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SUSTAINABILITY IN TRANSACTIONS

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About this report

Addressing the issues of sustainability, including environmental, social and economic impacts of the transition to a net-zero economy, represents a key challenge for most organisations. Despite this, business activity continues, with the investment and divestment cycle remaining another fundamental part of organisations' activities. Corporate acquisition and disposal transactions, including those that are private equity (PE) funded, are a fundamental part of many economies. The interrelationship between these two areas of focus, mergers and acquisitions / divestment and sustainability-related issues, is the subject of this report. Using the insights of nearly 50 accountancy and finance professionals from across the world, many of whom are members of ACCA or CA ANZ, this report provides a context for this interrelationship between sustainability and these major corporate transactions. The report is not a detailed explanation of the transaction process; rather, it is intended to support chief financial officers (CFOs) and their teams in identifying appropriate sustainability-related considerations during the investment and divestment workflows.

Foreword

Helen Brand OBE
chief executive, ACCA

Ainslie van Onselen
Chief Executive Officer,
CA ANZ

Sustainability criteria are increasingly important considerations in investment and divestment processes. As organisations transform their operating models, often through or as a byproduct of merger and acquisition transactions (M&A), the application of a sustainability lens presents opportunities and risks that cannot be ignored.

Yet despite this, the application of a sustainability filter to transactions is by no means uniform across organisations, industries, and countries. This presents opportunities for accountancy and finance professionals who continue to upskill their sustainability knowledge as the accounting profession evolves. They are often at the heart of these transaction processes, including the due diligence phase, bringing specific expertise and an ethical lens that enables them to quantify risks, assess outcomes, and identify 'deal breakers'. The completion, or otherwise, of a transaction is often influenced by this discovery process.

Having the skills to place the transaction-related information in context is essential, regardless of whether the initial assessment relies upon the expertise of others. We encourage our members to draw on the expertise, learning resources, support, and networks provided by professional membership organisations including ACCA and Chartered Accountants ANZ, and standard setters and trade associations such as the IVSC, Invest Europe and IMAA.

Contents

Key terminology

Mergers and acquisitions

Mergers and acquisitions (M&A) are business transactions in which the ownership of companies, business organisations, or their operating units is transferred to or consolidated with that of another company or business organisation. As an aspect of strategic management, M&A can allow enterprises to grow or downsize, or change the nature of their business or competitive position.

A ***merger*** is the legal consolidation of two business entities into one, whereas an ***acquisition*** occurs when one entity takes ownership of another entity's share capital, equity interests or assets.

Business combinations can also be classified as horizontal, vertical and conglomerate mergers (or acquisitions).

- A ***horizontal merger*** is between two competitors in the same industry.
- A ***vertical merger*** occurs when two firms combine across the value chain, such as when a firm buys a former supplier (backward integration) or a former customer (forward integration).
- A ***conglomerate merger*** occurs where there is no strategic relatedness between an acquiring firm and its target.

Divestment or divestiture is the reduction of some kind of asset for financial, ethical, or political objectives or sale of an existing business by a firm. A divestment is the opposite of an investment.

Transaction

The term ***transaction*** is used here to refer to the steps in undertaking either a merger or an acquisition. In the context of this report, the term is used to refer to the activity chain irrespective of the type of business combination involved.

Due diligence

Due diligence is a process that involves risk and compliance checks, conducting an investigation, review or audit to verify facts and information about a particular subject. In simple terms, due diligence means doing your homework and acquiring the necessary knowledge before entering into any agreement or contract with another organisation.

Third-party due diligence

Third-party due diligence is the process of assessing and evaluating the risks associated with engaging or partnering with third-party entities such as suppliers, vendors, contractors, agents or business partners. A comprehensive investigation and analysis of the third-party due diligence process is conducted to ensure that these third-party entities:

- comply with legal and regulatory requirements
- adhere to ethical standards, and
- pose no significant risks to the acquiring organisation.

Valuation

The assets of a business are pledged to two categories of stakeholders: equity owners and owners of the business' outstanding debt. The core value of a business, which accrues to both categories of stakeholders, is called the ***enterprise value***, whereas the value which accrues just to shareholders is the ***equity value*** (also called market capitalisation for publicly listed companies). Enterprise Value reflects a capital structure neutral valuation and is frequently a preferred way of comparing value, as it is not affected by a company's, or management's, strategic decision on whether to fund the business either through debt, equity or a portion of both. Six common ways of 'triangulating' the enterprise value of a business are:

- asset valuation: the price paid is the value of the 'easily saleable parts'; the main approaches to valuing these are book value and liquidation value
- historical earnings valuation: the price is such that the payment for the business (or return targeted by the investor) would have been supported by the business's own earnings or cash-flow averaged over the previous three to five years
- future maintainable earnings valuation: similar to the historic earnings valuation, but forward looking
- relative valuation: the price paid per unit of earnings or revenue is based on the same multiple for comparable companies and / or recent comparable transactions
- discounted cash flow valuation: the price equates to the value of 'all' future cash-flows – with synergies and tax given special attention; and
- comparison with similar entities.

Professionals who value businesses generally do not use just one method, but a combination. Valuations implied using these methodologies can prove different from a company's current trading valuation.

Earnout

Earnout (or earn-out) refers to a pricing structure in M&A where the sellers must 'earn' a part of the purchase price that is based on the performance of the business following the acquisition.

Sustainability and ESG

The terms ***'environmental, social and governance'*** (ESG) and ***'sustainability'*** are often used interchangeably. But while, in broad terms, both are concerned with environmental, social and governance factors, ESG focuses on evaluating the performance of organisations based on these factors and the risk they present for investment purposes, whereas sustainability is a broader concept that encompasses responsible and ethical business practices holistically. For this reason, ESG aspects are sometimes considered to be a subset of sustainability. In the sustainability conversation we are looking towards a longer-term future which balances environmental, economic and social elements in a progression to a sustainable future where nobody is left behind. Achieving sustainability requires a longer-term view than ESG and, according to the Brundtland Commission, which originally defined it, is about meeting the needs of the present generation without compromising the ability of future generations to meet their own needs (United Nations n.d.).

Executive **summary**

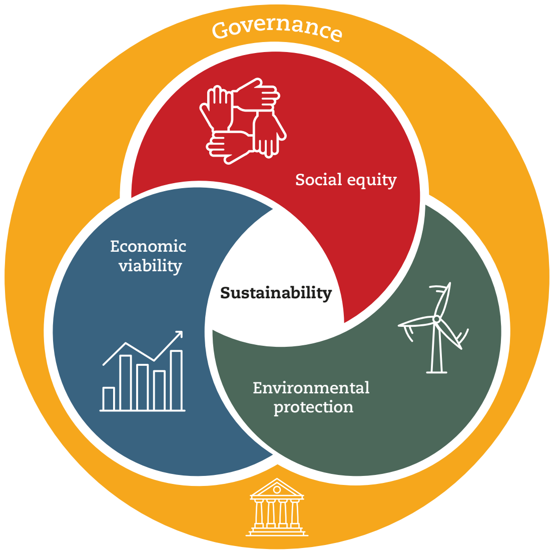
Three key messages from this report

- Sustainability-related opportunities and risks cannot be ignored in a transaction: they now form a fundamental part of the strategic intent of the transaction and the valuation of an entity.
- The assessment of these risks and opportunities must be comprehensively considered as part of the due diligence process, both as a specific workflow and as an integral part of other forms of due diligence.
- Organisations need to ensure that they have an appropriate level of expertise across the transaction workflow and in relation to the target's operations, assets and liabilities.

The transitioning of organisational models to a more sustainable state presents a major challenge for many entities, and in particular a challenge which questions the validity of traditional operating models and requires continuous improvement to achieve desired outcomes. For many organisations, it leads to the creation of specific teams and action plans to achieve the required outcomes, such as a 'just transition' that represents the combination of economic, social and environmental aspects (Figure ES1), around which sits a layer of governance. It is, however, fundamentally an organisational risk and it is important that these specific teams have appropriate knowledge and are engaged with it as part of the transaction process. Critical business risks are now arising from sustainability-related issues and these can pose a threat to the outcome of any transaction. There are equally significant opportunities as businesses seek to broaden their offering and acquire sustainability expertise and know-how and integrate these into aspects of their business model. The need to use new technologies, such as battery power in the automotive industry, can often be a driver for a transaction, as organisations work towards a more sustainable business model. In such cases, the desire for sustainability itself can be driver for an acquisition, but equally it can be a reason for divestment or demerger, in the case of a 'sunset' industry.

Using the insights of nearly 50 finance professionals from across the globe, it is possible to explore the extent to which sustainability-related issues are now a factor in the M&A transaction cycle. While for some organisations these are currently an integral consideration in the transactional process (see section 1.2), our research suggests that this is not uniform in application. The research has highlighted that the extent to which sustainability is considered varies by location and sector. In some economies and sectors it is still

FIGURE ES1: Dimensions of sustainability



> *'[Sustainability-related due diligence] is still a very much a box-ticking exercise. So, the question for me is, how do we make this front and centre of the conversation and bring other stakeholders along that journey?'*
> **UK-based chief financial officer (CFO)**

barely a subtle noise, while in others it is a loud drumbeat – so loud that it can be seen as one of the most critical factors in determining whether a deal proceeds or not. In part, this is because of the differing attitudes that investors hold towards the subject. For many financial institutions, the achievement of their own sustainability-related goals can only be realised through the actions of their clients, making sustainability central to the investment decision. Whether there should be a more substantial consideration of the environmental aspect is open to debate (see section 1.2) but, increasingly, there is a realisation that both the social and economic aspects of a transaction cannot be ignored.

The due diligence process plays an important role in the discovery of the potential opportunities and risks in the transaction. Sections 2 and 3 discuss this process from the perspective of the acquirer and acquiree respectively. How sustainability-related issues are incorporated in the due diligence process is considered in section 1.4. This can be done either as a standalone exercise or through integrating the assessment of the risks into other forms of due diligence. To ignore it entirely, however, is to create a risk which may well have changed the valuation of the transaction (as considered in section 1.6).

It can no longer be denied that sustainability-related risks are insignificant in the transaction workflow. The goal of sustainability is both a risk and an opportunity: an opportunity which can be crystallised through the integration (or demerger) of the two organisations after the completion of the deal (section 2.4).

Sustainability is a multidimensional issue for organisations and the areas that should be considered in the due diligence process (as considered in Table ES2) are both broad and interconnected. There is a need for expertise and experience in many areas, although it is also essential to appreciate the interconnections with other forms of due diligence that may be undertaken (as detailed in the Appendix).

Accountancy and finance professionals need to ensure that they are appropriately skilled, in recognising both the implications for the transaction workflow and the substantive opportunities and issues that pursuing sustainability represents.

There are several sustainability-related considerations in the transaction workflow, as summarised in Figure ES3. Several further considerations are given in Table ES1 and further detailed throughout the report, with several actions recommended in Table ES2.

At each stage of the transactional workflow sustainability-related issues will have an impact on specific interventions, from the perspective of either the acquirer or the acquiree. These are summarised in Figure ES4.

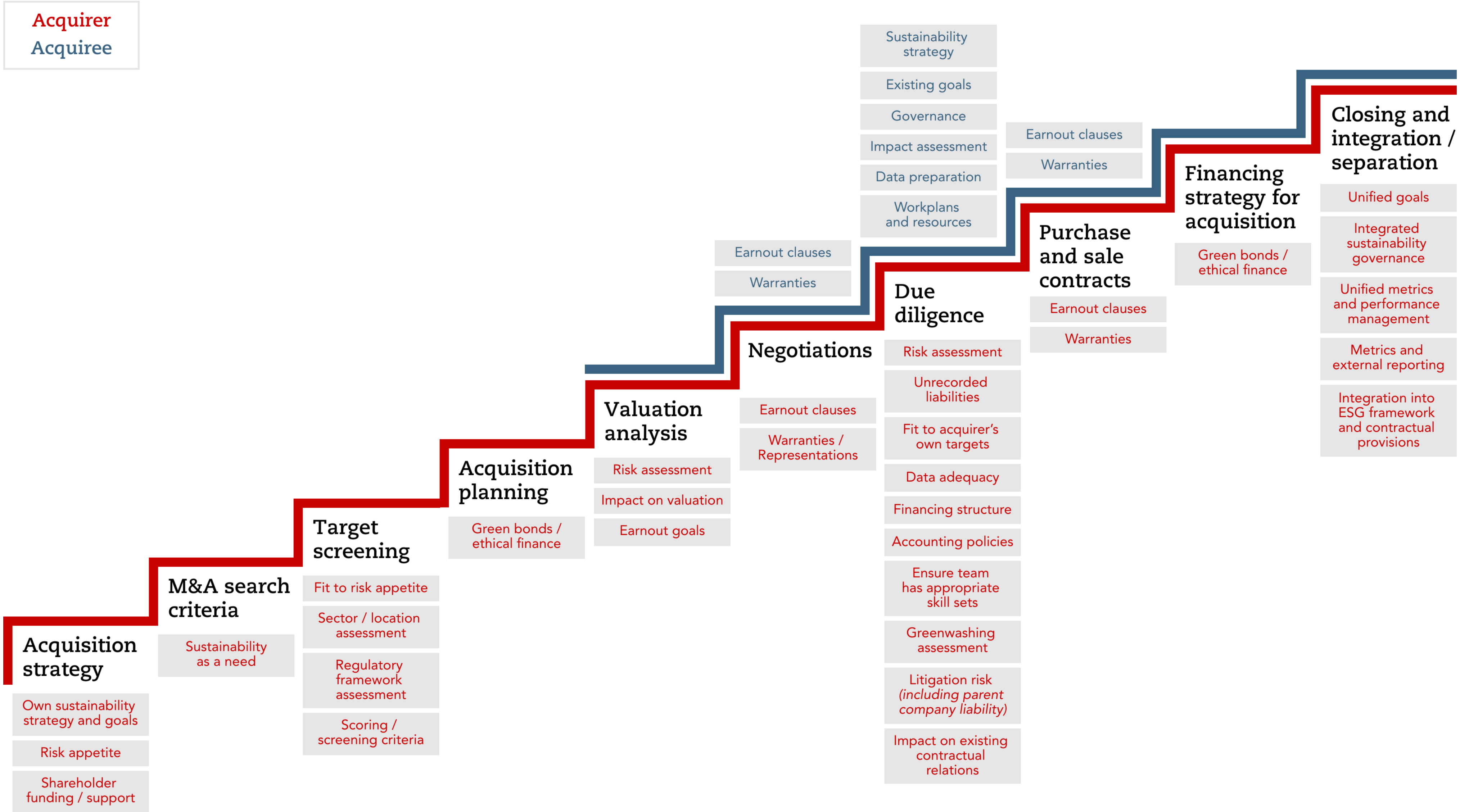
FIGURE ES2: Some areas to consider in sustainability-related due diligence

FIGURE ES3: Sustainability-related considerations in the M&A transaction workflow

Strategic and risk-based scope	Drive transactions towards strategic goals for sustainability and adopt a risk-based approach
Integrated approach	Integrate sustainability-related issues into all aspects of the due diligence approach
Operational rigour	Recognise that sustainability is a core part of the operating model
Agility and flexibility	Assume constant change and evolution of sustainability goals
Relevant expertise	Ensure that the depth of the sustainability-related risks is addressed by relevant experience
Actionable observations	Ensure that outputs of any assessment are actionable

Sustainability-related considerations in the transaction workflow

FIGURE ES4: Sustainability-related considerations in the transaction workflow



Sustainability-related considerations in the due diligence process

The following tables provide some examples of the questions that may be considered as part of an assessment of sustainability-related issues (and/or environmental, social and governance considerations (ESG)) during a due diligence process. The precise questions will vary according to the circumstances of the transaction and the risk profile of the acquirer and the acquiree.

TABLE ES1: Sustainability-related considerations in the due diligence process

STRATEGIC	
1.	Does the target have a sustainability (or ESG) strategy or framework?
2.	To what extent does this align with the acquirer's own strategic objectives?
3.	Does the target have an enterprise risk assessment which incorporates sustainability-related considerations?
4.	Does the target operate in an industry which is regulated and what is the impact of that regulation upon its sustainability objectives?
5.	Is the target a signatory to any global, regional or national standards relevant to the management and / or reporting of sustainability-related issues, such as the UN Global Compact or Science Based Targets Initiative?
6.	What sustainability-related issues are material to the target business and its stakeholders?
7.	How has the target embedded the requisite considerations in its organisational culture?
8.	Have any claims against the target been made in respect of sustainability-related matters, including greenwashing, sexual harassment, environmental regulation breaches and human rights?
9.	What are the target's ESG ratings, if applicable, and should access to these be available?
10.	What are the applicable sustainability reporting standards and regulatory requirements (including the International Sustainability Standards Board (ISSB) standards or the European Union Corporate Sustainability Reporting Directive (CSRD), and voluntary standards such as the Global Reporting Initiative (GRI) or Taskforce for Nature-related Financial Disclosures (TNFD))?

ENVIRONMENTAL	
1.	What resources used by the target may be subject to environmental risks? Have impact assessments been conducted?
2.	Does the target engage in appropriate environmental practices? Are these in compliance with local regulations and are they acceptable in the acquirer's jurisdiction?
3.	How does the target manage the environmental aspects of its business (including energy, land use, pollution, CO_2 emissions, materials, water use and waste)?

ENVIRONMENTAL	
4.	Does the target have proactive climate-change adaptation and greenhouse gas emissions reduction plans? Are these part of broader, organisation-wide transition plans?
5.	What are the target's physical and transitional climate change risks throughout its operations and assets?
6.	How does the target interact with environmental stakeholders and work to mitigate its ecological and biodiversity impacts?
7.	Has the target undertaken any certifications against environmental standards, such as ISO14001, and related standards and disclosures, such as the TNFD?
8.	To what extent are there any historic liabilities, for example through contaminated soil or on-site restoration, which may require specialist action?
9.	Are relevant business continuity planning procedures in place and, if so, do they address sustainability-related risks? What were the main lessons learned from the most recent exercise and how were they actioned?
10.	Does the target have a strategy to move, or is it in the process of moving, to a more circular or regenerative-based operating model?

SOCIAL	
1.	Does the target have human resources policies and procedures for its own workforce?
2.	Does the target comply with human rights legislation in relevant locations and are these standards acceptable to the acquirer, such as its policies towards unsafe or abusive labour practices?
3.	Does the target have appropriate whistle-blowing procedures in place and are investigative actions undertaken?
4.	What is the target's commitment to and action in respect of diversity, equity and inclusion, including the extent of staff training provided in relevant areas?
5.	Does the target undertake due diligence exercises in relation to its supply chain? Is it subject to any such procedures itself?
6.	Does the target have commitments in relation to the living wage, for example through industry associations?
7.	Does the target consider its social licence to operate in connection with the communities in which it is based and operates?
8.	Does the target have overseas operations that involve a heightened transactional risk, for example in relation to indigenous people?
9.	Does the target take steps to ensure product safety requirements are met to protect customers?
10.	Does the target comply with relevant standards and guidelines such as the International Labour Organization (ILO) standards on forced labour?

ECONOMIC	
1.	Has the target conducted an assessment of its geopolitical risks in the context of sustainability-related issues?
2.	Has the target conducted an economic assessment of the impact of sustainability-related issues on its operating model?
3.	If such an assessment has been conducted, what level of sensitivity analysis has been conducted?
4.	Do the internal reporting and performance-management processes include sustainability-related issues?
5.	Do the target's accounting policies address relevant sustainability-related issues?
6.	Have any external and / or internal audit findings identified issues, risks or opportunities and the extent to which recommendations have been actioned?

GOVERNANCE	
1.	Does the target have a governance structure for addressing sustainability-related issues with appropriately skilled individuals?
2.	Does the target have sustainability (or ESG) procedures, policies and processes (such as codes of conduct covering anti-bribery, anti-corruption, etc. measures) in place?
3.	Are there any management incentives in place to promote sustainability-related initiatives? How has the board been involved in understanding, developing and implementing the sustainability strategy, including requiring accountability from the target's management?
4.	Does the target have audit committee, risk functions / departments and internal audit functions that consider and monitor sustainability-related risks?
5.	Has the target performed a materiality assessment on its sustainability-related risks? If so, is it up to date and are there appropriate plans to review and maintain it?
6.	Has the target conducted an assessment of its sustainability-related and/or ESG performance and prepared any relevant reports?
7.	Have there been any instances of non-compliance and how did the target's management address these situations?
8.	Does the target have any outstanding litigations related to social or environmental issues?
9.	Has the target dedicated sufficient operational personnel and other resources to handle sustainability-related and/or ESG matters and how they are deployed in the organisation?
10.	Does the target proactively monitor developments that might change its sustainability-related risks and opportunities?

Top tips when considering sustainability-related issues in the transaction process

TABLE ES2: Top tips when considering sustainability-related issues in the transaction process

TIP		*EXPLORED IN SECTION*
OVERALL		
Recognise that the three interconnected dimensions (social, economic and environmental) of the sustainability-related agenda should be considered equally in a transaction.	→	1.2.1
Assess the impact of sustainability-related issues on the cost of capital in the transaction, and the implications for any variations in the modelling of future cash flows.	→	1.2.2
Assess relationships with, and key risks from, suppliers. Consider their own assessments of sustainability-related risks and action plans. Evaluate any supplier due diligence undertaken.	→	1.2.2
Assess the value of the brand and how it may be changed by any sustainability-related considerations.	→	1.2.2
Develop a due diligence strategy to enable an assessment of the sustainability-related opportunities and risks in the transaction.	→	1.4
Assess the current and known potential regulatory landscape from a sustainability perspective across all three social, environmental and economic dimensions.	→	1.5
Ensure the valuation approach includes sustainability-related factors as variables and is also included in any sensitivity analysis.	→	1.6
Conduct a skills assessment to ensure that the team has an appropriate range and depth of skills, knowledge and qualifications to address the sustainability-related risks and opportunities appropriately in the relevant aspect of the transaction.	→	1.7
ACQUIRER		
Understand how sustainability-related objectives are part of the overall business objectives. Determine criteria for any acquisition necessary for carrying out a risk assessment to ensure alignment takes place.	→	2.1.1
Ensure that investment committees have the requisite skills to assess the sustainability-related opportunities and risks in any transaction.	→	2.1.2
Ensure target screening criteria include sustainability-related risks and opportunities aligned to the acquirer's own risk-assessment profile.	→	2.1.3
Ensure that sustainability-related opportunities and risks are appropriately addressed in the specification of the due diligence work to be undertaken.	→	2.2.1
Ensure that all publicly available sources of information are identified and used.	→	2.2.2
Ensure that sustainability-related opportunities and risks are addressed appropriately in the specification of the due diligence work to be undertaken.	→	2.2.2
Consider the inclusion of any warranties or indemnities in the contract that address sustainability-related considerations.	→	2.3.1
ACQUIREE		
Develop a systematic plan to gather data covering sustainability-related opportunities and risks, recognising that some of the data required may not be from traditional sources.	→	3.1
In preparing the data room consider using relevant disclosure standards to enable the identification of data sets that might be included.	→	3.2.1
Consider external as well as internal data sources to capture a balanced view of the sustainability-related opportunities and risks within the organisation.	→	3.2.1
Consider structuring the data room to include a specific categorisation for sustainability-related data.	→	3.2.3

1. Do sustainability-related issues matter in the transaction workflow?

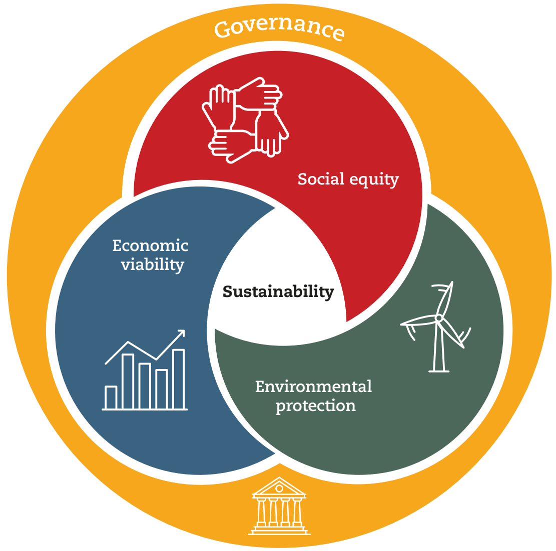
> *'We have to be conscious that there are "50 per cent" of organisations, particularly smaller ones, who cannot lose out from transactions or funding because they are not yet on their sustainability journey. We have to take them with us'.*
> **Republic of Ireland accountancy firm partner**

1.1 The sustainability-related context

1.1.1 The business context

The sustainability transition is multifaceted, embracing economic viability, environmental protection and social equity dimensions (Figure 1.1). The range of issues that it affects include not only climate and greenhouse gas emissions but also the biodiversity and social aspects[1] and how these interplay with each other and with the organisation's operating model.

FIGURE 1.1: Dimensions of sustainability



1 ACCA 2023a considers the social aspects of a just transition.

Sustainability-related issues may be considered to be one of the most significant organisational risks of the early 21st century. In relation to environmental protection, the dangers to the planet are significant if the temperature rise is not controlled. Although the Paris Agreement in 2015 sought to limit the rise in the mean global temperature to 2°C above pre-industrial levels, and with a preference to limit the increase to 1.5°C, the progress by governments and organisations towards this 2030 target has been slow.[2] Many organisations have faced a series of complex challenges in recent years, from the global pandemic of 2020 to 2022 and the inflationary pressures that in turn increased interest rates from 2022 and into 2023. In turn this has, for many, reduced the focus on a sustainable and just transition.

The reality is that organisations need to transform their operating models to become more sustainable. In this sense, the transition to a sustainable operating model is an organisational transformation which is similar in shape and form to other transformations currently being undertaken.[3]

Modelling the impact of sustainability-related issues on an organisation is a complex task. The technique of proximity analysis can be employed to consider climate and biodiversity considerations at a plant or site level. Asset-level data models[4] are often required to assess other impacts.

Sustainability-related risks, and a failure to address them, represent one of the most significant challenges that organisations face in the 2020s. Managing and mitigating these complex and interconnected risks is difficult and requires considerable effort and commitment, as reflected in both strategic and governance activities that are integral to the overall goal. While in this report much of the discussion is about the impact of the economic, social and environmental components, the strategic and governance activities are also integral to sustainability-related risks.

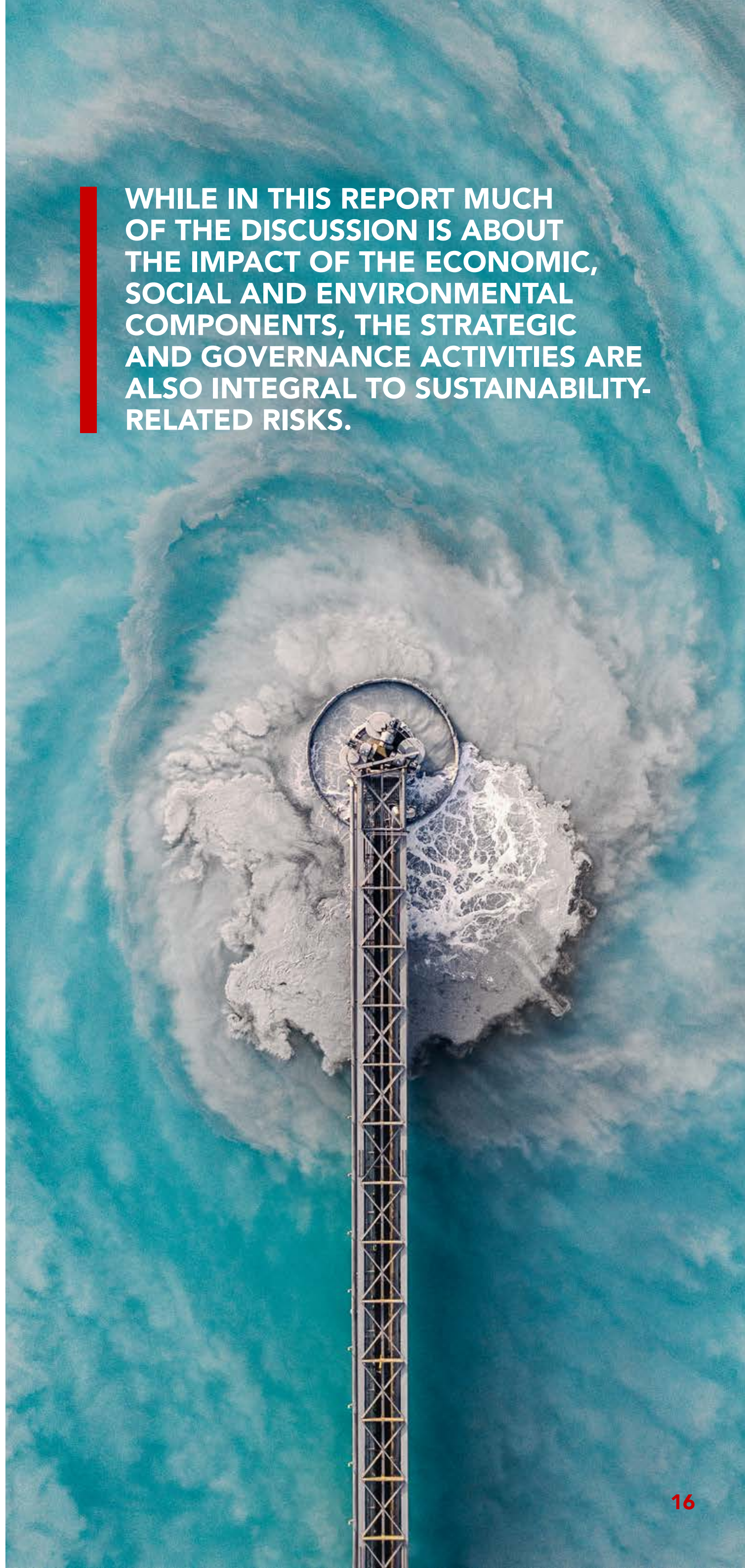
Organisations need to measure and, increasingly, report progress against their sustainability targets. As the investor markets look to relate the long-term viability of an organisation to its future sustainability, so access to capital is increasingly dependent upon the robustness of the plans in place and the tangible progress being made to hit defined targets. Capital markets are increasingly requiring disclosures related to climate and sustainability-related matters to provide decision-useful information for investors. As stakeholders, including investors, seek information and action from entities on sustainability issues, organisations are setting sustainability-related targets and measuring and reporting their performance.

Against this backdrop, organisations continue to be bought, merged and sold. While M&A activity across the business world is inherently cyclical and reflects economic cycles, there is a constant trade in organisations, either through strategic acquisitions or through PE and similar activity.

1.1.2 The dimensions of sustainability

A further consideration is whether each of the aspects of sustainability, the economic, the environmental and the social, receive appropriate levels of consideration in the M&A process. It is important to remember that these aspects are intrinsically interlinked.

In the experience of a CFO from mainland China, 'in most of the companies that I interact with, everyone is so focused on economic and environmental [aspects of the transaction], and least on social [aspects]. I think everyone is missing the S, as usual'. There can be a tendency to focus on those elements where insight and regulation is most established, but if organisations are to achieve a just transition to a sustainable future, then all three aspects need to be kept in balance. It should be remembered



WHILE IN THIS REPORT MUCH OF THE DISCUSSION IS ABOUT THE IMPACT OF THE ECONOMIC, SOCIAL AND ENVIRONMENTAL COMPONENTS, THE STRATEGIC AND GOVERNANCE ACTIVITIES ARE ALSO INTEGRAL TO SUSTAINABILITY-RELATED RISKS.

2 ACCA / IFAC / PwC 2023 considers the progress in developing emission plans as part of overall transition plans and concludes that there is still work to be done.

3 ACCA / CA ANZ / Generation CFO 2021 considers the process of transformation from an accountancy and finance perspective.

4 An asset-level data model can be considered the most granular level of modelling in an organisation. In this context, the risks (and opportunities) from sustainability-related issues can only be assessed at the level at which they have a real impact: the asset level. Hence, modelling sustainability-related considerations (and their financial impact) is often a complex task.

that social impact is measured in terms of both the human capital (employees) and human rights (of those in the supply chain, communities and customers). The culture of the organisation in supporting this activity is essential.

A UK CFO placed this discussion in context for an organisation in the service sector. 'I have got my due diligence checklist to start preparing information for, and it's all about the economic. It's not about anything else and it makes me think, "OK, that's fine". But the business will be very different if they don't embrace the brand. What they are buying is because of the people and what we represent and why we work for the company'.

Another UK CFO detailed some experiences of dealing with PE houses. 'Although the name might not be sustainability, they are looking at all those aspects anyway. They will look at environmental risk. Is there anything in your past? Are you doing anything that makes you a risky business? They will look at people risk. Are you doing the right thing for your people? Are you legally compliant? Do you support them in the right way? What are your HR [human resources] policies like, and can you prove that you do all of those things?

'And then you go to the genie, the governance. If you do not have good governance as a platform sitting throughout the business, they are not interested anyway because they will find out eventually that it is all a pack of lies. It is much easier to be upfront and say these are our governance structures and processes. So, you can actually have a lot of faith before you invest your time and your money into looking into our organisation, that what we say we do is actually what we do'.

A UK-based accountancy firm partner commented, 'environmental, social and governance are not mutually exclusive. They're mutually inclusive, and the S and the G in business for me is as important as the E because if you do not have effective governance and effective frameworks in your business at a top level, aligning to societal licensing and environmental [concerns] and there's a lot of potential external risk around societal [licensing]'.

Although there may be more emphasis on the environmental aspects in the minds of some who are initiating transactions, it is important to recognise the interdependence between the three aspects of sustainability. Environmental change has to come in tandem with social equity and economic progress. Whether the transaction is strategic, or PE driven, those pursuing it have to focus upon all three dimensions.

1.2 Does sustainability matter in the transaction cycle?

1.2.1 The criticality

The short answer to this question is 'yes'. As with any other organisational risk, sustainability is something that the acquirer and the acquiree need to consider in the transaction process.

Why does it matter? This is perhaps a more complex question to answer. The answer is heavily dependent upon the location, sector and size of the organisation involved. This effects the extent to which sustainability-related issues may be a critical factor in the final decision about whether to proceed with the transaction.

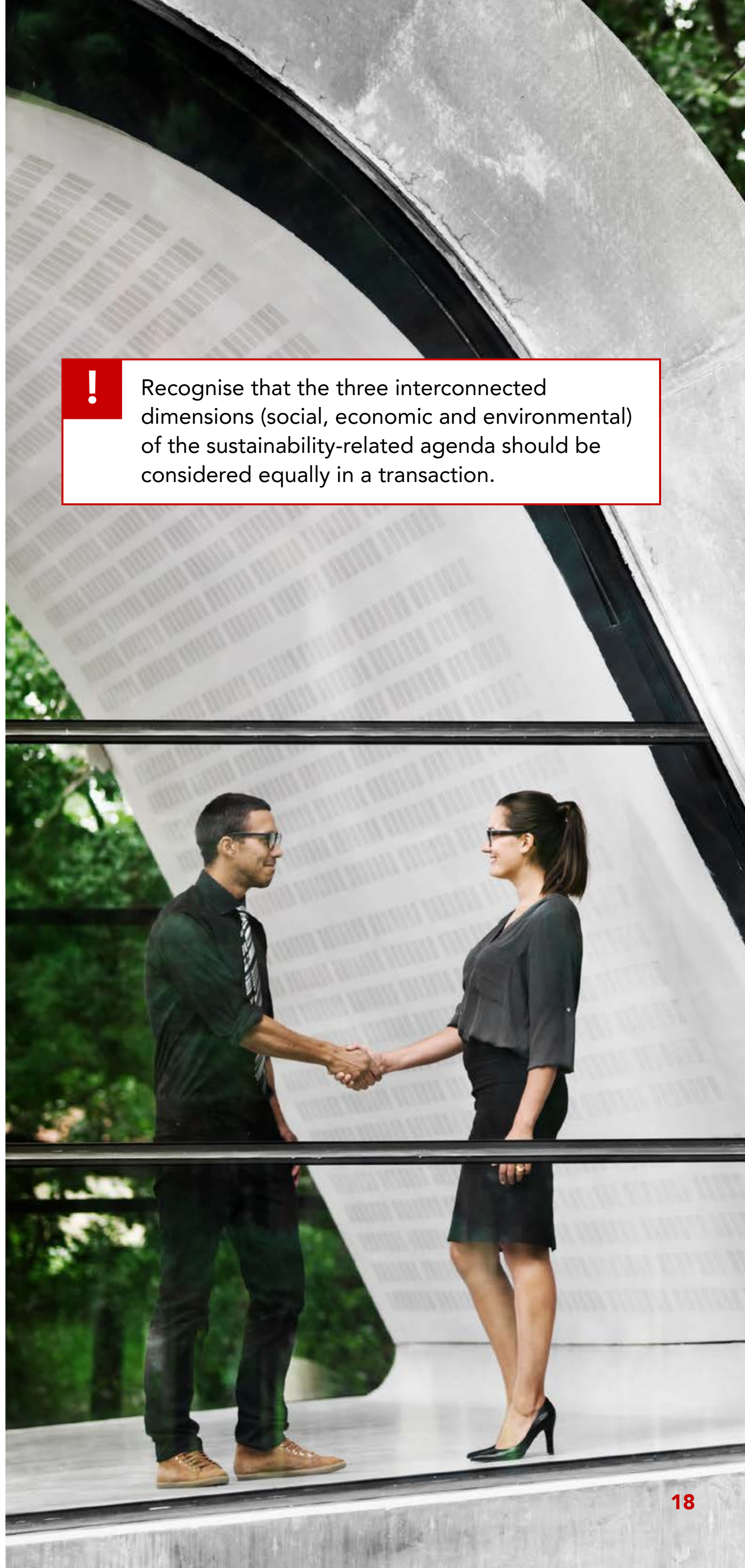
The exact nature of this effect is dependent upon the type of deal that is involved. As a consultant operating in the UK commented, in a strategic deal, the view of the future looks up to about 25 years ahead, while a PE backed deal might have a perspective of about five years. This difference is substantial and changes the view of the transaction and its benefits, but raises different questions about sustainability-related issues. These issues typically have a longer time horizon and the balance between the shorter-term transaction-based perspective and the longer-term time horizon can create a tension.

A roundtable participant who consults in M&A commented, 'I just can see how the world is changing, especially during the last five years, I would say that it has changed dramatically. The perception of the company's business has changed. If you look back… five years ago, people were not concentrated on their social aspect; it was [the] financial aspect of the company. What earnings before interest, taxes, depreciation and amortisation – commonly known as EBIDA– [will there] be? How it's calculated? What impact might [there] be in the next three to five years if one acquires [a given business]? They were looking at what kind of risks might mitigate the cost of the company that was actually paid out. Whether there is going to be a tax issue afterwards or any other impacts coming out of the operational part of the business. Right now, it is not only … that part, but also, I can see that the part related to sustainability is how clients are going to behave in the future and they can see rate of the market there. There are some issues coming into place when the company does not behave ethically – what kind of consequences will it face'.

Looking ahead, a CFO based in the UK commented, 'the growth in sustainability as a topic is exponential. I think in the next three to five years it will be embedded in [those] organisations [where] it is not [at present]. It will not be the box-ticking afterthought. It will be part of everyday life and everyday decision making. Rather than it just being seen as something that, if I am doing a transaction, I need to make sure I have not got a liability that I am buying into, it is something that is a true value generator going forward. It is a way that my business will be more successful because I have grasped the sustainability agenda in all facets, economic, environmental, social, and I have grasped all of that and therefore I am a more valuable asset'.

Another UK-based CFO explained that, 'I think it really actually does make a difference in terms of all sorts of things: in terms of the viability of a transaction and the different lenses [that] the different stakeholders put onto both you as a business, if you are the purchaser, and you as a vendor because there has been a huge change in expectations and that comes from investors, it comes from employees, it comes from customers, suppliers– this whole drive towards demonstrating that you are a responsible corporate citizen, whatever that means. I think it is now [at] the point where this can add value to the transaction'.

An accountancy firm partner in the Republic of Ireland sounded a note of caution. 'Looking at transactions and acquisitions from [the] side [of small and medium sized enterprises], …I don't think acquirers have high expectations of what they are going to find'. This participant added, however, that 'the future depends on it. For the company that is being acquired, if they are actually on that journey and they are taking the steps that are necessary, then it is really going to be a massive value add for them in a potential sale'.



! Recognise that the three interconnected dimensions (social, economic and environmental) of the sustainability-related agenda should be considered equally in a transaction.

Commentary by Prof. Dr Christopher Kummer, President, Institute of Mergers, Acquisitions and Alliances (IMAA), Austria

How important an aspect of the M&A process do you consider sustainability-related considerations to be? Is this an important consideration for your members?

EXPANDING THE FOCUS ON SOCIAL ASPECTS TO THE ENTIRE VALUE CHAIN IS DRIVEN BY THE REALISATION THAT A COMPANY'S SOCIAL PERFORMANCE CAN HAVE BROADER IMPLICATIONS, SUCH AS REPUTATIONAL RISKS, SUPPLY CHAIN DISRUPTIONS, AND REGULATORY COMPLIANCE ISSUES.

Sustainability in a wider sense has always been an important aspect when pursuing transactions. In the financial dimension, the quality of earnings, in the governance and organisation structure, how robust management teams are. Depending on the industry, environmental issues have always been taken into account.

There are two aspects that have become more important recently. Firstly, using ESG criteria to exit current investments and applying them to making new ones. Many companies have started incorporating ESG criteria into their exit strategies. This entails that when these companies contemplate divesting or selling their assets, they carefully assess how well these assets adhere to ESG principles. A company may decide to part ways with a business unit that falls short of its sustainability-related objectives or presents substantial ESG-related risks.

On the other hand, in the context of evaluating new investments or acquisition opportunities, organisations are now employing ESG criteria to gauge the extent to which the prospective target aligns with their sustainability-related objectives. This entails a comprehensive assessment of how the target company handles environmental concerns, engages with social issues, and upholds governance standards. Investments in companies that demonstrate alignment with ESG goals are perceived as more appealing and desirable.

Secondly, an aspect that is rather more important to consider in the M&A setting is the social aspects that may have been addressed only in an HR context so far and need to be addressed in a wider context; for example, also with regards to the entire value chain – upstream and downstream.

In traditional business settings, the social dimension has typically revolved around HR matters, encompassing aspects like employee wellbeing, diversity, and workplace conditions. Nevertheless, there is an increasingly prevalent acknowledgment that social considerations ought to be tackled in a more complete manner, extending beyond the confines of the organisation and encompassing a broader spectrum of societal concerns.

In the M&A setting, this means considering social factors not only within the acquiring and target companies but also throughout the entire value chain. This includes assessing how suppliers, distributors, and other business partners in the value chain manage social issues. For instance, a company acquiring a supplier may need to evaluate the supplier's labour practices, ethical sourcing of materials, and community engagement.

Expanding the focus on social aspects to the entire value chain is driven by the realisation that a company's social performance can have broader implications, such as reputational risks, supply chain disruptions, and regulatory compliance issues.

1.2.2 Four main factors

There are four main reasons why sustainability matters in a transaction (Figure 1.2). The extent to which these factors apply in different sectors, such as sunset or sunrise industries, and locations is, however, variable.

The first factor is the impact of the **financial institutions and investors**. Many of these have committed to their own sustainability-related goals which in turn can only be achieved through the investments that they make. A CFO commented that, 'there are so many investment houses trying to increase their overall sustainability credentials'. In several, but not all, locations this is a significant factor in determining the access to finance. A fund manager in Africa explained that in his experience the financial institutions there paid little attention to sustainability-related issues.

The investor perspective is also linked to the second factor, **supply chains**, which in turn is linked to the third factor, the **regulators**. Supply chains can be a weak point for many aspects of due diligence. While an organisation might proclaim sustainable credentials, such as control over suppliers, for example in the garment industry, this may create risks that can have a material impact on brand value. There is a risk of greenwashing where the information in prospectuses can potentially be misstated (as discussed later in this section). A member based in mainland China commented that, 'there are more and more governing bodies that are increasing the requirements around ESG compliance'. The year 2023 saw an increasing requirement for organisations to prepare disclosures on their progress on achieving their sustainability goals and targets, such as through the European Union's CSRD and the ISSB first and second reporting standards (ISSB S1 and S2), which are effective, or are intended to be effective, in many jurisdictions from 2024.[5] These standards require organisations to assess not only their own activities but those in their supply chains, including the use of supply chain codes of conduct and mandatory HR Due Diligence.[6]

The last factor is the role of the **customers/clients**. The extent to which they are influenced by the ethical behaviour of an organisation may be variable but brand value can be diminished by the highlighting of inappropriate activities. In the M&A process, it is important to consider whether the acquired, or disposed of, entity enhances or reduces brand value. Together with the attractiveness of an organisation to current and potential **employees**, the social aspects can form a significant risk or opportunity.

FIGURE 1.2: Four main factors as to why sustainability-related issues matter in a transaction

THE EXTENT TO WHICH THESE FACTORS APPLY IN DIFFERENT SECTORS, SUCH AS SUNSET OR SUNRISE INDUSTRIES, AND LOCATIONS IS, HOWEVER, VARIABLE.

5 The regulatory reporting framework and how organisations can prepare for it are considered in ACCA 2023c.

6 The relevance of sustainability-related issues in supply chains and the impact of regulation are considered in ACCA / Institute of Management Accountants / Chartered Institute of Procurement and Supply 2022.

! Assess the impact of sustainability-related issues on the cost of capital in the transaction, and the implications for any variations in the modelling of future cash flows.

! Assess relationships with, and key risks from, suppliers. Consider their own assessments of sustainability-related risks and action plans. Evaluate any supplier due diligence undertaken.

! Assess the value of the brand and how it may be changed by any sustainability-related considerations.

1.2.3 Geographic variations

The roundtable participants highlighted that the consideration of sustainability-related issues as a risk (or opportunity) in a transaction was by no means universal. A partner in a New Zealand accountancy firm noted that, 'If I look at some of my peers and what they're doing in larger offices like the UK, across [Oceania] and into India, ESG [considerations are] prevalent on most transactions, and we are not seeing that here [in New Zealand] at the moment. It is fair to say we are still doing quite a bit of education to the market and certain clients as to why this is important'.

A similar point was raised by a partner in a different accountancy firm based in Canada, and, as mentioned above, a roundtable participant questioned the level of acceptance in parts of Africa as well. An M&A adviser working mainly in the mid-market in Singapore commented that, 'it is not an emphasis for now, at least', continuing with the view that this would be the case until reporting requirements became mandatory for mid-market entities.

> **AN M&A ADVISER WORKING MAINLY IN THE MID-MARKET IN SINGAPORE COMMENTED THAT, 'IT IS NOT AN EMPHASIS FOR NOW, AT LEAST', CONTINUING WITH THE VIEW THAT THIS WOULD BE THE CASE UNTIL REPORTING REQUIREMENTS BECAME MANDATORY FOR MID-MARKET ENTITIES.**

Commentary from Professor Dr Christopher Kummer, IMAA

Professor Dr Christopher Kummer of IMAA commented that there is definitely a variation in how important these aspects are, for example, between players from developed markets vs. emerging and developing markets. But even within the field of companies from mature markets there is a wide variation on how seriously this is considered.

The extent to which sustainability-related factors are integrated into the regulatory framework can vary widely. Some countries and regions have more stringent regulations related to ESG disclosure and reporting, which can influence how companies approach sustainability in M&A. For example, the European Union has implemented comprehensive ESG disclosure requirements through its Sustainable Finance Disclosure Regulation (SFDR), while other regions may have less prescriptive regulations.

Cultural and societal norms play a significant role in how sustainability is perceived and prioritised. In some economies, there may be a strong cultural emphasis on environmental and social responsibility, leading companies to prioritise sustainability in M&A as a way to align with societal values and meet stakeholder expectations. In contrast, in economies where short-term financial gains are prioritised, sustainability may have a lower profile.

1.2.4 Responsible investment

Regulatory scrutiny of the sustainability-related credentials of investment funds has been increasing during 2022 and 2023. As mentioned in section 1.2.2 above, several funds are perceived as linking their own ambitions to investments that may or may not be sustainable in nature. This affects the investment and divestment cycle for investment funds and PE-backed transactions.

If an investment fund is a signatory of the United Nations Principles for Responsible Investment (PRI) and seeks to honour its first two principles, incorporating ESG issues into investment analysis and decision-making and ownership policies, this is a key driver for undertaking routine ESG due diligence (ESG DD). It is the combination of the increasing rigour of the PRI's annual reporting process, increased demands from their investors, and now the specific requirements of EU regulations, that is now driving greater uptake of ESG DD as a standard requirement.

If a fund is Article 8- or 9-aligned under the EU's SFDR,[7] then it is obligated to incorporate ESG issues into its investment decision making. Secondly, and perhaps more importantly, there is a need to evaluate whether the target could sit comfortably within such a fund. This may partly relate to whether it could be considered to be a 'Sustainable Investment', aligning with the requirements of the EU Taxonomy for sustainable activities (often known as the EU Taxonomy), and definitely whether it would be able to show continued improvement against the suite of Principal Adverse Impact key performance indicators (KPIs) and demonstrate it has strong social and governance controls in place.[8]

7 Although both the EU Taxonomy and the SFDR share a similar goal, they play distinct roles in shaping the sustainable finance landscape, each with its own unique purpose and contribution. They serve complementary purposes within the sustainable finance framework, but the distinction between them is important.

The EU Taxonomy focuses on classifying economic activities as sustainable, or not, on the basis of environmental objectives. It guides investment decisions and promotes capital flows towards sustainable activities.

SFDR addresses transparency and disclosure requirements for financial products and prevents greenwashing by providing accurate and standardised sustainability-related information. It also enables investors to make informed decisions, based on sustainability-related characteristics.

8 In December 2022, EU Commissioner Mairead McGuinness announced a comprehensive assessment of the framework to assess potential shortcomings – focusing on legal certainty, the usability of the regulation and its ability to play its part in tackling greenwashing. The open and targeted public consultations are an important part of this assessment. They will be complemented by workshops and roundtables, enabling stakeholders to submit further input.

The role of the SFDR and Taxonomy is to redirect capital to genuinely sustainable enterprises. Both create opportunities to invest in new solutions and, conversely, the risk of finding oneself invested in stranded assets, together with the risk of being accused of greenwashing. Both regulations drive the necessity to undertake a new type of due diligence that considers where an enterprise sits within a sustainable future.

The most sustainable businesses will be providing solutions to such problems; for all, there is a need to show that they will be good corporate citizens and able to stand the impacts of a changing world. In the EU, the CSRD and forthcoming Corporate Sustainability Due Diligence Directive (known as alternatively CSDDD or CS3D) will also drive obligations and transparency on the level of performance in these areas.[9]

In 2023 the UK Financial Conduct Authority (FCA) consulted on and published similar regulations (FCA 2023a), while the United States Securities and Exchange Commissions' taxonomy of 'Integration' and 'ESG-Focused' funds is somewhat comparable to the SFDR's Article 8 and Article 9 categorisation of funds.

In November 2023 the CFA Institute (representing chartered financial analysts), the Global Sustainable Investment Alliance (GSIA), and the Principles for Responsible Investment (PRI)[10] published a set of Definitions for Responsible Investment Approaches, which include guidance on several areas, including screening from a sustainability perspective. The CFA Institute commented that, 'the growing global interest in responsible investment approaches has spawned new ideas and practices, as well as new terminology that may or may not be initially clear or widely understood. Increased interest in responsible investment has prompted a need for standardized terminology to enhance communication among institutional investors, regulators, policymakers, and market participants' (CFA Institute 2023).

1.2.5 Private equity-backed transactions

Sustainability-related investments are substantial. Writing in January 2023, Brendan Cooper of Investment Metrics noted that, 'investing in investments that have sustainability criteria has accelerated in the past decade – there's now more than [US]$4trn in total global assets' (Cooper 2023).

For PE-backed organisations there are additional influencing factors. A CFO based in the UK commented, 'once you start with your one transaction and then you move on to your next because [as] soon as PE buys you, they are building value in and they want you to build value within your organisation to get you to that next transaction. You don't stay still. They don't buy, they don't invest and that's it. Off you go again. What tends to happen is [that] the ESG agenda tends to rise higher in priority'. Several of the roundtable participants who were either in PE-backed enterprises or were involved with PE houses noted the emerging impact of sustainability-related issues on the target multiplier that the was being sought at the end of the initial investment. They commented that there was an emerging recognition that value includes creating a sustainable organisation with a long-term future. It was also noted that this was just one factor that needed to be considered.

> **SEVERAL OF THE ROUNDTABLE PARTICIPANTS WHO WERE EITHER IN PE-BACKED ENTERPRISES OR WERE INVOLVED WITH PE HOUSES NOTED THE EMERGING IMPACT OF SUSTAINABILITY-RELATED ISSUES ON THE TARGET MULTIPLIER THAT THE WAS BEING SOUGHT AT THE END OF THE INITIAL INVESTMENT.**

A UK-based CFO commented that, 'a PE business might either say "no", we love your product, but we're going to reduce the multiple or we're going to take a hit on the valuation as a result, because there's work to be done there that will impact the profitability of the business. What I am not seeing is, when we are looking at companies or when we might be exiting at some stage, that the first thing that people are talking about is "we need to understand your sustainability"'.

Another UK-based roundtable participant who works with PE organisations commented that, 'lots of PE houses, where they invest within the portfolio companies, have multiple case studies where they can show that … the premium that others have paid [is higher] when [the original PE houses] have come to exit the position as a result of the effort and the changes that have occurred through the ownership by pushing to include more sustainable practices'.

An Australian accountancy firm roundtable participant commented that, '[we] see it in terms of funds, particularly PE, but also [from the point of view of] the investment managers, who have an ESG framework in place for their own portfolio, their own organisation and it is part of their actual investment decision-making process. We tend to see there is an examination of where there [are] potential additional cost considerations resulting from a lack of an ESG response or value-uplift opportunities as a result of investing in building out their ESG response'.

9 Agreement was reached between the EU Council and the EU Parliament on the due diligence directive in December 2023 for enactment in 2024 (European Council 2023). 'The extent to which financial services should be covered by the [CSDDD] Directive has been a key point of contention from the outset. While the Commission originally proposed no special treatment for financial services firms, the Council proposed leaving member states to decide for themselves whether to include downstream financial services (a worst-case scenario for those active in multiple member states), and the Parliament proposed their inclusion with some loosely worded exceptions for asset managements and institutional investors. Compromises have been made in the text, with the Parliament accepting the exclusion of the financial sector's investment and lending activities from the scope of the due diligence obligations. This has been conceded on the basis that it will be subject to review in several years' time' (Denton and McBean 2024).

10 A link to this and several other relevant resources is given in the Useful Resources section.

1.3 Impact on the transaction workflow

Given the clear case in the minds of those who contributed to the roundtables that sustainability is an important aspect of the M&A process, it follows that it is a consideration throughout the transaction workflow. Figure ES4 in the Executive summary provides an overview of the transaction workflow and highlights some of the sustainability-related considerations that occur during each phase. Sustainability acts as an overlay to the transaction workflow. It is implied in each stage, often with multiple considerations. Whether you are an acquirer or an acquiree, the impact cannot be ignored.

A roundtable participant from mainland China noted that, 'in due diligence, the focus has been on maximising shareholder value. However, ESG demands extend beyond this, aiming to create public benefits without harming others'.

The implications and several detailed actions are considered in more detail in Chapters 2 and 3, for the acquirer and acquiree, respectively.

1.4 Role of due diligence

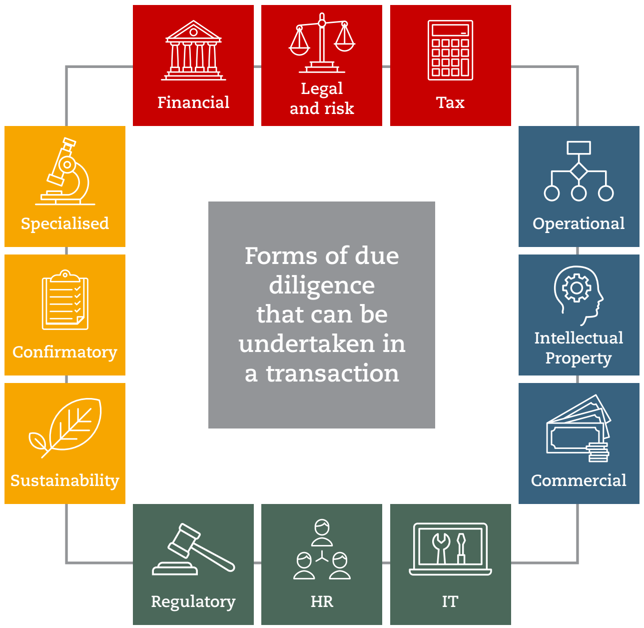
A roundtable participant who works in the M&A sector gave one perspective on the role of due diligence. 'During [the] due diligence process you find out so many interesting things and everything comes to the surface. Then you cannot hide the real intentions of the management strategy'. An Australian roundtable participant also commented, 'ultimately, the reason you do this is to uncover the risks that you are comfortable to take and those that you are not comfortable to take, and/or those that you need to manage differently. The diligence is a process of discovery [about the] new business, so that you know what you are buying and what you've got to deal with and what…opportunities and risks are coming out of it'.

There are several forms of due diligence that an acquirer may choose to undertake, as shown in Figure 1.3. The choice will depend upon the assessment of the respective transactional risks in each area.

Whether or not the decision is made to undertake a specific sustainability due diligence exercise as part of the transaction process, it is important to recognise that sustainability is a factor in most aspects of due diligence that are undertaken. This was highlighted by several contributors to the research who commented that sustainability was clearly a factor in commercial due diligence as it affects the customer viability of the organisation, for example. Further examples of the relevance of sustainability to each form of due diligence are given in the Appendix. More detailed considerations at an industry level can be developed by reference to tools such as the Sustainability Accounting Standards Board's Materiality Map (SSAB 2021).

A roundtable participant from mainland China commented that, 'the essence of sustainability, whether environmental or across all ESG aspects, is vital. In M&A and financial due diligence, pinpointing sustainable enterprises is a key focus

FIGURE 1.3: Forms of due diligence that can be undertaken in a transaction



and an area for skill enhancement. "Unsustainability" often stems from poor economic assessments of industry trends, competitive landscapes, or core competencies, leading to unsustainable business models. In practice, identifying these factors in financial due diligence is crucial'.

A roundtable participant from Canada explained that, 'sometimes the challenge is in adequately integrating sustainability…from the starting point of [identifying] the material factors. It could look very different in different transactions and that is why, unlike more traditional models where you can apply some [specific] things across all transactions, here it is different, [as is] the context of where that target is'.

When considering the factors relevant to the scope of the due diligence, the extent to which the target has conducted third-party accreditations and certifications may well need to be considered. Such programmes may offer certifications for policies and procedures and themselves have an element of third-party verification associated with them.

A New Zealand-based roundtable participant commented that, 'I think if we pose the question to investors or buyers in a transaction and [ask] "are you making investment decision that is environmentally and socially sustainable?", the answer would inevitably be "yes". I think, …[you need to] peel the onion and ask why they think that and on what basis they have formed that opinion. The experience in New Zealand is slightly more do-it-yourself. The investors or the principals are comfortable that they have identified the main sources of risk and have not commissioned the due diligence to address those [risks]. [Instead], they have captured it, for example, within legal or technical or environmental due diligence work streams, rather than using sustainability due diligence to identify those key risks'.

An Australian transaction partner in a large accountancy firm commented, 'I think we've seen a lot of focus, …[recently], [on] green washing and legal cases being launched around green washing. Companies will want to be able to prove that their ESG programmes, their environmental programmes, are robust'.

A roundtable participant highlighted some of the practical steps needed when undertaking due diligence, especially in respect of the social dimension of sustainability. 'When I act as a consultant, we…look at the substance that sits behind [the assertion being made]. We always comment, "OK, that's your glossy, that's your brochure. That's wonderful". Where is the substance? And you really dig through and [find] what you're looking [for]. For example, you have told me your staff are happy: put six employees in front of me today. Do not prepare them. Let me talk to them because I want to know how much they tell me [about whether] … everyone buys into your sustainability practices and everyone has had ESG training, etc. Show me that the receptionist knows it. Show me that such and such. So, if you are paying a premium for that cultural knowledge, that cultural support and assume it is a services company, how far is it true? I think you can get a gut feel for that and …[I learnt] from a conversation I had with a PE house [that] they walk away from deals if they find that the substance is not there, no matter how attractive the deal is'. Several roundtable participants highlighted the potential of greenwashing, or bluewashing, in the assertions that organisations make. One roundtable participant highlighted the link between greenwashing and the overall confidence one can have in the assertions that the acquiree makes. 'After all, if they are prepared to paint a [false] glossy picture on their sustainability activities, what else are they window dressing?'

The role of due diligence is to identify potential risks and their impacts should they materialise. One of the most significant challenges that organisations will face to the late 2020s and beyond is reconfiguring their business models to be sustainable. A failure to include sustainability assessment as a core part of the transaction process, whether as a discrete exercise or embedded into other elements, is potentially to fail to recognise the nature of that risk. Sustainability is a complex issue, and assessing the risks inherent in its failure requires expertise, as several of the contributors highlighted. It cannot be ignored, but how can you scope the necessary work?

Dr Max Tuchler and colleagues from Deloitte Germany have reported that, 'It is of note that the approach to ESG due diligence is not a "one size fits all" approach for all industries. Each industry presents its own array of environmental impact[s] and stakeholder interaction[s] that must be considered. For example, a target in the chemical industry would have a particular emphasis on the environmental factors, such as disposal of hazardous waste, whereas for a target in the textile industry the focus may lay [sic] on the social factors such as child labour or poverty wages. Hence, ESG criteria need to be selected from a bouquet of KPIs, taking industry-specific and target-specific factors into account' (Tuchler et al. 2021).

It should not be forgotten that due diligence can often have positive benefits. A UK roundtable participant who works in transactions commented, 'there are lots of cases out there where, as a result of the due diligence, it was identified that the way the business was operating was not the most efficient. For example, I know of one example … of a tiling company where they changed the products and utilised the wastage to develop new tiles. They were able to change the operating model and increase the value of the business as well as making it more… environmentally friendly'. The EU issued a Competition Merger Brief in September 2023 which outlined its view, with examples, of how sustainability-related to EU merger control and may be a beneficial factor (European Commission 2023).

! Develop a due diligence strategy to enable an assessment of the sustainability-related opportunities and risks in the transaction.

1.5 Regulatory and other challenges

The process of conducting a specific form of due diligence related solely to sustainability was discussed by several of the contributors and roundtable participants.

The first challenge raised was the absence of a unified or framework standard in relation to sustainability. There are several standards that cover components and there are more in development, but these tend to focus more on disclosure when, usually, broader issues are concerned.

> **ONE PARTNER SUGGESTED THAT ABSENCE OF CONSISTENT STANDARDS MEANT THAT SOME FIRMS LOOKED TO PROVIDE ASSESSMENTS OF SUSTAINABILITY-RELATED RISKS RATHER THAN A COMPREHENSIVE DUE DILIGENCE REPORT.**

This presents a challenge in defining the scope of any due diligence undertaken. One partner suggested that absence of consistent standards meant that some firms looked to provide assessments of sustainability-related risks rather than a comprehensive due diligence report.

A European-based transaction professional foresaw a change in appetite for including sustainability considerations in the due diligence process. 'I love it that it is now [part of] the accounting standards and legislation is now coming top down because the difference [is that], up to now, [the] Paris Agreement ultimately was voluntary, a gentleman's agreement, and now that it is obviously coming top down, it is just beautiful because we [as leaders in this area] are literally all pushing an open door'.

A transaction partner based in mainland China gave the following example of some of the complexities of incorporating sustainability into the due diligence process.

Example of some of the complexities of incorporating sustainability into the due diligence process

'When considering ESG in the due diligence process, [our firm] encounters different challenges and difficulties, which can be categorised into two areas based on client needs: professional technical fields and non-technical fields.

Professional technical fields

'For instance, if the client needs soil analysis or data on emission reduction and metal content, our financial institution lacks the expertise to conduct such assessments. In these cases, we collaborate with other environmental departments. This collaboration is essential because these technical areas require specialised knowledge and capabilities that our financial team may not possess.

Non-technical fields

'In contrast, there are aspects we can handle within the non-technical domain. This process involves several steps. First, during discussions with our clients about the scope of work, we understand their demands and assess whether we have the relevant experience. If we decide to proceed, we contemplate from which angles to approach the task. After reaching an agreement with the client, we then advance the corresponding work.

Practical implementation

'In practice, our main clients for ESG-related issues are fund companies and investment firms; [our work is] assisting them with non-purely technical matters. For purely technical aspects, such as carbon emission measurement and calculation or soil contamination, they independently seek services from environmental assessment companies to produce reports. These reports help determine if the pollution levels meet investment standards.'

> **THE DUE DILIGENCE PROCESS HAS LONG INVOLVED EXPERTISE OUTSIDE THE TRADITIONAL SCOPE OF AN ACCOUNTANCY PRACTICE, EVEN WITH SPECIALIST TRANSACTION EXPERTISE.**

The due diligence process has long involved expertise outside the traditional scope of an accountancy practice, even with specialist transaction expertise. In addressing the sustainability risks faced by a potential acquirer, the use of specific expertise may be required, but bringing sustainability expertise into an accountancy firm's transaction team is also an important step.

Another challenge is the quality of data available to those conducting the due diligence. As a roundtable participant from Brazil noted, 'there is a problem within the due diligence because the information about sustainability is not [as] good as the financial information'.

A roundtable participant from Canada considered the impact of sustainability regulation in a different way. 'The premise of the growth of sustainability [assessment] in the first place, was that [you] cannot manage what you do not measure. A lot of [the emphasis] has been on disclosures driving companies to the initial starting point and to really begin to think about what this really means for myself as a business. As we begin to see that flowing into mandatory disclosure regimes, a lot more countries [are] coming up with [a] stronger implementation framework. If I talk about an environment outside Canada on the commitments that they are making, they are nationally determined commitment[s] around becoming net zero and the implementation of that. As you begin to see policy and regulation growing, then that becomes a key driver. If I am going to acquire or be acquired, first stop is: what will impact me, my licence to practise or a key regulatory fine? So that for me becomes a very key driver'.

The second challenge raised by several roundtable participants was the limitations of the skill sets of those who perform the work. More than one participant used contaminated soil as an example of a factor which had arisen in their transactions. Assessing the impact of such a risk requires detailed expertise, albeit expertise which must be integrated into the overall assessment. The roundtable participants highlighted the need for those accountancy and finance professionals who might lead, or coordinate, the overall approach, to become more literate in detailed sustainability objectives: perhaps not to the extent of gaining all the necessary expertise themselves, but being able to contextualise and interpret the experts' work. A roundtable participant commented, 'the starting point of thinking about risk [in sustainability-related issues] is [identifying] those most significant impacts because they affect the natural resources and relationships on which the organisation depends, and the cumulative impact of many organisations over time also brings risks'.

One area of expertise is in the valuation of a potential acquisition in which sustainability concerns also affect the transaction process.

> **!** Assess the current and known potential regulatory landscape from a sustainability perspective across all three social, environmental and economic dimensions.

THE ROUNDTABLE PARTICIPANTS HIGHLIGHTED THE NEED FOR THOSE ACCOUNTANCY AND FINANCE PROFESSIONALS WHO MIGHT LEAD, OR COORDINATE, THE OVERALL APPROACH, TO BECOME MORE LITERATE IN DETAILED SUSTAINABILITY OBJECTIVES.

1.6 Impact on valuations

The complexity of placing a value on a potential acquisition increases when considering sustainability aspects. A roundtable participant in mainland China commented that, 'assessing past economic performance is… easier than projecting future sustainability. The goal of financial due diligence is not just to produce a favourable report or judge past performance, but to predict future development. This involves considering economic sustainability, potential major environmental impacts, and social factors that could lead to a sudden decline in performance'.

The uncertain effect of sustainability-related issues and of the investment needed to address specific risks should be considered. Transactions are often based upon the concept that the synergy created when two organisations unite can create more value for the stakeholders than the two entities can create separately, and have long-term benefits. The sustainability overlay to this is key, as it can either create or destroy value as the organisation seek to make the necessary changes to their operating models to achieve the required goals. Having a clear view of how sustainability-related issues interplay (through investments, changes in supply chains, wages and conditions of employees, for example) must influence the valuation of the entity being acquired.

An Australian roundtable participant commented in relation to the impact of sustainability-related concerns on the valuation that, 'all I've heard people talk about …is [that it is] the cost that matters. I like [the approach from one of the Big Four accountancy firms] because I think if you start with thinking [that] it is [only] the cost that matters, you miss out things that ultimately should affect the price'.

Another challenge that affects valuation considerations is the quality of the data available. As a European roundtable participant commented, 'it is much easier to do the valuation on the E than the S and the G because it is again back to – unfortunately – the reliability of the data. As we know, that is the biggest issue at the moment because we do not have reliable data and we do not have comparable data'. In addition, it may be that, potentially, there is reliable data only on certain aspects of the environment, as, for example, data on biodiversity and water scarcity are equally difficult to ascertain.

The International Valuation Standards Council (IVSC) which publishes global standards on the valuation of organisations, has integrated ESG into the revision of its standards which are effective from 31 January 2025 but available for early adoption. Standard IVS 104 considers data and inputs and has been revised to address the broader range of data which is available to the valuer and the variability of the data. A valuer must consider the accuracy, completeness, timeliness and transparency of the data that they include. An appendix to IVS 104 provides more detailed guidance on ESG issues and requires that the factors taken into account in developing the valuation are measurable and are reasonable in the application of professional judgement. There is a requirement that the valuer needs to clear in the scope of the applicability of each of the E, S and G components and be clear on how this is reported in the valuation which they prepare. The IVS acknowledged in their briefing sessions which were conducted as part of the launch of the revised standards in February 2024 that there would need to be additional work undertaken in this area (IVSC 2024). In addition to the standards the IVSC are also releasing a series of sector specific papers which include ESG considerations in valuations.

THERE IS A REQUIREMENT THAT THE VALUER NEEDS TO CLEAR IN THE SCOPE OF THE APPLICABILITY OF EACH OF THE E, S AND G COMPONENTS AND BE CLEAR ON HOW THIS IS REPORTED IN THE VALUATION WHICH THEY PREPARE.

Some of the traditional approaches need to be critically appraised as the variable nature of the impact of this agenda can range from additional commitments to rectifying environmental issues to impacts on interest and discount rates that may be applied. Incorporating these considerations requires thought and a deep appreciation of the complexity of the issues. The absence of quantitative financial data to include in the models, especially for private entities, creates uncertainty, as one of the roundtable participants highlighted.

The final effect on the valuation of an organisation comes from the stress testing of the valuation model and its assumptions. As one roundtable participant commented, 'we always looked at this stress testing [from] a financial services perspective and you must highlight your top 10 risks. To me, climate risk is just one now that it is in top 10. So, from that point of view, in terms of your methodology and how … you apply the evaluation. it's just… tweaking the variables and your risk capital'. This participant continued by commenting that there are also opportunities. 'If you look at your full supply chain, your labour issues, your gender gap as an opportunity, then all those things can be lifted up in terms of the valuation'.

! Ensure the valuation approach includes sustainability-related factors as variables and is also included in any sensitivity analysis.

1.7 Developing skills and knowledge

As for many other technical areas, it is important to develop an appropriate level of skills and knowledge about the subject. Determining the impact of sustainability-related issues in the transaction process in general, but in valuations especially, is an area where technical knowledge is particularly required.

A roundtable participant working in the transaction sector commented, 'we find that there are several industry associations in the investment community that have ESG due diligence questionnaires that general partners and limited partners[11] are encouraged to use when they are having conversations'.

Fully assessing the impact of sustainability-related risks and opportunities requires a significant familiarity in the range of considerations across each of the social, economic and environmental areas, together with the strategic and governance considerations that wrap around them. As noted in section 1.5, the development of various strands of regulation and guidance across the whole area means that for any assessment to be sufficient there needs to be a range of expertise within the team. Each of these individuals needs to be aware of the current trends and developments, many of which may be nuanced by sector and location. Continual education is especially important in this area. Industry associations and professional bodies, some of which are listed in the useful resources section, provide appropriate development opportunities.

Anyone leading either an acquisition or undertaking due diligence activities should perform a skills assessment against the potential risks and opportunities to ensure that the team contains the appropriate balance of skills and knowledge. By its nature, those in the team involved in a transaction, from investment committees (as discussed in section 2.1.2) through to those involved in the post-closure integration (as discussed in section 2.4), possess a range of deep skills and expertise. Few have an end-to-end role in the transaction process. Sustainability-related risks and opportunities add another dimension to this. Intersecting transactional and sustainability-related skill sets is vital in addressing the risks and opportunities effectively.

A level of professional scepticism is also required. In section 1.4, the risks of 'greenwashing' and 'bluewashing' were highlighted. It is important for those undertaking work in this area to consider these risks and treat assertions made by organisations with the necessary level of scepticism. They should look to identify and corroborate evidence throughout the activities in the value chain.

! Conduct a skills assessment to ensure that the team has an appropriate range and depth of skills, knowledge and qualifications to address the sustainability-related risks and opportunities appropriately in the relevant aspect of the transaction.

11 A PE firm is called a general partner (GP) and its investors that commit capital are called limited partners (LPs). Limited partners generally consist of pension funds, institutional accounts and wealthy individuals.

2. The acquirer's perspective

> *'I think it is great that accountancy and finance professionals are involved in this because we bring a rigour and a focus on evidence from our training. That is important, but we do need to be thinking beyond what we can easily do in financial terms'.*
> **Australian roundtable participant**

2.1 Identifying the target

The first phase of the acquirer's activities focuses on identifying the target. In this phase, sustainability is an important consideration. An overview of the activities in this phase are shown in Figure 2.1, together with some key activities related to sustainability.

FIGURE 2.1: Identification phase

2.1.1 Acquisition strategy and risk appetite

The first step for any organisation that is looking to undertake either a strategic or a tactical acquisition is to determine the overall strategy for such activities, and how this aligns with the organisation's overall strategic objectives and hence with its acquisition strategy.

The organisation will have its own sustainability strategy and may well be undertaking and reporting its own activities. For many roundtable participants, correctly identifying the strategic goals and risk appetite were fundamental steps – steps that were sometimes missed. A dilution in the acquirer's strategic goals and an increase in risk can have an adverse effect on the organisation, not only because of the diversion of resources to address sustainability-related issues, but also because of its impact on the overall assessment of the quality of acquirer's own activities. A key question is whether the expertise exists in the acquirer to manage the sustainability-related risks of the acquiree, especially if this is not a horizontal integration, or is one that involves different regulatory regimes.

A roundtable participant from Canada commented, 'as an acquirer, you have to think …"if I am to invest, if I want to buy this particular company, what is the impact on the potential reputational risk that I could be exposed to, if they have severe environmental or social issues that are not adequately mitigated"'. The participant continued, 'That is the challenge and the interesting part of it, to see how that impacts the price…and…from a vendor point of view, how does that impact your ability to bargain for a better price and that is really what you are seeing now. How much is that? I guess that is the theory and the framework, but how much are we seeing that…happening [in practice]? I would say it depends on where you are located'. This participant contended that it might be making a difference in Europe but less so in Canada, where it may well be being ignored.

A roundtable participant in mainland China had encountered, 'a case in the tyre industry, where wastewater treatment and waste management were critical issues. The project stalled [owing] to these environmental concerns, highlighting the significant challenges in dealing with hazardous waste'.

A UK-based roundtable participant from the transaction sector commented, 'from my risk perspective, it is quite crucial to make sure [sustainability] is certainly considered within every single transaction, regardless of your lens, your sector or your geography'.

Sustainability-related risks are contextual to an industry and location. Undertaking the risk appetite exercise fully, with sustainability in mind, requires lateral thinking and the application of industry expertise. There are often many secondary considerations, especially for the social agenda, which need to be fully encapsulated.

> **!** Understand how sustainability-related objectives are part of the overall business objectives. Determine criteria for any acquisition necessary for carrying out a risk assessment to ensure alignment takes place.

2.1.2 Investment committees

Investment committees, typically but not exclusively in PE or private investment houses, establish a prudent process for managing investment strategy, and are primarily responsible for strategic oversight as well as monitoring the performance of the investment portfolio. They often appraise potential transactions and hold a governance role to ensure that the potential investments that an organisation wishes to make do not have an inappropriate level of risk. Given that sustainability-related issues present a significant business risk for many organisations, investment committees need access to an appropriate level of skills to assess this risk and opportunity (as discussed in more general terms in section 1.7). In setting their investment criteria, they need to be clear on the level of risk (and, indeed, opportunity) that they are willing to take, given the investment profile of the organisation.

A UK-based CFO commented during a roundtable session, 'if you think about the people who are on the investment committees, they are…like all of us. We are having a conversation about ESG now because we are all still getting our heads around it. So, I think we all need to be open eyed about this and accept that you have got to make it really easy for people'.

A roundtable participant in mainland China commented, 'ESG is often considered in the pre-investment phase, but it is not actively brought up. Clients usually mention legal issues related to the environment or social welfare, such as environmental assessments and compliance with social security contributions. Financial sustainability is more about profit forecasts and valuations, and less about ESG considerations'.

If the entity is a PRI Signatory or is a fund manager with a fund that falls within a labelling regime[12] and is targeting an acquisition, the thoroughness of the activities of the investment committee is crucial. The target / acquiree needs to meet the investment objective.

> **!** Ensure that investment committees have the requisite skills to assess the sustainability-related opportunities and risks in any transaction.

2.1.3 Target screening and acquisition planning

In the target screening process of assessing potential acquisitions and determining which are worth developing further, sustainability should be a significant consideration.

Earlier in the process, the acquirer will have determined its own risk appetite, including the impact of sustainability-related considerations. In typical target screening, the acquirer may consider areas such as size, scalability, market share, earnings and geographic footprint. To this it is important to add sustainability considerations stemming from the economic, social and environmental agendas.

At this stage it is important to consider regulatory implications, including current, expected and potentially foreseeable ones. These stem not only from reporting requirements (such as those from CSRD, or ISSB S2, for example – see section 1.2.2) but also requirements that

12 In a labelling regime, investors in the fund must be told 'what their money is being used for, based on clear sustainability-related goals and criteria' (FCA 2023b)

are specific to a particular industry, for example wastewater treatment. This can be especially important when overseas where the regulatory regime may be different. As an example, a forthcoming obligation to manage wastewater discharges may require significant investment and changes in the operating model, both of which need to be included in the financial forecasts. There might also be public relations considerations: even if investing in an area where regulation on wastewater is lax and expected to remain so, news that the company was polluting abroad might not play well in home markets.

A final consideration in this area is the relative weightings of factors in the assessment criteria. Several of the roundtable participants explained that sustainability-related issues had typically not factored heavily in the assessments. A review of the risk appetite should help to define the relative importance of this issue. As one roundtable participant commented, it might not be the most significant factor, but it should be towards the top because the risks are significant.

> **!** Ensure target screening criteria include sustainability-related risks and opportunities aligned to the acquirer's own risk-assessment profile.

Having identified the target and made the approach, the acquirer will now move on to the detailed assessment of the deal.

2.2 What assurance is sought?

In the second phase of the M&A workflow, the activities of the acquirer (as shown in Figure 2.2) focus on valuation analysis, negotiations and investigation through performing relevant due diligence. The nature of that due diligence, as explored in section 1.4, can vary between a formal level of assurance or a level of comfort, according to the scope of the work specified.

This phase also embraces the negotiation, which represents the first interaction between the acquirer and the potential acquiree.

FIGURE 2.2: Assurance phase

2.2.1 Valuation analysis and negotiations

Section 1.6 considered how the valuation process may be influenced by sustainability-related issues. At this phase of the transaction, the acquirer is looking to place a value on the target and the considerations discussed in that section should be applied.

In a PE-backed deal it may be appropriate to consider how sustainability issues may change the potential earnout multiplier. Several roundtable participants discussed whether the multipliers were being adjusted for relevant risks. The view was that in some cases adjustments were being made, however, the overall objective of the PE house was to ensure that the organisation was sustainable when the period of its investment was drawing to a close. Therefore, the necessary expenditure (both capital and operational) was being factored into the calculations.

> **!** Ensure that sustainability is factored into any valuation, either through an adjustment to a required rate of return or through necessary outlays.

Negotiations will, inevitably, include sustainability considerations as contractual clauses are finalised and warranties agreed.

2.2.2 Due diligence

The nature of the sustainability due diligence that may be undertaken and how it interrelates with other due diligence activities that may be undertaken at the same time has been discussed in section 1.4 (see Figure 1.3).

It is important to be comprehensive in the activities undertaken and for the acquirer to refer to its own risk appetite and ensure that all the areas that have been identified are included within the scope. The following two examples from roundtable participants highlight some of the thought processes that the acquirer needs to have to ensure that a comprehensive set of risks are addressed.

An Australian roundtable participant commented that, 'what's happening in the supply chain [is] particularly important and external assurance is fundamental. I am really a strong advocate for expanding the scope of external assurance, and particularly assurance over that process of determining the most significant impacts. Because if it [is] not externally assured, you do not know whether an organisation is giving you a complete picture of those most significant impacts'.

In undertaking due diligence, you are looking at potential risks and opportunities. A Europe-based roundtable participant commented, 'one of the key risks is your reputational risk. Imagine you are an acquirer, and you want to have a big press release to say you acquired [a certain] business and then you realise that the sustainability claims are false. That is a significant issue'.

An indicative list of questions or considerations from a sustainability perspective are given in Table ES1.

! Ensure that all publicly available sources of information are identified and used.

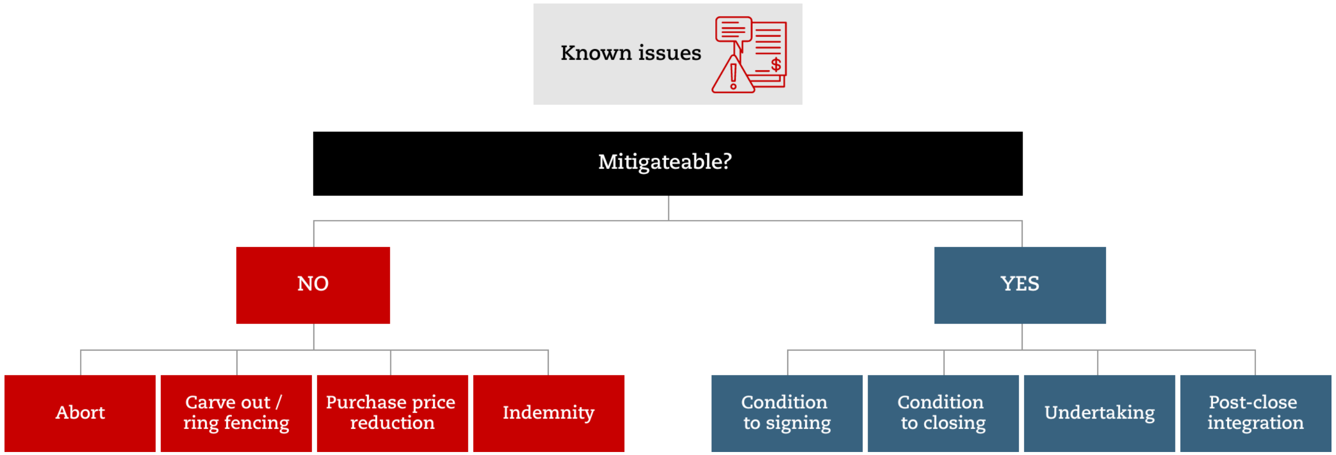
! Ensure that sustainability-related opportunities and risks are appropriately addressed in the specification of the due diligence work to be undertaken.

Having obtained the due diligence outputs, it is important to assess the outcomes against the acquirer's risk appetite. In this sense, sustainability-related issues are no different from those of other risk elements. It is at this point that some sustainability-related issues may become deal breakers. Indeed, a KPMG US survey in 2023 as quoted by ESG Today concluded that 'more than half of respondents indicat[ed] that red flags on ESG could be a deal stopper (51%) or result in additional closing conditions (52%), and 44% [said] it could result in a valuation reduction. 53% of respondents said that material ESG due diligence findings have resulted in deal cancellations, and 42% said that they have resulted in purchase price reductions' (Segal 2023).

As with the implications of any risk that is identified, there are several options if an issue is discovered and quantified during the due diligence process (Figure 2.3).

It is important that each risk is assessed appropriately and on its own merits. Not all non-mitigated risks should lead to the aborting of the transaction. Likewise, not all mitigated risks should be left to be managed in post-closing integration (see section 2.4). Indeed, planning for the post-closing integration needs to have commenced by this phase.

FIGURE 2.3: Options upon identification of an issue in the due diligence process



2.3 Contracting

The third phase of the M&A workflow includes the completion of the transaction (see Figure 2.4).

FIGURE 2.4: Contracting phase

2.3.1 Purchase and sale contracts

The contracting phase is inevitably one of finalising the deal and preparing for completion. The inclusion of sustainability-related considerations, such as earnout clauses and warranties, needs to be considered, and these should be formulated and agreed. For areas such as sustainability-related issues where there remain several uncertainties, these considerations are complex and legal advice is paramount.

Jochen Ellrott, a partner in Freshfields, a global law firm, noted in June 2022 that, 'to date, ESG aspects have not yet given rise to truly novel, widely used [sale and purchase agreement (SPA)] clauses, let-alone established market practices. However, as the relevance of ESG risks and issues continues to increase, we expect them to be addressed in the transaction documents in a broader, deeper and possibly tailored manner' (Ellrott 2022).

The acquirer may choose to impose a condition precedent (known as a 'CP') before the closing of the transaction, which may require the acquirer to undertake certain actions before the closure of the deal. Sustainability-related risks may be addressed by such conditions. Examples of these conditions may include a minimum ESG rating downgrade, deterioration in ESG indicators, or press and social media coverage. Such terms may present challenges as there may not be established standards to cover them, which itself may give rise to disputes.

It may also be appropriate to seek warranties in certain areas as discussed in section 2.2.1. Ellrott notes that 'it is worth keeping in mind, however, that warranties are not only about damages claims, but also about disclosure. So, even if a buyer ultimately cannot claim damages, the disclosure may still prove to be helpful in the buyer's quest to understand the ESG profile of its purchase. Also, the mere fact that the topics were addressed in the due diligence and the SPA demonstrates to the outside world that ESG was front and centre when the deal was done' (Ellrott 2022). In addition, warranty and indemnity insurance may be available.

An example of such a clause, related to the social element of sustainability, is the so-called Weinstein clause that is being inserted in contracts in some jurisdictions. A Weinstein clause, also known as a '#MeToo Representation and Warranty', requires target companies to warrant that:

- the company's senior executives – directors, officers or senior managers – are not and have not been involved in any sexual harassment claims; and
- no settlement agreement has been entered into over any such allegations.

In October 2022 Coll and Holman of Bloomberg Law cited that in the US in the previous year 'more than half of deals valued over $25 million included specific language focused on sexual harassment or misconduct', though they also question the effectiveness of such clauses (Coll and Holman 2022).

Other examples of warranties that might be considered include one where the organisation being acquired confirms the seller's:

- compliance with environmental legislation
- possession of all necessary permits to carry out its operations
- statements that:
  - it is not a party to any environmental court claims
  - it has not caused any toxic or hazardous discharges to the soil, ground and water, and
  - it has no obligations to remedy soil at any site.

Joana Andrade Correia of Chambers Europe noted in 2022, however, that 'the SPA warranties will not provide the purchaser with full protection, because they are usually in force for a limited period. Some of the main issues related to environmental damages may be hidden for an extended period. Thus, it is crucial that the most essential environmental warranties are deemed fundamental warranties, which remain effective for a more extended period [than] the basic warranties' (Correia 2022).

> **!** Consider the inclusion of any warranties or indemnities in the contract that address sustainability-related considerations.

2.3.2 Financing strategy for acquisition

In several economies, the extent to which the organisation has enacted, and is enacting, a credible sustainability strategy affects the costs of finance available. Several roundtable participants commented on the detailed information on their activities that they need to provide to financial institutions. Others commented on the impact of ESG ratings on the ability to raise capital (as discussed in section 3.2.2), although those providing the funds may use a variety of ratings in addition to their own proprietary overlays in determining a course of action. The perception gap may well be the issue.

ACCA has provided a commentary on the use of green finance in its report *Green finance skills: The guide* (ACCA 2023b).

2.4 Post-closing integration – the 'first 100 days'

The final phase is what happens after the completion of the transaction: bringing the two organisations together (or decoupling, in a disposal of part of an organisation). This is typically referred to as the 'first 100 days', although the actual period will vary. The key considerations from a sustainability perspective are shown in Figure 2.5.

FIGURE 2.5: Post-closing integration

Figure 2.6 provides a more detailed workflow for this activity.

The bringing together of two entities in a manner that achieves the synergies in value creation on which the transaction was predicated, in the case of a strategic transaction, or sets the organisation on a growth trajectory, in the case of an investment-based transaction, is often challenging. Yet the merger needs to be successful in as short a period of time as possible, hence references to the 'first 100-days', although in practice, as noted above, this is a notional period as the initial integration activities may well take longer.

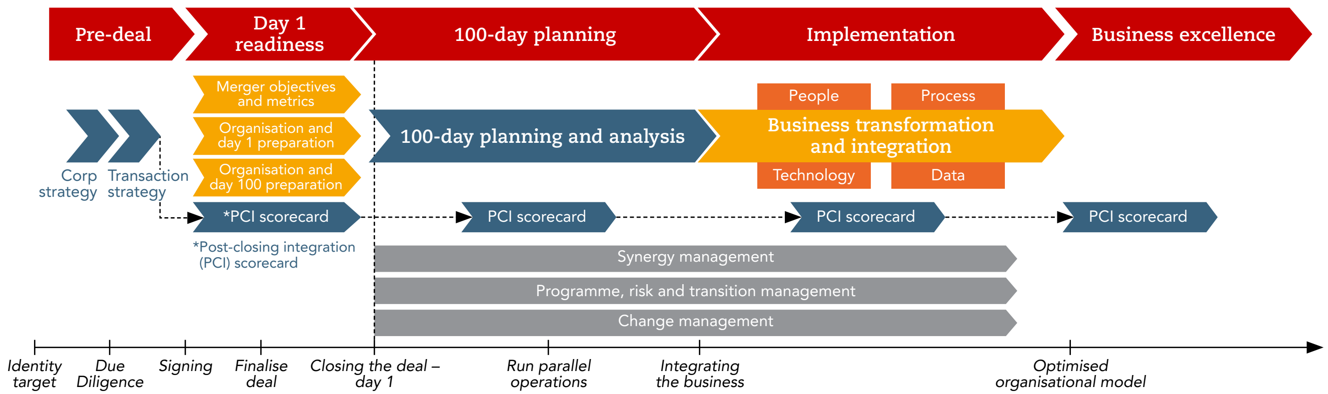
There are several sustainability-related areas that should be considered when engaged in the integration activities. The exact set will vary depending on the organisation(s) concerned, but they may include:

- establishing a unified sustainability-related strategy with relevant roles and responsibilities
- creating a unified governance structure and accountabilities
- resetting sustainability-related targets / baselines
- understanding reporting obligations on new entities; for example, the EU has requirements for organisations to undertake sustainability reporting even if they have an exemption from financial reporting
- considering sustainability-related issues within the combined organisation, such as employee wellbeing
- unifying procurement processes, including supplier codes of conduct
- unifying measurement processes for key sustainability-related activities, especially in areas where the data is less than robust, and
- integrating relevant sustainability-related measures into the performance-management processes in a consistent manner.

From a sustainability perspective, in a strategic transaction there is a need to integrate two distinct teams who may have differing approaches to the overall objective. By the end of the 'first 100 days' the objective must be to have a functioning overall sustainability team with clear responsibilities and accountabilities. In many organisations, especially in the mid-tier and smaller enterprises, the responsibility for sustainability, particularly sustainability-related reporting, may sit with the CFO, and indeed, may be part of the finance function. As such, alongside finance function integration, it may add complexity for the CFO in determining the right structure for the team. As part of this there is the important consideration of key-person dependency.

For those entities with existing reporting requirements against sustainability-related objectives, the finance team needs to ensure that the relevant data continues to be collected but is also capable of being aggregated or consolidated. In *Planning and Performance Management Paradigm* (ACCA / CA ANZ / PwC 2022), the necessary challenges of bringing non-financial objectives into the performance-management process are discussed. These complexities multiply in a merged, or even a demerged, entity. Sustainability data sources are often not as robust as financial data sources and, at least initially, may be far more informal in nature, which itself gives rise to greater integration challenges.

FIGURE 2.6: Post-closing integration approach



3. Selling an organisation

'If you do not look clean enough, you just will not get the financing and you will not get the deal'.
UK-based CFO

3.1 The due diligence process

The nature of due diligence required should reflect the needs and the assessments of the acquirer. Getting that right must be based upon an understanding of the risks, and this is especially true in relation to sustainability-related issues.

A New Zealand partner specialising in transactions and due diligence commented from the perspective of the seller that, 'we do adapt our preparatory work when we are vendor side in advance. For example, if [we] are targeting US PE, we have got a fairly good idea about how they might structure their 120 questions that will come into due diligence at some later point, but that might be very different from what actually [is required]. There are one or two local strategic investors here who are the most likely investors in [the] business and that would be much more tailored to how they have been approaching sustainability for themselves as an organisation and how they are already articulating their sustainability strategy to the market'.

It may well present a challenge for the finance leadership preparing for due diligence, as the scope will vary according to the requirements of the instructing party. Data on sustainability-related issues is often not robust and nor is it captured in formalised systems. In approaching due diligence there needs to be an approach of 'best endeavours'. This will be particularly important where the acquiree is not yet required to report externally, either partially or fully, against sustainability reporting standards. The veracity of such data may be open to question and, therefore, it is important to conduct a level of assurance before the commencement of the due diligence process.

> **!** Develop a systematic plan to gather data covering sustainability-related opportunities and risks, recognising that some of the data required may not be from traditional sources.

3.2 The data room

3.2.1 Preparing for the data room

The key question for the acquiree, when preparing a data room,[13] for the acquirer is: what data is relevant and should be provided? While the exact requirements will depend upon the extent and scope of the due diligence exercise being undertaken and what data is available, it may be helpful for those organising the data on behalf of the acquiree to consider the applicability of the various reporting standards that consider sustainability. While focusing on the progress made, these can provide insights as to the types of metrics that might be expected in the data room.[14] A list of relevant questions is given in Table ES1 'Sustainability-related considerations in the due diligence process', and this may also be used to prompt the inclusion of appropriate data.

> **!** In preparing the data room consider using relevant disclosure standards to enable the identification of data sets that might be included.

There are three broad sources of data that can be used in the data room. These come from the following sources.

1. **Data reported directly by the organisation**, such as annual or quarterly sustainability-related reports, financial disclosures, modern slavery requirements, submissions to standards providers and questionnaires. Organisation-reported data is the first and most obvious source of sustainability-related data for due diligence. Depending on the size, location, and transparency of the organisation in question, some of this data may be publicly accessible.
2. **Third-party collected data**, such as that from organisations such as Morgan Stanley Capital International (MSCI), London Stock Exchange Group Data and Analytics (formerly Refinitiv) or Sustainalytics. This ESG data may be purchased or licensed from third-party providers to help with the due diligence process. Often, this data is made available in the form of ESG ratings or scores. There can be concerns as to the use and consistency of such data, as some of the roundtable participants commented. In certain cases, the ratings are based on generic sector data and might not give a fair impression of the organisation itself. It should be recognised that external agencies do place a degree of reliance upon this data and the ratings which may be formulated from it.
3. **Alternative data** sources such as geospatial data and social media sentiment data. Alternative data providers offer additional information that can be used in conjunction with more traditional data sources referred to above.

> **!** Consider external as well as internal data sources to capture a balanced view of the sustainability-related opportunities and risks within the organisation.

3.2.2 Role of ESG ratings

The relevance of ESG ratings in the due diligence process is worthy of further comment. As Jason Krychiw of Conserve notes, 'investors prefer companies with better overall ESG scores because they typically have fewer liabilities, making it easier to acquire capital and hire top talent. These companies also often have successful stakeholder relationships and a brand reputation' (Krychiw 2023). Similarly, he continues, 'Companies with a low ESG score are thought to have the worst environmental, social, and governance impacts. Undesirable ESG scores have also been linked to rising poverty levels in the communities where the firm operates, as well as poor employee mental health'.

Regulators are increasingly expressing concern about the use of ESG ratings. Regulators in the US, Hong Kong, Japan, Singapore, India, UK and EU have all recognised the need for a more uniform set of rules for ESG metrics. For example, in the US, the Securities and Exchange Commission (SEC) is working to standardise climate-related disclosures by public companies with the hope that it will aid in improving the accuracy of the ESG ratings of these companies. In the UK, the FCA has launched an industry code of conduct for ESG ratings and data products providers (FCA 2023c). The Board of the International Organization of Securities Commissions (IOSCO) has also published guidance in 2021 (IOSCO 2021).

On 5 February 2024, the EU Council and the EU Parliament agreed on a provisional text for the ESG Ratings Regulation. Under the Regulation, in-scope EU providers of ESG ratings will require a licence from, and be supervised by, European Securities and Markets Authority. In-scope ESG ratings will provide an opinion on a company's or a financial instrument's sustainability profile, by assessing its exposure to sustainability risk and its impact on society and the environment. Whilst the regulation still requires approval it is expected to apply from the second half of 2025.[15]

In December 2023, the International Regulatory Strategy Group and the International Capital Market Association (ICMA) jointly published a code of conduct for ESG ratings and data providers (ICMA 2023). In line with recommendations by IOSCO, the Code focuses on promoting transparency, good governance, management of conflicts of interest, and strengthening systems and controls in the sector. It is intended to be internationally interoperable and could be used by jurisdictions where no local Code or regulation is in place.

13 A data room is a secure place that is used to store privileged data, usually for legal proceedings or mergers and acquisitions transactions. Data rooms are used for storing documents, file sharing, securing sensitive documents, and conducting financial transactions.

14 ACCA 2023c provides guidance for preparers collecting non-financial data, including relevant guidance in this instance.

15 Further details are contained in von Livonius and Riedl (2024).

3.2.3 Data collection

The data collected and presented will be a mixture of both qualitative and quantitative data. As a starting point the organisation should consider the key performance indicators that it has incorporated into performance management processes to reflect its sustainability-related strategic objectives. The data from which these indicators are derived should form part of the data room, but much of the data on sustainability also has both quantitative and quantitative aspects, which may themselves be subjective. Examples include ESG / sustainability policies and commitments, and governance data. Such data will give an appreciation of the risk-assessment process that the organisation undertakes and how the risks are governed.

Several of the roundtable participants who undertook due diligence commented that they infrequently saw sustainability (or indeed ESG) information included as a discrete data set within the data room. Given the potential risk profile that may attach to sustainability and the focus that it might receive in the due diligence process, this is perhaps surprising.

> **!** Consider structuring the data room to include a specific categorisation for sustainability-related data.

3.3 Implications for finance leaders

Finance leaders can ill afford not to recognise the importance of the sustainability agenda as a significant factor in any transaction involving an organisation. In many cases it can be a make-or-break factor.

The accountability for sustainability sits in varying places in an organisation, depending upon the level of complexity and the size of the organisation. In smaller organisations it may be a responsibility of the CFO; in larger organisations there may be a separate sustainability function. Whichever model is adopted, it is often the responsibility of the CFO to drive the transaction process. Ignoring sustainability presents a significant transactional risk.

> **FINANCE LEADERS CAN ILL AFFORD NOT TO RECOGNISE THE IMPORTANCE OF THE SUSTAINABILITY AGENDA AS A SIGNIFICANT FACTOR IN ANY TRANSACTION INVOLVING AN ORGANISATION. IN MANY CASES IT CAN BE A MAKE-OR-BREAK FACTOR.**

Commentary from Professor Dr Christopher Kummer, IMAA

From the perspective of a finance leader who is looking to sell or be acquired, what should you be thinking about regarding sustainability-related issues and opportunities?

It should be definitively on the radar screen. I do not see [sustainability-related factors] necessarily added as acquisition criteria per se, but these factors should be seriously considered in due diligence and for plans post close and in post-merger integration.

Finance leaders need to acknowledge that these factors are gaining prominence among investors, stakeholders and potential acquirers. While these factors may not be the foremost criteria for an acquisition, they can exert a substantial influence on the appeal and desirability of a deal.

During the due diligence process, finance leaders should assess their own organisation's ESG performance and identify areas where improvements can be made. This proactive approach can help mitigate potential risks and demonstrate a commitment to sustainability.

Be prepared to transparently communicate your sustainability efforts and progress to potential acquirers or investors. This includes providing data, reports and disclosures related to ESG performance.

Finance leaders should recognise that sustainability considerations should not stop at the deal's closure. Post-merger integration plans should include a strategy for aligning sustainability practices, cultures and goals between the acquiring and target companies.

16 This process is considered in ACCA / CA ANZ / PwC 2022 and ACCA / IFAC / PwC 2023.

Conclusion

'I maintain an optimistic outlook, believing that societal mechanisms and legal policies will progressively influence sustainability positively'.
Roundtable participant in mainland China

Sustainability-related issues are now a significant factor in the transaction process. Their integration may be in its infancy, but it will be increasingly important. The list of sustainability-related topics will continue to grow as regulation and market expectations evolve. Sustainability-related issues are integral to the future operational success of the organisation, in either a strategic or an investment-led transaction. The nature of the sustainability journey that most organisations need to undertake is one that affects the operating model. Whether this is to a greater or lesser extent will depend upon the sector and the location(s) in which the organisation operates.

Sustainability considerations exist at all steps in the transactional workflow. From the initiation of the search through to the post-closure integration of the organisations (or to the demerger of the entities). To ignore these considerations creates a transactional risk, or opportunity, in its own right.

Assessing the impact of sustainability-related issues on the transaction and the valuation of the organisation is not, however, straightforward. It requires a detailed understanding not only of the sector and jurisdictions involved but also of the various aspects of the drive for sustainability itself.

There are six key considerations which organisations need to bear in mind to deliver sustainability-related risks in the due diligence process (Figure C1).

- The starting point has to depend on the **strategic** objectives of both the acquirer and acquiree. Alignment of sustainability objectives is an important factor and also needs a **risk-based** approach.
- Sustainability-related due diligence needs to be **integrated** into the overall approach to the transaction, whether it is a standalone aspect or an integral aspect of other due diligence aspects. It is not a standalone business issue: it is integral to the future of the organisation. It also needs to be reflected in the valuation.
- There must be **operational rigour** in commoditising the assets of the organisation in relation to the achievement of sustainability objectives, recognising that this is both an opportunity and a risk.
- There is a need to recognise that the sustainability agenda is **agile and flexible** as our level of understanding of the issues develops and the regulatory environment evolves. Sustainability-related concerns will continue to be integrated into the operating model.
- Sustainability-related issues are technical issues and attaining these therefore needs **relevant expertise** but this needs to be incorporated into the overall assessment so those leading the work across all phases need to have a detailed appreciation of the issues such that they can analyse and interpret the information presented to them in an appropriate manner.
- Any issues identified need to be framed as **actionable observations**. Transactions may fail not because of sustainability issues themselves, but rather from a lack of understanding of their implications and how their risks can be addressed in a post-closure process.

In conclusion the following points should always be considered in the M&A cycle:

- Sustainability-related opportunities and risks cannot be ignored in a transaction: they now form a fundamental part of the strategic intent of the transaction and the valuation of an entity.
- The assessment of these risks and opportunities must be comprehensively considered as part of the due diligence process, both as a specific workflow and as an integral part of other forms of due diligence.
- Organisations need to ensure that they have an appropriate level of expertise across the transaction workflow and the target's operations, assets and liabilities.

FIGURE C1: Six key observations for sustainability in due diligence

Appendix – Relevance of sustainability-related issues to other areas of due diligence

Table A1 provides some suggestions of potential sustainability-related risks and opportunities that might be considered in other aspects of due diligence. This list is intended to provide examples and should be considered against the full risk assessment that the acquiring organisation should undertake before instructing any due diligence provider. The list is not exhaustive nor are the activities mutually exclusive. Many of the considerations apply both in the organisation and across its value chain. Cross-reference should also be made to the topics identified in Table ES1 in the 'Executive summary'.

TABLE A1: Relevance of sustainability-related considerations to other areas of due diligence

DUE DILIGENCE ACTIVITY	POTENTIAL SUSTAINABILITY-RELATED CONSIDERATIONS
Financial	• Impact on cash flow of changes in operating model • Level of capital investment needed and over what time period • Compliance with disclosure requirements
Legal and risk	• Illegal activities, such as breaches of worker rights, and forced labour • Environmental impacts from activities • Breaches of covenants • Outstanding legal claims and disputes • Legal contracts for existing customers / clients including commitments to sustainability-related objectives • Signatory to relevant conventions and standards
Tax	• Use of grants for investment and capital expenditure • Legally required and fair proportion of taxes paid
Operational	• Changes in production processes • Risks to key locations • Sustainability key performance indicators and metrics in operational performance management
Intellectual property	• Specific rights owned by the organisation that may be affected by sustainability-related considerations • Potential infringements of third-party rights • Expiry of patents and intellectual property rights; or diminution of value

DUE DILIGENCE ACTIVITY		POTENTIAL SUSTAINABILITY-RELATED CONSIDERATIONS
Commercial		• Impact on key suppliers of sustainability risks • Impact on customers of sustainability risks • Adequacy of supplier codes of conduct and due diligence processes • Impact of sustainability-related risks on the operating model, including the need for new sources of supply
Information technology		• Adequacy of systems and processes to collect non-financial information • Adequacy and appropriateness of data sources related to sustainability information and disclosure requirements • Adequacy of IT and data strategy for addressing changing data needs • Assessment and management of cyber risk
Human resource		• Changes in access to talent • Wages and rewards in line with accepted norms • Appropriate level of skills in the organisation for managing sustainability risks
Regulatory		• Compliance with laws and regulations on environmental and social issues • Adequacy of preparation of future-related disclosures
Sustainability		• Governance procedures for sustainability-related risks and opportunities • Adequacy of sustainability-related strategy
Confirmatory		• Adequacy of historic disclosures around sustainability-related risks and opportunities • Outstanding claims or proceedings
Specialist		• Impact of specific activities related to sector or location of potentially acquired organisation and their relevance to sustainability (for example, power generation)

Useful resources

The following resources may provide useful information and context, although they are not specifically recommended by either ACCA or CA ANZ. This is not a comprehensive list and other sources of information will be relevant in specific circumstances.

Due diligence approach

Institute of Mergers, Acquisitions and Alliances – including a qualification pathway

Global Reporting Institute (GRI) – Corporate sustainability due diligence policies and sustainability reporting

Valuation

IVSC – Valuation Standards

Private Equity and investment management

Invest Europe – ESG guidelines

British Investment International – ESG Toolkit for fund managers

Institutional Limited Partners Association – ESG Due Diligence questionnaire

ESG Data Convergence Initiative – reference source for PE in the context of ESG

United Nations Principles for Responsible Investment (PRI) – Climate Change for Private Markets

EU taxonomy for sustainable activities – EU-wide classification system for sustainable activities

US Securities and Exchange Commission – Climate-Related Disclosures/ESG Investing

PRI, CFA Institute, Global Sustainable Investment Alliance – Definitions for Responsible Investment Approaches

Prospectuses

European Securities and Markets Authority (ESMA) – Public Statement: Sustainability disclosure in prospectuses

Standards and regulations

International Sustainability Standards Board – Sustainability Standards Navigator (for access to Disclosure Standards S1 and S2)

European Union Corporate Sustainability Reporting Directive

International Labour Organization – Forced Labour, Modern Slavery and Human Trafficking

International Regulatory Strategy Group and International Capital Market Association – Code of Conduct for ESG Ratings and Data Products Providers

European Commission Sustainability-related disclosure in the financial services sector (SFDR) – consultation (closed 15 December 2023)

International Accounting and Assurance Standards Board – Understanding International Standard on Sustainability Assurance 5000

Financial Conduct Authority – CP22/20, Sustainability Disclosure Requirements (SDR) and investment labels

Other bodies

Taskforce for Nature-related Financial Disclosure

CPD – a not-for-profit charity that runs the global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts

Science Based Targets Initiative drives climate action in the private sector.

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