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# The Global Corporate Advisor

The Corporate Finance newsletter of Crowe Horwath International



Welcome to the March issue of The Global Corporate Advisor. This month we address a variety of topics drawing upon the experiences of Crowe Horwath offices in various parts of the world.

The opening article by Marc Shaffer in Chicago examines the role of due diligence and how it fits in the lifecycle of a deal. Among other things, the article outlines various steps that need to be taken for due diligence to be the most useful and emphasizes the role of all disciplines during the process.

The issue also contains an article by Markus Scheurer and Karl-Michael Krüger from Germany, illustrating how a reversed asset deal can be the best answer when an asset deal is not desirable and a component of the business is to be retained by the vendor.

The final article in this issue finds Darryl Norville from Perth sharing insights on common concerns that may arise with impairment testing of mineral assets.

The combination of subdued market conditions and increased focus by regulatory bodies on the quality of impairment testing has made the assessment of potential impairment scenarios even more crucial for professionals.

Don't hesitate to get in touch with your local advisor if there is any topic you'd like us to include.

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## Contact Us

The GCA team is here to respond to your needs relating to M&A transaction support, valuations and advisory services. If there is a topic you would like us to cover in future issues of the GCA newsletter, don't hesitate to contact Peter Varley, Chairman of GCA, at [peter.varley@crowecw.co.uk](mailto:peter.varley@crowecw.co.uk). Alternatively, please contact your local GCA team member to discuss your ideas.

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## Life Cycle of an M&A Deal: Where Due Diligence Fits In

By Marc Shaffer, Chicago

Due diligence is a critical component of the merger and acquisition (M&A) process where the full implications of a proposed transaction are investigated and buyers can address uncertainties regarding the target company.

This article presents an overview of the M&A deal life cycle, focusing on how the due diligence phase must be integrated into other parts of the cycle.

The life cycle of an M&A deal starts with the strategic plan phase where a company identifies its desire to grow through M&A. The plan should consider what value add is to be achieved and what a desired M&A target company should look like. Next is the creation of a list of potential M&A targets that fit the acquisition criteria identified in the strategy phase.

A letter of interest is typically required to be submitted by the buyer, especially if the potential seller is utilizing a broker or an advisor. Minimal, if any, due diligence is allowed during this phase. Indeed, if its competitors are part of the potential buyer pool, it may be better for the ultimate buyer if detailed due diligence is not required for this phase. These competitors may otherwise gain valuable marketplace intelligence that could be used against the target and ultimately integrated entity.

After approaching each of the M&A targets and identifying a party willing to consider a sale, it's important to consider valuation and seller expectations before developing a letter of intent. Key deal points are often negotiated before delivery and acceptance of a letter of intent. Where an auction process is involved, some diligence will likely be required at this point as it behooves the seller to have educated buyers competitively bidding against each other. Once a letter of intent is signed, leverage switches from seller to buyer. Thus the seller wants much of the core diligence to have been performed prior to signing a letter of intent. Buyers have the opposite desire of not incurring diligence costs (hard and soft) during a competitive phase, as they may not end up being the selected dance partner.

In a negotiated deal without competing buyers, due diligence is normally not performed until after a letter of intent has been signed. It is frequently completed between the letter of intent and definitive agreement signings. If the deal is not a 'sign and close', diligence might be performed after signing of a definitive agreement but before closing. In this situation, only material differences between information provided before and after due diligence could cause a deal to be re-valued or not consummated.

It is very important that planning of the integration of the two companies begins during the due diligence phase. Many companies make the mistake of waiting for the certainty of a deal to close before planning integration. This misses the value of using the diligence process to not only evaluate value-add drivers but also begin thinking about how the combined entities will operate. Because of this, it is important for the integration manager to be part of the diligence team.

### Target identification

Several sources can be used to identify acquisition candidates that fit a buyer's strategic goals. Market research providers such as Bureau van Dijk, OneSource, Frost & Sullivan, Experian, IDC, Mergermarket, and Hoovers can provide lists of potential targets to be vetted by companies and their advisers. Other typical sources of target companies include public stock research analysts following the sector, competitor sections of public company filings, industry association leadership, recommendations from senior employees, and referrals from investment bankers, attorneys, board members and investors. The better corporate development officers maintain relationships with all industry participants in order to achieve proprietary deal flow when companies ultimately seek to sell.

It is important to develop a summary profile for each candidate prior to approaching them about a deal. The summary should address target markets, key products/segments, turnover, profitability, geographic footprint, synergy potential, estimated enterprise value and acquirability. The summary allows the buyer to identify best-fit candidates.



Figure 1: Typical M&A deal life cycle

The following are steps a buyer should take prior to making an offer:

- Assess the potential target – obtain any public information, analyze industry trends such as earnings outlooks, and assess comparable industry acquisitions and multiples.
- Determine your position – document your strategic objectives for the transaction, such as industry consolidation or obtaining competitive advantage, and identify whether the seller has any leverage over you and what information you wish to learn prior to bidding. Consider utilizing professional advisors and also contemplate the expectations of the other party.
- Assess the value of synergies and reverse synergies, such as incremental costs a division might incur upon separation from its parent. It is important to consider the one-time costs to be incurred to attain the synergy values.
- Develop the valuation thesis by using the three common valuation approaches: comparable public companies, comparable M&A transactions and discounted cash flow.
- Draft the initial indication of offer letter.

## Key documents

An M&A transaction typically follows a three-document process:

1. Letter of interest – non-binding, provides your range of value, defines structure parameters, and outlines next steps in the process.
2. Letter of intent – typically still not a binding agreement, however specific provisions of it may be. It defines purchase price and basic transaction structure, expected closing date, exclusivity period (where the selling party will not solicit or engage in discussions or negotiations with other potential buyers), confidentiality (non-disclosure), and conditions of the transaction, such as:



- completion of due diligence to the buyer's satisfaction and who is financially responsible for it
  - side agreements implicit in the transaction, such as employment, non-compete and continuing supply
  - expectation that final purchase agreements will include representations and warranties.
3. Definitive agreement – stock purchase agreement or asset purchase agreement, which may also be a merger agreement. This document sets out all the necessary details relevant to consummating the transaction and is legally binding.

Ancillary documents must be negotiated at same time as the definitive agreement. Examples are escrow agreements, transition services agreements, supply agreements, non-compete agreements, employment agreements (for key employees), intellectual property assignments, lease agreements, and assignment agreements.

A deal can be closed at the time of signing the definitive agreement or at a later time often contingent on the actions of a third party. Requirements that may delay closing include:

- regulatory acceptance such as completion of the anti-competition review process
- novation of significant contracts, particularly contracts with governmental customers
- lease assignments where the location is critical, such as with retail store operations.

## Due diligence

When it comes to due diligence, buyers want full access and unlimited time, which must be balanced with the need to move quickly once a deal starts to become 'public', even if only within the walls of the buyer and/or seller organizations. Sellers want a speedy process with limited diligence, typically more to protect confidentiality and minimize administrative hassles than to hide issues.

A recent study by the M&A Research Centre in the UK<sup>[1]</sup> provided evidence to support the widely held belief that a longer due diligence process results in better deal-making by acquirers.

The study suggested that more diligence allowed acquirers to gather additional information on the target that could be used to negotiate a lower price.

Due diligence provides decision clarity and options. It mitigates the typical scenario where companies market themselves in as positive a light as possible in a sale process as investment bankers tend to put the best possible face on the business. Buyers are often not aware of all the issues that may affect the value drivers of the business and many issues may not be uncovered until due diligence is performed.

[1] Source: [http://www.cass.city.ac.uk/\\_\\_data/assets/pdf\\_file/0004/202828/Due-Diligence-M-and-A.pdf](http://www.cass.city.ac.uk/__data/assets/pdf_file/0004/202828/Due-Diligence-M-and-A.pdf).

The common activity of buying a house can illustrate the value of due diligence. Sellers tend to present their house in the best possible light to prospective buyers with the help of professional photographs taken using optimal lighting, targeted marketing material and staging of a home viewing. Buyers do not have full information about potential structural or mechanical issues at the time of their initial offer. Through a house inspection, legal review, title search and financing contingencies they have opportunities to cancel the purchase or adjust the purchase price if issues are uncovered. As such, buyers are essentially performing due diligence on their potential purchase.

The following due diligence considerations need to be negotiated and agreed upon as early as possible in the M&A life cycle:

- when the diligence will be performed – before or after the letter of intent, before signing of the definitive agreement, or even after entering into a definitive agreement but before closing (which is much less frequent)
- how much diligence will be allowed – this includes the types of diligence, such as financial, tax, legal, information technology and human resources, and the depth of the analyses
- the timeline for completing diligence – this should be created working backwards from the proposed transaction close date
- the stakeholders that the buyer will be allowed to meet – with open discussion about the level of access granted to corporate headquarters personnel, business unit senior management, line managers, customers, vendors, lenders, legal counsel, risk management personnel, the finance department, auditors, tax advisers, human resources, employee benefits consultants, information systems personnel, insurance agents, and board of directors members

- the role that investment bankers/M&A advisers or other professionals will have in the diligence process – they may manage the diligence process very tightly, in contrast to other sales where the seller is the primary contact
- how diligence documents will be produced by the seller – at a secure physical data room, through electronic transfer such as email, CDs or memory sticks, or the more prevalent electronic data room. It is important to have control over which documents are provided and reviewed, as a good process will link the ‘knowledge’ terms in the definitive agreement indemnification language to the documents provided. Given this, all documents provided must be thoroughly reviewed.

Remember that all disciplines need to be considered and coordinated, including finance, human resources, employee benefits, sales, marketing, distribution, operations, quality, taxes, legal, health and safety, information systems, risk management, and sourcing.

Following are two examples of issues that need to be negotiated before diligence begins:

1. Environmental reports – Will you rely on existing reports commissioned by the seller or its lenders? Who will pay for new studies? How will you handle reporting to regulators should previously unreported damages be discovered, considering that a potential buyer may have an obligation to report even if it does not consummate the deal?
2. Compliance/sensitive payment analysis – What level of investigation will be allowed for an anti-bribery assessment? Options include completing an anti-corruption checklist only,

interviews of employees, background investigations, and/or disbursement support testing. How will you handle reporting to regulators should sensitive payments be discovered?

Most of the diligence areas listed above may be viewed as issue identification, risk avoidance, and integration planning activities. However, synergy validation may be the most valuable diligence activity because many transactions are valued with the inclusion of an assumption of significant synergy attainment. It is critical to develop a Synergy Execution Plan that identifies ‘how, who and when’ in order to drive the synergy achievement as soon as possible after closing. This plan is best developed during the due diligence process.

One aspect of diligence that is frequently overlooked is a continual assessment of how the market environment is changing during the deal process, particularly in reaction to knowledge of your deal becoming public. Someone outside of the identified diligence team should be assigned the task of keeping abreast of market changes. It is easy to get caught up in the momentum of the deal, and constant reassessment of fit with strategic plan is required. Also, it is important for the due diligence process to be closely linked with those negotiating the deal and those individuals responsible for drafting the letter of intent and definitive agreement, typically legal counsel. Due diligence discoveries and deal environment changes might cause the buyer to change the characteristics of its offer to the seller.

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# Reversed Asset Deal as an Alternative Way to Acquire Assets of Core Interest

By Markus Scheurer and Karl-Michael Krüger, Germany

A Reversed Asset Deal is a way to:

- at the final stage only acquire what you really want,
- reduce legal risk, and
- reduce the financial risk and time generally required to dispose non-core assets after the completion of a share deal.

Usually when acquiring a business there is a choice, in the first instance, between a share deal and an asset deal. When acquiring the legal entity via a share deal, the advantage is that, in general, it is technically easier and straightforward. You buy the company as a whole, with everything it comprises, which includes the company's history with aspects that you may not wish to take over, such as non-disclosed liabilities, looming lawsuits and hidden tax threats.

In case these issues reach a level of importance putting the whole transaction at risk, or where the company's history is not clear, or sufficient guarantees cannot be provided by the sellers to solve such risks, the only alternative may be to execute the acquisition via an asset deal. Asset deals reduce such threats and risks considerably, since only specific assets and liabilities are taken over and not the entire business. However, an asset deal could face problems based on its legal structure and may therefore be an extremely risky alternative.

## Why?

There could be many reasons. For example, your target may own many long-term contracts, which are vital for the future existence of the company or even form the basis of its business model. These would have, in fact, formed one of the reasons for acquiring the business in the first place. In this case, an asset deal might not be possible since long-term contracts can generally only be transferred with the consent of the contractual third party. Therefore, all contracts might have to be renegotiated. A customer or any other third party to such a contract may even reject the idea of extending the business relationship. Consequently, such long-term contracts which were originally drawn to favor your target company – and implicitly your future business – are not likely to be transferred or prolonged without any amendments influencing future profitability or risk position.

Examples of such contracts include construction contracts in real estate and machinery, service contracts such as lease contracts on copiers or IT hardware. They may even include property leasing contracts in retail businesses. In some cases, these contracts may even have a "Change of Control" clause, but that is uncommon.

In such cases, following a risk assessment you may end up purchasing the legal entity in the course of a share deal and, in doing so, take over all businesses belonging to it. However, it is possible that the acquired company or business includes activities which you may not be looking for. There may be branches or locations/subsidiaries or activities, not actually forming a part of the core business, which make no sense for you to either keep or continue. In most cases, you might consider a spin-off after the deal in order to sell these to a third party. However, there is a risk that this may not work or there may be a time delay or you may not find a suitable third party buyer at all.

In some cases banks may show resistance to even bridge-finance such deals, particularly if you cannot prove to them that you can sell the activity in question at a decent price in a foreseeable time horizon. They may even ask for your plan B if you need to run this specific activity in case the intended sale fails to take place.

On the other hand, there may be a seller who would be interested in keeping some of the assets himself. It could be a building or he may plan to pursue a separate business with a specific part of his current business, not in competition with you or the originally planned deal. In case these businesses are in separate regions, clearly defined legal and business regulations could solve the problem.



This is where a Reversed Asset Deal could come into play.

The advantage of selling a part of the business or certain assets back to the original owner is that you can combine the Sale and Purchase agreement (SPA) for the legal entity with the re-selling of these assets in a single contract.

### So you are:

- a) sure that you have a buyer for that part of the business,
- b) there is no delay, and
- c) you will not have to finance that part of the deal.

Let's illustrate this by an example, where we recently set-up a Reversed Asset Deal for a client to solve such a situation.

A longtime client sold his business with plans to retire early. In this process he signed a non-competition agreement in good faith. However, he started considering a restart of his previous business because retirement was not satisfying him to the extent he was expecting. His former employees, who were feeling uncomfortable under the new owners, also got in touch with him.

Such thoughts were hindered by the agreed non-competition clause. The clause primarily included restrictions on certain countries, which led us to the possible strategy to look for companies in countries not covered by the non-competition agreement.

The client was aware of a company and the shareholder of such a likely target. This company had a respected name and position in the industry. However, the shareholders were not very active in the chosen field and, for private reasons, had opened a branch totally unrelated to the company's name and core business. Because of the urgency to get back into the business, the client had already signed third party contracts before the SPA, under the name of and with the consent of the target, who later became the seller. In this case, the only option for our client was to buy the legal entity and sell back the unrelated business to the selling shareholders.

We hope that we have illustrated that deals are not always – or should we say, nearly never – straightforward. But thinking out-of-the-box helps in finding creative solutions to challenging situations. It also allows for the final economic goal to be achieved.

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## Common Issues with Impairment Testing of Mineral Assets

By Darryl Norville, Perth

Since 2008, significant changes in economic conditions have reduced access to debt and equity funding and have led to changes in the supply/demand balance for most commodities, resulting in increased volatility in their prices.

In corporate reporting terms, the consequence of these uncertain economic conditions has resulted in many resource companies needing to write down the book value of exploration assets and mineral properties and the likelihood of future impairment losses is ever present.

The combination of subdued market conditions and a renewed focus on the quality of impairment testing by regulatory bodies means that directors need to ensure that appropriate consideration is given when assessing potential impairment scenarios.

### IFRS framework

#### Exploration versus Development and Production Assets

IFRS 6 (Exploration for and Evaluation of Mineral Assets) requires exploration and evaluation assets to be assessed for impairment when facts and circumstances suggest that the carrying amounts of such assets are no longer considered recoverable. Once a project has reached the development phase and is deemed to be commercially viable, IFRS 6 is no longer applicable and IAS 36 (Impairment of Assets) applies.



Impairment is deemed to exist where the recoverable amount of a cash generating unit (CGU) is assessed to have a lower value than the book value of the related assets (and liabilities) of that CGU, recoverable amount being the higher of its fair value less costs to sell (a market based model) and its value in use (an entity specific model).

### Watch out for indicators of impairment

IAS 36 requires goodwill to be tested for impairment each year, irrespective of whether there is any indication of impairment. However, assets are required to be tested at year-end if any indicators of impairment exist.

There may be multiple triggers for an impairment test. Triggers commonly seen in today's climate include:

- Reduction in commodity prices and increased development capital expenditure costs, leading to the carrying amount of the mineral asset being greater than the market capitalization of the entity
- Insufficient funds to complete the exploration program or development phase, so that the commercial production phase cannot be reached
- Higher than expected costs of finance to develop a resource, meaning that the resource cannot be exploited commercially
- The period for which the right to explore has expired or will expire in the near future, and is not expected to be renewed
- Insufficient exploration expenditure incurred during the period, infringing the terms of the exploration license, leading to the threat of loss of license
- Entering into farm-in arrangements with other parties, reducing an entity's economic interest in a project.

## Common issues with impairment testing of mineral assets

The technical requirements of IAS 36 are complex. As a result, there are a number of issues that are commonly seen with impairment assessments of mineral assets. Drawing on our experience, here are some of the issues most frequently encountered.

### **Selection of a value in use (VIU) basis over fair value less cost to sell (FVLCTS)**

Many clients prepare a simple VIU test and give no consideration to the asset value derived under a FVLCTS test. A VIU test is likely to derive a lower asset value, if undertaken in accordance with the standard. This is because a VIU test is restrictive in that the assessment is required to be based on the current condition of assets – that is, cash flow benefits to be derived from either uncommitted future restructuring or from future enhancements to the capability of assets cannot be factored in.

Therefore, when there is expected mineral exploitation potential beyond current mine plans or an entity envisages enhanced revenues from additions of capital or lower costs from prospective rationalisation programs, directors should consider using FVLCTS (if other market participants would also include such scenarios to value the assets in question).

### **Application of a discount rate that is not consistent with the cash flows**

Specific assets/projects and CGUs often have different risk and return profiles to their parent entity. In these circumstances, the asset or CGU may have a different required rate-of-return and therefore a different discount rate to the consolidated parent. Likewise, country-specific risk premiums should be considered for assets held in different jurisdictions.

In addition, matching the correct type of discount rate to the correct type of cash flow is essential to perform meaningful discounted cash flow (DCF) calculations. Cash flows and discount rates can be real or nominal, geared or ungeared (drawdowns, repayments and interest), pre or post-tax and a combination of these.

Many valuation practitioners prefer to perform calculations using either a post-tax weighted average cost of capital or a post-tax cost of equity discount rate (with appropriately matching cash flows) since they believe this to be a more technically correct approach to the valuation.

### **Cash flow forecasts and underlying assumptions should be 'reasonable and supportable'**

Forecasts should be based on the latest management approved budgets or forecasts. These are required to be based upon reasonable and supportable assumptions that represent the management's (or the market's) best estimate of the economic circumstances that will prevail over the remaining life of the CGU.

Greater weight should be given to external evidence. For example, commodity price and foreign exchange assumptions should be compared with analysts' forecasts, current at the date of the assessment. Care should be taken to ensure that there is consistency in the selection of foreign exchange and commodity price forecasts.

Assessment should also include consideration of the potential impacts on value of variations in these key assumptions.

### **Working capital balances incorrectly excluded from the CGU asset base**

IAS 36 requires assets and liabilities that generate cash flows independently of other assets and liabilities, to be excluded from the CGU, such as inventories, receivables, payables and provisions. However, in practice, impairment testing is normally based on forecasts for the business which include cash flows from the settlement of working capital balances.

IAS 36 allows companies that have included cash flows from the settlement of working capital balance to leave forecasts unadjusted, as long as the carrying value of the CGU is adjusted to include working capital assets and liabilities.

### **Problems encountered when determining cash flows associated with tax payments**

Accumulated tax losses at the date of valuation need to be excluded from cash flows of the CGU as they are considered to be a corporate asset.

The tax payments included in a FVLCTS assessment are based on the tax bases of assets. Therefore, the carrying amount of a CGU should be based on a post-tax basis, which is the net of any temporary timing differences.

As a VIU assessment is performed on a notional pre-tax basis, tax payments should be calculated using the accounting bases of assets. Therefore, the carrying amount of a CGU should be based on a pre-tax basis, with no adjustment for temporary timing differences.



### The correct treatment of foreign currency cash flows in impairment assessments

Many CGUs have cash inflows (and outflows) in currencies other than an entity's functional currency. For example, most commodities are commonly priced in US\$ terms.

Under a VIU test, foreign currency cash flows are required to be estimated in the foreign currency and discounted using a rate appropriate to that foreign currency and then translated at the prevailing spot foreign exchange rate.

Under a FVLCTS assessment, market based foreign exchange assumptions are used.

Any hedging contracts are required to be separately assessed under IAS 39 and should not be included within the impairment assessment.

### Incorrect calculation and application of a pre-tax discount rate in VIU assessments

IAS 36 requires companies to perform VIU calculations using pre-tax cash flows and a pre-tax discount rate. However, the most readily observable rates for equity are on a post-tax basis. Therefore, it is considered acceptable to use a post-tax discount rate with post-tax cash flows.

Companies still need to comply with the disclosure requirement of IAS 36 and disclose a pre-tax rate discount rate.

Determination of a pre-tax discount rate is not as simple as grossing up the post-tax discount rate by the standard rate of tax as this does not take into account the timing of future cash flows, the useful life of the CGU and the expected tax cash outflows.

### Where to next?

If you require assistance with impairment testing calculations, please contact our valuation team at Crowe Horwath.

Our valuation team provides valuations of businesses, shares and other securities to assist shareholders, management teams and boards in analyzing merger and acquisition transactions and to make decisions around landmark events, including the preparation of independent expert reports.

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