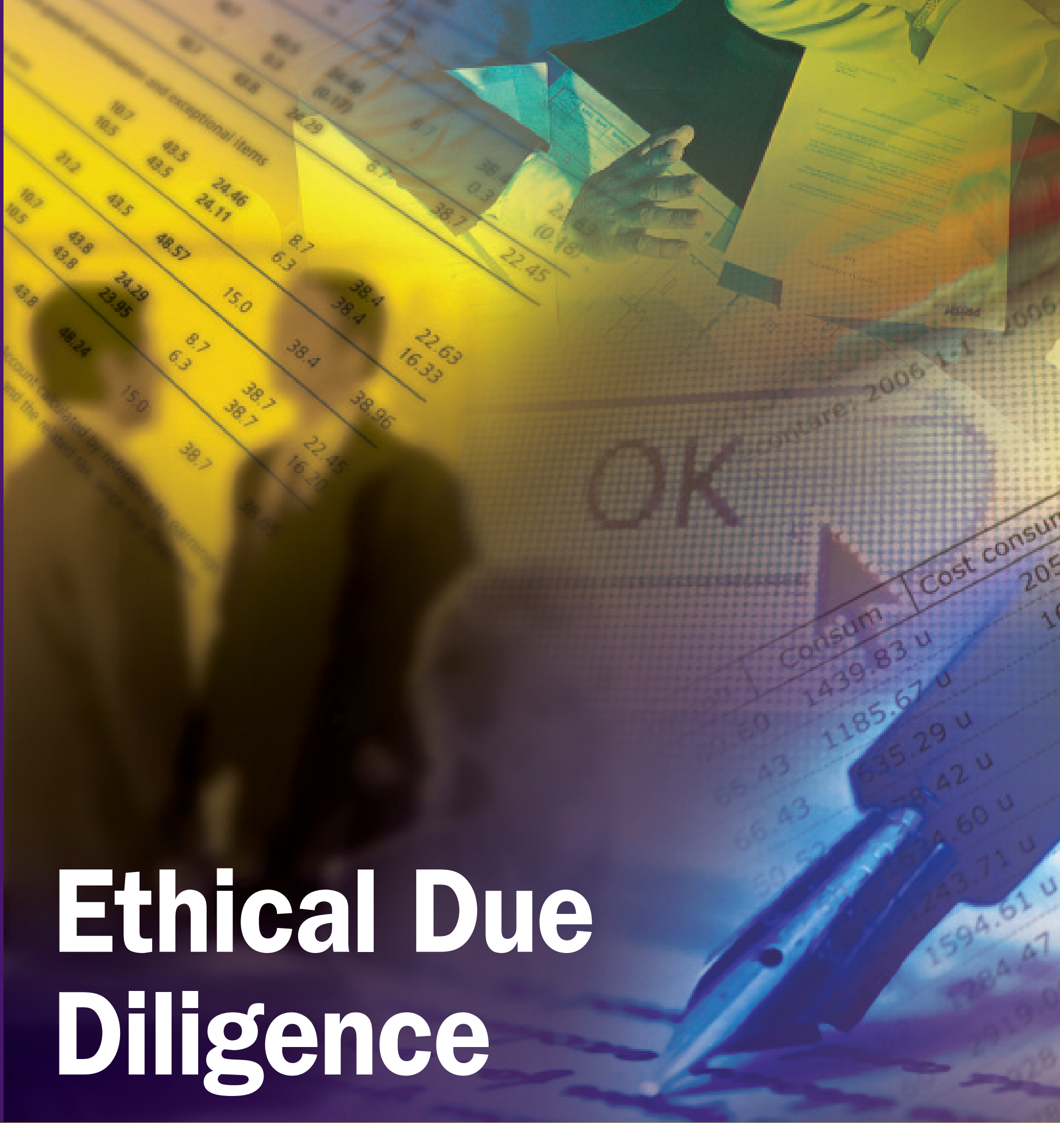

Ethical Due Diligence

An introduction and guide

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Contents

Executive Summary

To run successful businesses, companies need to be sure that their relationships with other companies and individuals are sound and secure. Traditionally, this has involved an examination of the third parties' financial position and business record through a process of due diligence.

However, the growing pressure on companies to show that they behave responsibly has added an ethical dimension to this exercise: is the third party ethically sound, are its values compatible, does it pose risks to reputation? This has created the need for a further process to provide answers to these questions.

Out of this need has risen the concept of “ethical due diligence” (EDD), which is an extension of traditional due diligence. But where the traditional form is essentially about verifying facts and claims made by a company, EDD aims to make a judgment about the ethical character of a target company and identify potential sources of ethical risk. The record shows that mergers often fail because of cultural mismatches between companies.

The issues covered by EDD fall under the broad category of non-financial risk, which is to say ethos, governance, reputation, alignment with ethical values and standards of corporate behaviour, and internal controls.

EDD can be applied in many situations where company relationships are about to be established:

- ahead of a merger or takeover
- before entering into a joint venture
- in appointing agents and suppliers
- before making a loan or investment
- in recruiting employees and directors.

In all these cases, EDD can help the company decide whether a proposed business partner operates to required ethical standards, and gain assurance that it will not expose the company to risks which might damage its reputation or its own ethical stance.

Although much EDD work can be carried out using publicly available information, it also requires a deeper understanding of the ethos of the proposed business partner so that the strength of its ethical commitments and the means it uses to enforce them can be judged. Specialist firms are evolving who can carry out this sort of work.

EDD is viewed as a separate exercise from regular due diligence because it is voluntary, i.e. not a regulatory requirement. However, many of the issues it covers come increasingly under direct regulatory control, e.g. governance, anti-bribery, employment policies. The gap between ethical and regular due diligence is therefore narrowing: in many areas the two now overlap.

For this reason, EDD can be viewed not as a “voluntary” exercise so much as an integral part of a company’s approach to risk management. Some people have argued that EDD is not a voluntary process, but a requirement insofar as companies which do not engage in it ignore ethical values and expose themselves to unnecessary risk.

Although much remains to be learnt about EDD, it is already clear that companies which adopt it should be able to reduce their ethical and financial risks, and gain competitive advantage over those which ignore or downplay them.

This report was compiled in 2006 and early 2007 using interviews with companies and experts, and published documentation. It describes the process of EDD, and shows how it can be deployed to support business decisions. The report also provides a guide to good practice and shows by means of case studies how it is already being applied.