capabilities within your organisation and what level of confidence the board should have in this space.

Is there recent assurance on this risk area for the board to rely on? Is it required?

9. Market knowledge

There is always a strategic imperative for venturing overseas; expand into a new market, take advantage of an innovation hub, mitigate a regulatory-type issue or simply reduce overheads.

There is little to replace local knowledge as to what it is really like on the ground. Is the talent pool migrating elsewhere? Is there just too much red tape at every turn to make it worthwhile?

With an objective lens, look at the research the organisation has undertaken. Is it more than generic information you could obtain from a search engine?

10. Incorporation process

And finally, the incorporation process itself. Procedures, costs and timelines differ between countries; as with taxation and regulations, different jurisdictions pose benefits and challenges which need to be considered.

Although this is a specialist area, internal audit may find it prudent to ask due diligence questions around intellectual property rights, domain name usage and other related matters.

Closing thoughts

These 10 considerations provide a foundation for engaging with stakeholders, taking an active role in due diligence and also thinking broadly about the risks associated with existing and / or new overseas facilities. CAEs should think about how they can add value at all stages of a project to set up overseas operations.

“In the corporate world, if you have analysts, due diligence and no horse sense, you’ve just described hell”.

Charles Munger, vice chairman, Berkshire Hathaway