HR DUE DILIGENCE

ICAEW CORPORATE FINANCE FACULTY
BEST-PRACTICE GUIDELINE 73

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FOREWORD AND ACKNOWLEDGEMENTS

This human resources (HR) due diligence guideline is designed to help advisers and their clients better understand the cultural and people-related risks and opportunities that are a consideration in the deals process. It follows the publication of similar peer-reviewed guidance from the Corporate Finance Faculty on areas such as commercial due diligence and financial due diligence. The guideline includes insights from many of the faculty's leading member firms with the objective of setting out market best practice.

People-related costs have long been a major consideration in deals, particularly those involving companies with many employees. This guideline provides a framework to consider areas of due diligence beyond a more traditional analysis of profit and loss (P&L) and balance sheet items such as overhead and pension liabilities. Looking beyond the financial and cultural impact of reshaping an organisation, HR due diligence also requires consideration of the likely impact on employee morale and retention.

With cultural and people-related issues so frequently cited as one of the primary reasons transactions fail to achieve their potential value, HR due diligence has morphed from being on the periphery of the transaction due diligence process to a fundamental consideration of any deal.

The guideline has been written for use when commissioning due diligence and therefore will be of value to: lead advisers; management and principal investors in both private equity and corporates; banks and providers of private capital; and lawyers. It will also be useful for providers of other forms of due diligence to avoid duplication.

Thanks are due to Louise Hunter, Harriet Innes, Richard Heerey, Andrew Howard and Shikha Yadav and their colleagues from Deloitte for their dedicated work in preparing this publication. My thanks also to my colleague at ICAEW, Katerina Joannou, for collating the guideline and taking into account comments from so many of our member firms.

It is people that form the heart of any organisation and are the root cause of its success. I believe that considering people simply as a "human resource" is a fundamental mistake. But we had to give this guideline a name and HR due diligence is what it's called. As with all the guidelines produced by the corporate finance faculty, I hope you find its contents both thought-provoking and useful.

David Petrie
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INTRODUCTION

People-related costs are often the largest expense for a business. HR due diligence, undertaken in connection with a transaction, explores these costs to understand the key drivers, exceptional items and liabilities to ensure they are reflected correctly in the transaction pricing. HR due diligence also highlights potential opportunities, as well as barriers and timing issues that could impact a buyer's plans for the business. This enables the buyer to identify solutions or ways to mitigate these issues ahead of time.

In this guideline we explore the breadth of what HR due diligence can include and the interplay with other forms of due diligence. We look at how HR due diligence might be adapted to different types of transactions, locations, industries and commissioners. We also refer to the practicalities of carrying out HR due diligence in the pre-signing period and what the next steps might be from a people perspective, from signing to completion and beyond. In covering these topics, the guideline aims to set out best practice for parties commissioning due diligence, HR due diligence providers and subjects of due diligence exercises who are preparing data to respond to requests.

ICAEW's principles of integrity and confidentiality are particularly applicable to HR due diligence as reputational risks and the impact of the HR work and the transaction on individuals need to be considered. As with all due diligence exercises, the principles of objectivity, professional competence and due care also apply to HR due diligence work.

Throughout this guideline, we will refer to a target business as the subject of a due diligence exercise. This applies whether the due diligence is being carried out for a seller or a potential buyer of the business, with the guideline intended to be applicable in both scenarios. It largely focuses on due diligence related to a standalone business but also comments on integration and separation aspects.

People issues are one of the primary reasons transactions do not achieve their potential value.

WHAT IS HR DUE DILIGENCE?

HR due diligence has developed significantly in the last 10 years, providing a valuable addition to financial and legal due diligence.

As a rapidly evolving area, HR due diligence can be understood in different ways by different advisers. Certain aspects of the scope may be more relevant for a particular transaction, and this is explored in more detail in the next section of the guideline.

OBJECTIVES OF HR DUE DILIGENCE

HR due diligence has two primary objectives:

1

Assessing the people-related costs and liabilities within the business to help inform the pricing of the transaction

2

Analysing the potential people-related complexities in running the business and making long-term changes (post-transaction)

In line with other financial-based due diligence assessments, the debt and ongoing costs in the target business need to be estimated for both buyers and sellers. This will enable them, or lenders, to reflect this in the transaction pricing. Historically, HR due diligence may have focused mainly on quantifying the debt associated with defined benefit pension plans, as this was often the most significant item that needed to be understood from a value perspective and had complex cash funding requirements. As defined benefit schemes have become less prevalent, particularly in the UK and US, the focus has broadened to include ongoing staff costs and liabilities, incentive plans and the cost of the HR function itself.

For a buyer, HR due diligence also helps to anticipate any integration steps or standalone considerations that may arise after the transaction has been completed. For a seller, HR due diligence will focus on the people aspects of separation planning and any ongoing HR services they will provide to the target (or vice versa) in a transition period after the transaction completes. It will identify red flags that may impact the timing and cost of making changes from a people perspective, or the ability to do so. These might include significant differences in employee benefits or culture between the businesses that are to be integrated. It might also include operational complexities, such as the need for union consultations, or the capacity of the HR function, as well as any employment law considerations and potential restrictions that could impact planned integration steps post-completion.

OVERVIEW OF TOPICS COVERED IN HR DUE DILIGENCE

The key focus areas in an HR due diligence exercise will be shaped by the specifics of the target business. For example, a start-up single-market business will have very different considerations to a long-established international business. This might include understanding to what extent HR policies and processes have been established compared to investigating where defined benefit pension liabilities have accumulated over time. The context of the transaction will also steer the scope. For example, it may involve a corporate trying to understand the cost of harmonising benefits with their own plans in future, compared to a financial buyer looking to model historical and future salary increases within the target. These differences are explored further in the next sections.

However, the initial scope of an HR due diligence exercise will typically encompass all aspects of people-related costs and risks in a business. This broad exercise helps to ensure that risks and opportunities are identified comprehensively for further investigation. A framework for this broad review is illustrated below.

The framework covers seven distinct areas, each addressing different people-related aspects of the business.

1. **Workforce profile and structure**: this could involve understanding who is in the target business (for example, location, grades, reporting lines and department categorisations), whether employees are supplemented by temporary workers or contractors, and assessing the current vacancy level. This may include an assessment of the criteria that determined which employees are included within the perimeter, a review of current restructuring programmes and gaining an understanding of headcount growth projections and strategy.

2. **Culture and employee engagement**: this could involve an analysis of the employee turnover rates to understand whether there are particular issues with retaining staff, either across the business or within a particular function or location. This analysis will be complemented by reviews of employee engagement data, performance management processes, diversity statistics and policies, and the key drivers of culture within the target business (for example, leadership statements, mission and values).

Framework for HR due diligence

3. **Leadership team**: this could involve confirming which roles or individuals play a part in leading the company, key vacancies and the succession planning in place. To assist future retention planning or costing exits, the compensation and benefits package of these individuals will be reviewed, including contractual payments linked to the transaction. Key talent or critical roles outside the leadership team may also be considered here where they are significant to the ongoing success of the company.

4. **Reward**: this could involve reviewing the process that determines salary and pay bands, any benchmarking carried out, as well as historical and expected pay rises. This can also include how short-term and long-term incentive plans are used by the business, any unwritten promises and any payments that will be triggered on the transaction (for example from share plan crystallisation). If transaction bonuses are being considered, what is the framework for selection and how and when will they be funded.

5. **Benefits**: this could involve understanding the key benefits provided to employees, with a particular focus on defined benefit pension plans or other plans that may require a net debt deduction in the transaction pricing. There may be analysis of the cost of the plans and any exceptional items or expected changes, including work to understand whether any new plans need to be established in a carve-out situation. Further detail on what benefits are contractual or custom and practice might also be considered.

6. **HR function**: this could involve understanding the HR function roles and responsibilities, the costs associated with HR vendors and systems, maturity of HR policies and any HR initiatives in progress. This might include looking at how particular processes are managed, such as employee mobility or minimum wage compliance.

7. **Labour relations, compliance and disputes**: this could involve reviewing the terms of collective bargaining agreements (and similar) to identify operational restrictions or process implications for the transaction. There may be an analysis of legal risks and costs relating to potential or unresolved grievances, disputes, employee litigation or compliance issues (future or historical liabilities). Further analysis could cover how historical severance payments were calculated, statutory obligations, a view on any limitations on future restructuring, and a summary of key legal terms and conditions. Local due diligence teams may be required for knowledge of local legislation and best practice.

Whether it is a potential buyer or a seller, those commissioning HR due diligence work should determine the scope according to their objectives and the specifics of the business. In the case of vendor due diligence (VDD), this would be to fit the needs of a future buyer as the beneficiary of the report. A targeted scope that considers just one or two of the framework areas may be appropriate in some circumstances. Different scoping approaches can be taken, with the framework on page 4 illustrating one possible way to structure an HR due diligence exercise.

Data protection considerations

HR due diligence will often involve handling personal data, from which individuals (particularly those in unique or senior roles) can be identified even when data is anonymised.

The data will also list remuneration for all individuals. This might be sensitive internally within the target business and cause competition issues if shared with a buyer operating in the same market.

"Clean" data rooms can therefore sometimes be used, which limit the number of people at the target/seller and the buyer who can see the information. Advisers are typically all "clean team" members and can see all information.

GDPR and similar relevant local data protection regulations should be considered when transmitting, storing and protecting documents with personal information.

INFORMATION SOURCES

There are typically three sources of information that HR due diligence practitioners can use in their work:

1. **Data room documents**: this might be pre-populated or prompted by an information request list. The key document from an HR due diligence perspective is typically the employee census, which provides an anonymous employee list. The contents of this file will vary but information like service dates, job title, function, salary and bonus will allow analysis to be carried out on the employee population. Documentation provided will also often include employee handbooks, benefit policy documents, historical cost information, collective bargaining agreements, incentive plan documentation, director service agreements and sample employment contracts. In addition, when carrying out buy-side due diligence, a VDD report may be available for review.
2. **Q&A**: through a written Q&A process, confirmations can be provided, for example about whether there are any ongoing restructuring exercises, any known disputes or compliance breaches, or any exceptions to the standard terms presented in the data room. The Q&A is also an efficient way to clarify points raised in the documentation, for example confirming with the target's management what a field in the census means or who certain policy documents apply to.
3. **Management call**: a one to two-hour call with the management team of the target business allows for more qualitative areas to be explored, for example drivers for the turnover levels exhibited, employee sentiment/culture and reward philosophy.

The information provided at the due diligence stage of a transaction will often be limited, so the HR due diligence provider will need to make some assumptions to test with management, through Q&A and the management call. As this work is being conducted before a deal has been signed, it is unlikely that there will be sufficiently granular data to fully plan for Day 1 in terms of benefits/payroll cutover and communication, or detailed preparation for consultation. This is also not the purpose of a due diligence exercise. Typically, after the deal is signed, more granular data will become available and closer working between the parties is possible, which allows for the planning to take place before the deal completes.

TIMELINE

A typical buy-side HR due diligence exercise will take four to six weeks to complete, with the time-frame often dictated by the overall deal process and exclusivity periods. An illustrative timeline showing the various stages of work is shown below, but this is highly dependent on the timing and quality of the information provided and availability of management for a call. Interim (red flag) reporting may also take place during the due diligence exercise.

Illustrative timeline of an HR due diligence exercise

	Monday	Tuesday	Wednesday	Thursday	Friday
Week 1	Submit information request list and names for data room access			Initial review of data room and revise information request list	
Week 2	Review populated data room and raise Q&A Update analysis for new documents and Q&A responses provided				
Week 3	Prepare and send agenda for management call Continue to monitor data room / Q&A and update analysis			Management call	Follow up questions from management call
Week 4	Continue to monitor data room / Q&A and update analysis			Write up findings	
Week 5	Refine reporting and discuss with commissioner				

The typically short timescale means that HR due diligence needs to be targeted at material issues, with ruthless prioritisation to retain focus on helping to inform the buyer's key questions of whether they should buy the asset and how much they should pay for it.

As noted, more detailed planning on how to execute the transaction from a people perspective is typically not possible with the limited data provided at this stage, and in the timescales available. However, initial thinking can be carried out at this stage on how people-related risks that have already been identified can be mitigated.

AI solutions can help to speed up the analysis for a due diligence exercise, including by translating documents, summarising policies and preparing comparisons between different contractual terms. Analytical tools can make the basic investigation of the data more efficient, leaving more time to explore potential trends or anomalies and form conclusions. However, it is crucial to remain cautious about the potential risks associated with using AI, such as inaccuracies in generated summaries or translations. Human oversight is always required to validate AI-driven findings and provide professional insights.

The due diligence work will be iterative throughout the period as new information is provided and Q&A responses are received.

REPORTING

The conclusions of the HR due diligence work will typically include a summary of the key aspects of the target from a people perspective and the potential implications for the buyer. This may include a quantification of additional costs or savings, prioritisation of risks and a discussion of potential next steps. The reporting can be split into stages, with an initial high-level red flags document, followed by a more detailed report. This is likely to be accompanied by a discussion of the findings and an opportunity for the commissioner of the work to ask questions.

The HR due diligence report may need to be redacted if it contains information shared in a "clean" data room. Alternatively, data might be aggregated or anonymised if there are sensitivities about the individual information or implications contained in the report. This will typically be agreed and managed with competition law advice from the buyer's and seller's legal advisers on what can and cannot be shared.

In addition to the commissioner of the report, third parties such as banks, lenders, and warranty and indemnity (W&I) insurers may need to see the due diligence report. This can be managed but will require additional disclosure or the agreement of hold harmless letters.

The summary about the target business might draw on data analytics tools to visualise the current population and any interesting aspects like a skew in the grades, location footprint or the spread of service lengths. Many technology solutions provide the ability to interrogate the data in real time, which can be particularly helpful in exploring a complex global population.

Reporting will include financial considerations and other risks the due diligence commissioner may opt to include in transaction documentation (for example the sale and purchase agreement) and/or planning. This is explored further in the next section.

HOW COMMISSIONERS USE THE FINDINGS

Some may view HR due diligence as "nice to have" rather than essential, covering areas that may improve the business but are not deal-critical before signing. However, the findings can often influence the purchase price and highlight vital protections that should be included in the transaction documentation.

The scope of HR due diligence, and the way in which the findings are presented, will impact how quantifiable and actionable the results are for the user. A due diligence report that focuses on an early-stage high-level plan for operationally running the business may not make the people-related financial implications apparent. Considering each area of the framework set out in the previous section systematically can help to uncover the items that may require a price adjustment, or operational risks for which protections might be needed.

In this section, we first consider translating the HR due diligence findings into potential price adjustments and then look at the non-financial issues that a legal solution could address in the transaction documentation.

FINANCIAL IMPLICATIONS FOR THE PURCHASE PRICE

A simplified, illustrative formula for calculating the purchase price for a business is set out below. In this guideline, we will consider how HR due diligence can lead to adjustments to the EBITDA reference value and to debt items being deducted to arrive at the purchase price. As can be seen from the formula, these adjustments will have a direct impact on the amount to be paid for a business.

The fact that financial buyers are increasingly dedicating resources to investigating people-related costs and risks in the businesses they look to acquire highlights the potential materiality of HR due diligence adjustments within this formula. There is an awareness that these issues can impact the exit value and how much to pay for a business to generate a return.

EBITDA x Multiple – Debt = Purchase Price

EBITDA stands for **earnings before interest, taxes, depreciation and amortisation**. It is a measure of a company's profitability that shows how much money it generates before accounting for certain expenses.

The multiple is a number that is **used to value a company** based on its EBITDA. It is typically derived from the market value of similar companies in the same industry.

Debt refers to the amount of **money that a company owes** to creditors or lenders. Other adjustments might be made to reflect the normal level of working capital.

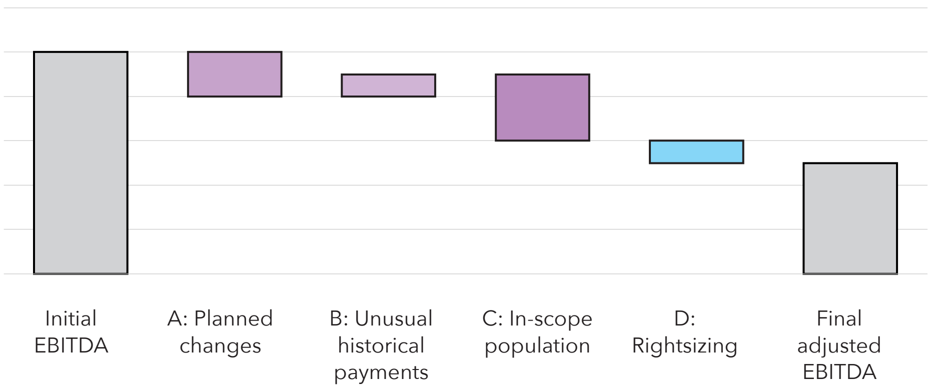
The purchase price is the **amount of money that a buyer pays to acquire a company**. It is calculated by subtracting the debt from the product of the EBITDA and the multiple.

EBITDA

Adjusting EBITDA to arrive at a "normal" EBITDA figure is essential for valuation purposes. Normalisation helps to provide a more sustainable view of the business's performance by removing unusual or non-recurring items. The impact of the EBITDA multiplier amplifies the significance of any adjustments made to EBITDA to arrive at the purchase price.

Adjustments to people-related costs can be a matter of judgement so views are often dependent on the perspective and interests of different parties. The findings from the HR due diligence workstream should be understood and incorporated into the overall deal valuation, ensuring consistency with the treatment and assumptions made in other adjustments.

Illustrative EBITDA bridge



This chart illustrates some example findings from HR due diligence, which could be considered as EBITDA adjustments and impact the purchase price. This list is not exhaustive.

A: Planned changes – adjustments could be made for changes to recurring costs that are expected to impact EBITDA on an ongoing basis. Planned changes could include enhancements to employee benefit plans or an expected change in the annual cost of long-term incentive plans as performance criteria or the eligibility for the plan are altered.

B: Unusual historical payments – such payments could be removed as they distort the EBITDA. Unusual payments may include one-off bonuses (such as historical transaction bonuses) or one-off severance costs. Judgement may be required on the one-off nature of costs. For example, severance may not be considered a one-off cost if exercises take place in most years and are expected to continue in the future.

C: In-scope population – in carve-out transactions, the employees who will be in the transaction perimeter need to be determined. The perimeter definition has a direct impact on the expected employee costs in the new entity. The costs may need to be adjusted if it is judged that the perimeter has not correctly provided for the number of people who will transfer to the business and/or the number of people who are required to run the business. Vacancies can distort the true employee cost in any transaction, whether standalone or carve-out.

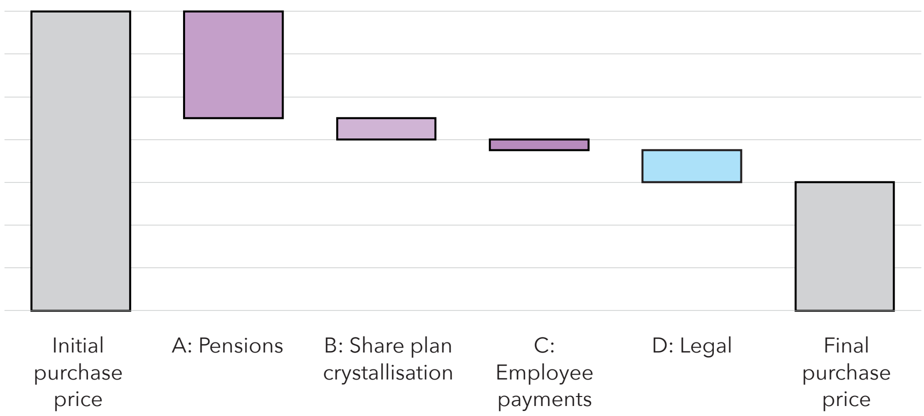
D: Rightsizing – the buyer may wish to allow for potential synergies or dis-synergies when considering future EBITDA. This could include an expectation that the HR function could be reduced in size (saving money and increasing EBITDA), or the due diligence could uncover an undersized HR function that will not be able to manage the volume of change required in the organisation. The buyer may choose not to disclose these adjustments to the seller but consider them in their own workings.

DEBT

Debt typically refers to one-off items that the business will need to settle after the transaction. These debts will have been built up while the business was owned by the seller, who will therefore have to bear the cost. By deducting these items from the price to be paid, the buyer passes the cost back to the seller.

Accounting standards can provide a guide to some debt items by looking at what could be recognised on the balance sheet as a liability of the target business. These are often accepted as legitimate debt deductions in global transactions, although practice may vary by jurisdiction.

Illustrative debt bridge



This chart illustrates some example findings from HR due diligence, which would be considered as debt-like and impact the purchase price. This list is not exhaustive.

A: Pensions – long-term employee benefit plans typically build up a debt to be paid at a future point when an employee retires from the business. These liabilities can include pension plans but also termination indemnities or jubilee payments. There are a variety of long-term employee benefits in different parts of the world and there can be arguments for treating them as debt-like or as a regular annual cost of the business depending on the characteristics of the plan and local market practice.

B: Share plan crystallisation – on a transaction, the vesting and exercise of share options may be accelerated. To the extent that these awards will be funded by the target business, the payment could be considered debt-like. The net cost to the business should be considered after allowing for any income from the payment of the exercise price by participants and the cost of any related taxes.

C: Employee payments – one-off payments linked to the transaction are often made to employees. One example is a retention bonus scheme planned and implemented by the seller, with the payments to be made from the target business, which would be considered debt-like. The buyer may choose to implement a further scheme at their own cost to manage retention for the years after completion, which would not be a debt item.

D: Legal – there may be potential employee-related payments that are not yet known with certainty. For example, it may be dependent on the outcome of a court or tribunal ruling in an employee dispute, or a rectification for past compliance issues, like a failure to automatically enrol employees in a pension scheme or pay employees the correct holiday pay. If these payments are likely to be made, a best estimate may be included as debt items. Accounting standards on contingent payments can be a useful guide to treatment here.

OPERATIONAL RISKS AND POTENTIAL PROTECTIONS

Legal protections

Employee-related risks cannot always be directly priced into the financials of the transaction. There may be risks that are considered "known unknowns", where the data and access provided during the due diligence have not been good enough to positively determine whether something is an issue or not, and/or its value. There may also be "unknown unknowns" that have not been alluded to during the due diligence process and perhaps are unknown to the target management themselves. These "unknown unknowns" might include legacy exposure to an off-balance sheet pension scheme, or employee rights that have been preserved following previous acquisitions under laws such as the UK's Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE).

The legal documents for the transaction can be used to help mitigate these risks through:

- **warranties** – an assertion by the seller that information disclosed is complete and that facts about the business are true; and
- **indemnities** – a recourse to the seller for payment if particular issues or costs arise in the future.

One risk to be particularly vigilant for in HR due diligence is a lack of integrity and professionalism in the leadership team as this could damage the reputation and value of the business. A broader review of public information for key individuals can help identify potential risks. This is unlikely to be managed through value adjustments or through transaction documents but should be considered in plans for the future leadership of the business and any changes or mitigation actions needed.

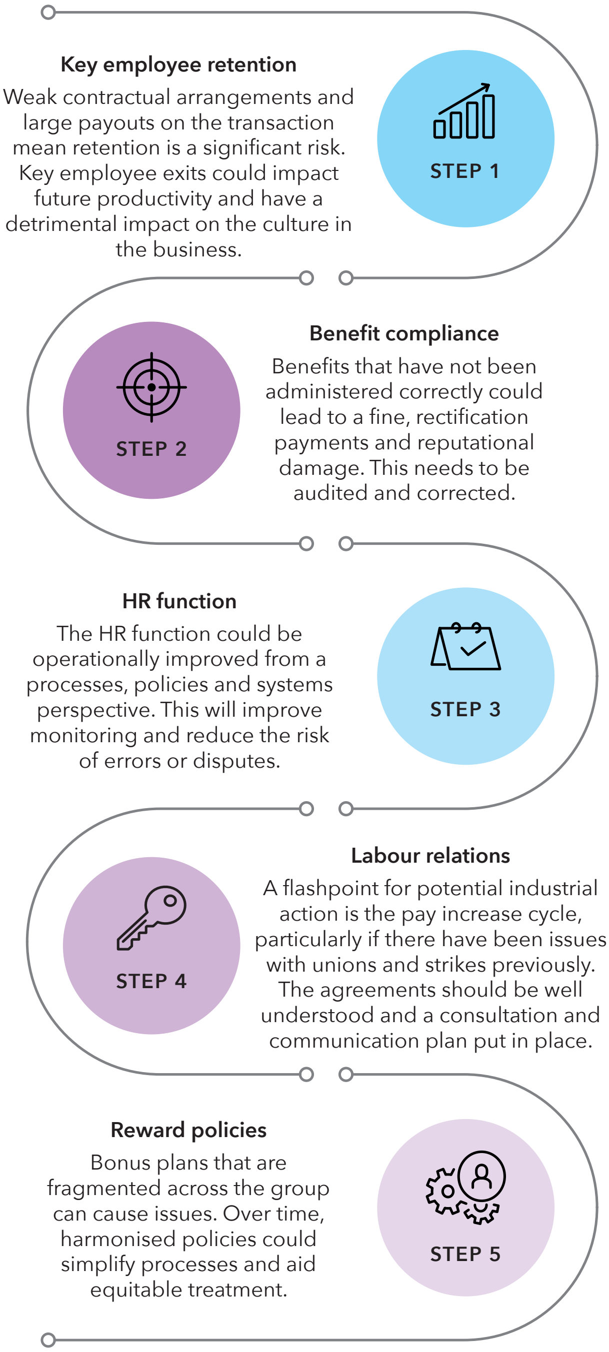
PLANNING FOR THE FUTURE

In addition to risks, the HR due diligence process may also identify neutral information about the target business, or information that presents an opportunity for the future. This information can help with initial planning about how the business could be run, key priorities after completion from an HR perspective, or provide an insight into how complex an integration with another business could be.

HR due diligence can be a critical mechanism to understand and implement the appropriate steps to mitigate attrition during and after a transaction, and therefore preserve value and business as usual operational activity.

The diagram below illustrates operational risks often identified in HR due diligence and the potential order in which management may choose to address them after completion.

Illustrative order for addressing operational risks



The level of detail and time available at the due diligence stage is rarely suited to comprehensive future planning. An ideal output for a due diligence exercise would include high-level views on areas of focus, potential costs and points to investigate further.

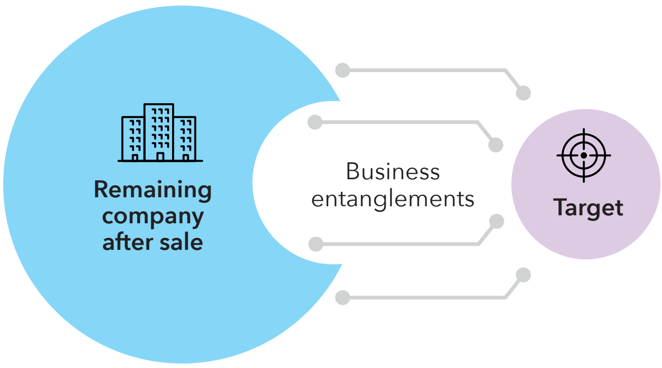
CONSIDERATIONS FOR SEPARATION AND INTEGRATION TRANSACTIONS

The guidance so far is all relevant for a company that is being bought or sold with the intention of continuing as a standalone business. If the target is being carved out of a larger group, and/or there is an intention to integrate it with the buyer's company in the future, HR due diligence can provide additional insights.

Separation of target from seller's business

In a separation, HR due diligence may be commissioned by the seller (VDD for the benefit of the buyer or sell-side advice) to aid understanding of the target business from a people perspective.

Schematic of separation



In a separation, people-related business entanglements can create complexities, particularly concerning the allocation of employees across the remaining and new companies, leadership team compensation, group-managed compensation and benefits, and shared HR functions. Particular areas of focus include:

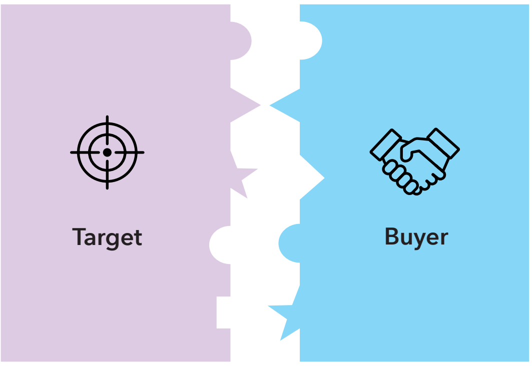
- **Workforce profile and structure:** how many and which employees are transferring with the business, and how the list has been determined, particularly for employees in shared service functions like HR and finance. Employee transfer steps, including required consultations, may also be covered.
- **Leadership team:** overview of leadership experience and credentials. It may also cover any changes required to leadership remuneration packages, for example, share plans might crystallise and need replacement. In addition, an overview of director service agreements will allow the buyer to assess if they may need to be updated to ensure they offer adequate protection going forward. For example, post-termination restrictions may need to be updated.
- **Benefits**: new benefit plans may be established for the target business's population outside of existing group-wide schemes, with an expected change in costs. It will also cover the vendor contracts and systems in place, which legal entity they sit with and what will be novated. Defined benefit pension schemes may require a lump-sum payment at the time of the transaction and negotiation with pension scheme trustees.
- **HR function**: how an HR function has been or will be established for the target business, and any transitional service agreements (TSAs) that are proposed for systems or services. For example, this could be to provide continuity in payroll processing for a short period of time following completion of the transaction.

Due to the complexities and potential cost implications of separating out a business, the buyer is also likely to commission HR due diligence to test the assumptions that have been made by the seller. The buyer can rely on a VDD report, which is prepared for their benefit, and request top-up due diligence to look at areas not covered by the VDD. For example, a buyer may want to confirm that the business is the right size and not over or underweight from a people perspective.

Integration of target with buyer's business

In an integration, the buyer may extend the scope of HR due diligence to include a comparison with their own (or a portfolio company's) business in order to start assessing how the businesses might come together in the future.

Schematic of integration



This could include:

- **Culture and employee engagement**: cultural clashes can be one of the key reasons why an integration fails in the long term, with high employee turnover and low morale impacting costs, reputation, brand and productivity. Although a detailed employee survey cannot be carried out at the due diligence stage due to access restrictions, initial indicators can be compared to see if significant cultural issues will likely need to be managed. For example, the number and type of employee grievance, disciplinary and whistleblowing cases can be a useful source of information for this purpose.

- **Reward**: the two organisations are likely to have differences in their reward cycles, maturity of performance management, and bonus structure and metrics. Starting to compare them side by side can be the first step towards a future harmonisation plan.

- **Benefits**: differences in the benefits provision could mean an increase in costs later as the businesses are harmonised to "level up" to the more generous pensions and health benefits. Employee engagement and questions also often centre around lower or no cost benefits, such as Christmas parties, parking spaces and birthday holidays, so it is also worth being aware of these differences.

- **Labour relations, compliance and disputes**: a comparison of where there are trade unions or works councils can identify differences in practice, or in the terms of the agreements. Combining the businesses may bring more people into the scope of a collective agreement. Future integration plans will also need to take account of employment law considerations, including potential restrictions or compliance with information and consultation obligations.

There is unlikely to be sufficient information, access and time for detailed integration planning at the due diligence stage of a project. However, due diligence can provide early indicators of potential issues that can be explored in more detail after the deal has been signed.

HOW HR DUE DILIGENCE IS USED ALONGSIDE OTHER DUE DILIGENCE WORKSTREAMS

The commissioner of an HR due diligence report is also likely to commission work in other areas, such as financial, commercial, tax and legal due diligence. Some of these areas have been addressed by other ICAEW guidelines, so this guideline does not repeat what they cover. However, there are some areas of potential overlap between different due diligence workstreams, or where links should be made. For example, the information requested as part of HR due diligence is likely to overlap with the information requested by legal or tax workstreams. However, the lens through which this information is reviewed and the conclusions drawn are likely to focus on different areas. The information request lists should be coordinated across workstreams to reduce duplication wherever possible.

The various due diligence workstreams may be undertaken by the same practitioner, or different practitioners, but alignment should always be possible between different workstreams.

A call should be arranged early in the project to align on the scope of work and key areas of investigation across workstreams and avoid duplication or missing areas. It is also useful to keep workstreams aligned on areas of enquiry and findings as the due diligence progresses. Key areas for HR due diligence to consider when reviewing findings across multiple workstreams include:

- **Financial due diligence**: HR due diligence will look in more detail at certain lines in the income statement and on the balance sheet and should align with the analysis being carried out as part of financial due diligence. Findings that impact net debt or EBITDA adjustments are typically captured by the financial workstream from across all other workstreams.
- **Tax due diligence**: overlapping areas of enquiry will often include share options, employee benefits, fair pay (for example, minimum wage compliance) and the status of independent contractors. However, HR due diligence will consider these from an employee management and employment law perspective, including future annual cost expectations. Tax due diligence will primarily consider the tax treatment and potential tax liabilities and penalties associated with non-compliance in these areas.
- **ESG due diligence**: diversity and inclusion policies and their interaction with legislative requirements in different countries will be of interest to both ESG and HR due diligence. Similarly, both workstreams will explore the culture of the target business. The findings in these areas tend to be shaped by the different priorities and viewpoints placed on them (for example, employee management or regulatory compliance).
- **Legal due diligence**: this workstream will consider similar documents to HR due diligence such as the terms of the share option grants, pension plan rules, HR policies and procedures and employment contract provisions. Legal due diligence will focus on the risks and potential areas of weakness across these documents but will typically not quantify the potential debt or impact on future EBITDA of any changes. HR due diligence will typically review the same documents from a more financial and operational viewpoint.

When correctly planned and managed collaboratively, multiple due diligence workstreams can enhance and complement each other to provide a richer and more considered conclusion.

VARIATIONS IN THE SCOPE

Businesses come in all shapes and sizes. HR due diligence can add value in all businesses, but the key questions and areas of focus will vary depending on the business context.

The scope of an HR due diligence exercise should be tailored to the specifics of the target business to ensure the best use is made of the limited time available. The size of a company and its history can lead to different routes of questioning. The target's location and industry can also help to guide likely areas of focus based on knowledge of specific issues that may apply to that region or sector. Additionally, topical issues may emerge, for example when new legislation is introduced or considered. The examples provided in this section illustrate how the scope might vary for different types of target businesses.

The party commissioning the work should also align the scope to their priorities (or in the case of VDD, those of a typical potential buyer) and the context for the transaction. The scope and level of detail required will be dictated by the level of risk that a buyer is willing to take in the transaction purchase price and future profitability, linked to the overall business case and materiality of the acquisition, among other things.

The scope needs to make allowances for the data that is likely to be made available, and restrictions and limitations on the work carried out must be made clear. The level of data available will depend on the systems in place, level of centralisation and timescales for the transaction. The number and role of people from the target business involved in the transaction will also place limits on the data that can be sourced and made available. If only a tightly controlled group of people know about the transaction it can mean that they will only have time to respond to the most value-critical requests across all workstreams. In some scenarios no-one from the HR function will be involved in the transaction, so the opportunity to understand the processes and HR management of the business will be more limited.

An HR due diligence exercise can be tailored to fit the future plans for the business. For example:

- if a buyer is expecting to integrate the target business with their business or another company, the HR due diligence can start to uncover possible areas of misalignment or potential synergies. This could include side-by-side comparisons of benefits, contractual terms, bonus plans and culture;
- if the buyer wants to grow the business significantly, the HR due diligence can investigate whether the fundamental mechanics are in place to manage and support this growth from a people perspective; or
- if a seller is carving out a business, the HR due diligence can explain how separation will work from an employee transition perspective, how the HR function will be established in the new business, and the reward and benefits policies of the new entity.

All businesses have employees, so they all have something worth exploring.

SIZE OF THE BUSINESS

Employee-related costs and risks need to be investigated in any size of business. The framework introduced earlier in this guideline will work for large and small companies, but will have different questions and areas of focus under each topic as illustrated below.

The focus will also depend on the commissioner of the due diligence report. A corporate strategic buyer looking at these entities might have more questions about harmonisation and cultural fit with their own organisation, whereas a financial buyer might be more focused on the standalone cost modelling over the next five years.

	Large, long-established business	**Small, recent start-up business**
Workforce profile and structure	Have there been acquisitions over time that mean the population is fragmented? What differences are there between the different population groups or locations?	To support rapid expansion, are temporary workers being used who should be classed and costed as permanent employees? Are current vacancies costed?
Culture and engagement	What do the latest engagement surveys show and what steps have been taken to address any issues?	How does the target management define the culture and values of the organisation? Is the business retaining employees as it expands or are there areas of higher turnover? How might employees view the buyer's culture?
Leadership team	How long has the leadership team been in post? Have there been any reputational issues with previous leaders and are there any disputes related to exits? What are the contractual terms for senior leaders?	How is the future success of the business interlinked with the founder(s)? What is the strategy for retaining or transitioning knowledge from the founders after the transaction?
Reward	What process is followed to benchmark and increase salaries each year, and where does the company set pay relative to the market? What initiatives are in place to address gender pay gap issues and manage pay compliance?	How are salary increases and bonuses managed across the organisation? Is there any policy/plan documentation or are payments more ad-hoc and discretionary? How have bonus payments varied over time?
Benefits	Are defined benefit pension plans recognised on the balance sheet and how should these be valued within net debt?	Are the benefits provided typical compared to local expectations? What matters do employees care most about (including non-financial) and should be maintained after the transaction to aid retention?
HR function	How big is the HR function compared to industry benchmarks? Does the business use centres of excellence and support centres to improve operational efficiency?	How mature is the HR function (less HR infrastructure can mean a higher risk of compliance issues)? Are policies and processes in place? Are there learning and career development programmes to manage top talent? Is there an HR system or is information managed manually?
Labour relations, compliance and disputes	What unions and collective bargaining agreements are in place? Have there been strikes historically or other issues with industrial relations? Are there any material disputes or compliance issues that need further investigation and/or rectification?	How is compliance with requirements for reward and benefits being monitored and managed, including for overtime, minimum wage, holiday pay and automatic enrolment?

LOCATION

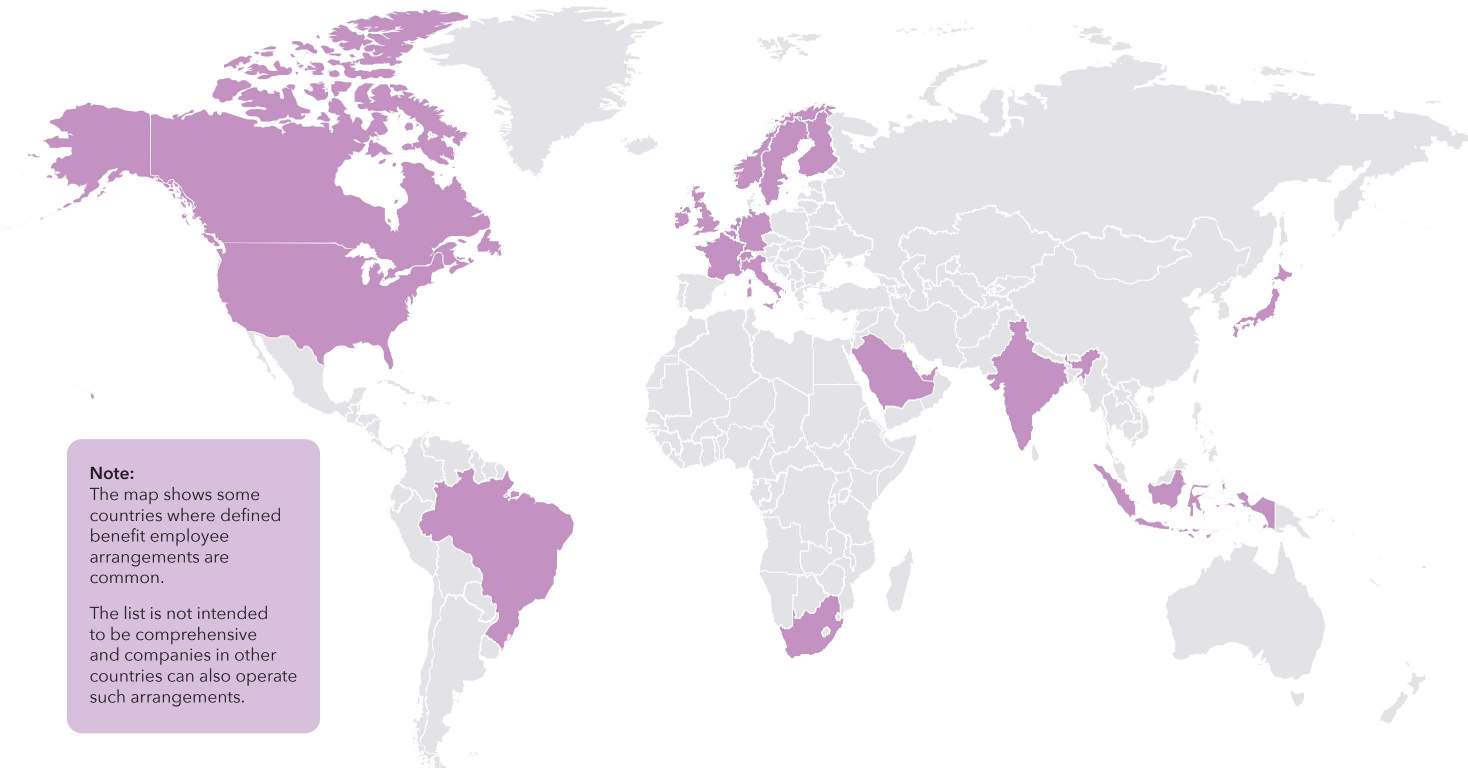
When looking at international companies or companies headquartered outside of the UK, the principal areas of the scope that will need to be adapted are reward, benefits and labour relations. The other areas of the scope are relatively constant across geographies as they relate more to the internal workings of the business.

To comment on labour relations, it is useful to engage with local advisers who understand the regulation nuances and what to look out for. This local lens can also help to interpret the information provided to identify what is in line with typical practice, or to differentiate between issues that all companies are facing compared to an unusual target-specific problem. One example of this is employee litigation or disputes, which are more common in some countries and so less remarkable than they would be if seen elsewhere.

Reward policies may be internally managed but an understanding of local legislation, such as minimum wage requirements and any expected changes to these, will assist with pricing in potential cost increases. The local labour market and inflation expectations will also impact the level of risk associated with employee retention and future cost increases.

The type and cost of benefits typically offered will vary by country, so a local view will help provide an understanding of whether the target's offering is particularly generous or poor compared to their competitors. The map below highlights locations that might typically have long-term employee benefits that represent a debt-like liability for the company. This can range from an established occupational pension system to statutory end-of-service awards. This is not an exhaustive list, nor will businesses in these countries always have these types of liabilities.

Key countries with defined benefit liabilities



INDUSTRY

The key questions an HR due diligence exercise will focus on will differ depending on the industry, as illustrated below.

This is not a definitive or exhaustive list and businesses can vary significantly within the same industry.

	Consumer products and services	Energy and resources	Technology, media and telecommunications	Health care and life sciences	Financial services
Workforce profile and structure			Carve outs and mergers are common – how will this work from a people perspective, for example organisation, reward, benefits and HR policies?	Are temporary workers being used to fill shortages? Is this cyclical, how much is it costing and are there operational risks?	
Culture and engagement	How high is employee turnover (by location/ function)? What is driving this and what are the associated expected future costs?				Does the employee culture support a strong compliance approach within the organisation? How do processes compare to the buyer's organisation?
Leadership team		Are there key people who understand the infrastructure and need to be retained while knowledge is transferred?		Are there key people in research and development who need to be retained while knowledge is transferred?	
Reward	Are there processes to ensure compliance with minimum wage, and how much is the total wage bill expected to increase by in future?		What will happen to the growth and share plans on the transaction, how does performance compare to targets, and how will the payments be funded?		How is remuneration currently structured for the senior team including deferrals? What will happen after completion of the transaction?
Benefits		Is the target participating in defined benefit pension schemes, including schemes that do not appear on the balance sheet, and are they in net debt?			What benefit plans are in place, and do any of them have associated liabilities that might be treated as a net debt item?
HR function			How are start-ups running HR processes in their business and what might change after completion of the transaction?	How high is employee turnover and are the recruitment and onboarding processes fit for purpose?	
Labour relations, compliance and disputes	Are there ongoing employee disputes, for example around overtime, equal pay, shift work etc?	For networks across Europe particularly, what local labour laws and collective bargaining agreements need to be considered for the transaction?			

WHAT COMES NEXT?

HR due diligence will not include a detailed plan for implementing the transaction or for running the business in the long term. However, it will provide a head start for these activities to take place after signing.

If the deal progresses successfully, there will be two further broad phases of work after signing.

- **Signing to completion** – this will typically involve more, but not full access. The key focus of this phase is preparing for the transaction to take place successfully, including any required employee consultation and transition steps and setting up a new entity where relevant (including a new HR function and incentive and benefit plans).
- **Post-completion** – the companies will be under common control and the buyer will have full access to people and data within the business. This stage could include a period of bedding in, or it could involve immediate initiatives to transform the business.

There are typically at least a few weeks between signing and completion, although this can take much longer when approvals are required for the transaction, for example from competition authorities. A brief outline of the HR steps that could be undertaken in the signing to completion phase is provided overleaf. This illustrates the planning and activities that do not need to be completed during the due diligence period and are more suited to the following phase. However, these activities build on the due diligence enquiries, as shown in the sidebar boxes. This list is not exhaustive.

SIGN TO CLOSE: DAY 1 PLANNING

Transactions are a time of change for employees. The planning should consider changes happening across the organisation in detail to minimise disruption to business continuity and increased employee turnover. This will include planning what will be changing, the best time and method to communicate those changes, and to which groups of employees. However, the buyer cannot directly communicate with acquired employees at this stage. The activity will typically be driven by the seller, but the buyer is likely to provide input to explain their future vision for the company and try to alleviate employee concerns (if relevant). The culture of the seller and the buyer should be considered as part of the change and communication management strategy.

This activity will be supported by the understanding of the employee engagement, turnover levels and culture acquired through HR due diligence. This will help the buyer focus attention on possible issues.

Labour relations

In addition to the best practice communications with employees, there may be legal requirements for consultations or the need to engage with employee representative groups as part of the transaction. The need for consultations will typically depend on the location, number of employees and the mechanics of the transaction, for example, if employees are being transferred to a different employing entity. The collective bargaining agreement terms and the history of labour relations will also inform what steps need to be taken to consult and how long this is likely to take.

This activity will be supported by the understanding of the employee population, and labour relations and requirements for employee consultation.

Leadership

Engagement with and retention of the leadership team will be given particular focus. During this period, individual agreements may be designed for the key employees that the buyer wants to keep within the business. A mix of financial and non-financial incentives would often be considered (such as development opportunities, culture, engagement and benefits). Confirmation of the leadership team will be a first step in defining any future organisation structure, so the decisions around who to retain need to progress during this period.

The knowledge about current compensation packages and likely payouts on the transaction for each individual, from share options and other agreements, will help to inform retention decisions.

Reward and benefits

The design of new reward programmes for post-completion will need to be considered, particularly if a business will no longer be listed or is being carved out of a wider company. A refresh of reward programmes can also link incentives to the new strategic direction of the business. In a carve-out scenario, new benefit plans will also need to be established for the new business. If a buyer is considering future harmonisation of reward and benefit programmes with their own, then these plans can be considered, although they would only be implemented after completion. Considerations may include analysing any legal restrictions, whether anyone may be adversely impacted by the changes, and what the likely cost of change would be.

An understanding of the existing reward and benefit programmes along with initial side-by-side comparisons will give this planning and analysis a head start.

HR function

From an HR perspective, there is often a significant amount of work to prepare the business for a transaction and manage employees through the change. Ensuring that the HR function is set up for success to support this activity will be a key part of the planning during this stage. In addition, any planning to continue, separate or change the HR function will need to be completed. This includes considering separation or integration of HR systems, how payroll will be run on Day 1, having the required policies in place and accessible to all employees, and managing the transition of recruitment pipelines and training.

The HR function, vendors and outsourcing arrangements summarised in the HR due diligence will help to plan the changes and impact on the HR function.

POST-COMPLETION

Following the due diligence exercise, the buyer may want to conduct a deep-dive into potential issues that were identified, once full access to data has been granted and it is possible to organise a full employee survey. Initially, this is likely to focus on areas that may be non-compliant in order to manage potential exposure to fines and rectification payments, before moving on to aspects that could be run more effectively in line with best practice. Managing the people costs and risks through the full transaction lifecycle will be a long-term process, with each stage building on the one before. The HR due diligence exercise provides a strong foundation to help accelerate and shape the future stages.

CONCLUDING REMARKS

HR due diligence is a broad and flexible exercise that can be used to help quantify potential people-related costs and risks, and provide a basis for future HR planning.

HR due diligence is applicable to and can add value in nearly all transaction scenarios. It is typically designed to consider a wide range of potential costs and risks. The limited time available during the due diligence phase of a transaction cycle should be spent looking at the biggest of these issues without limiting the scope of the work. Initial planning can help to tailor the scope to fit the circumstances of the deal, the specifics of the target business, and align the output with other due diligence workstreams.

In addition to informing the transaction price and legal documents, the HR due diligence process also lays the groundwork for HR relationships with the other side of the transaction (where applicable) and provides the foundations to kick-start more detailed HR planning after signing.

Studies consistently demonstrate that people-related issues can destroy value in transactions if not managed correctly. HR due diligence is now prevalent in the market as best practice and is the first step towards mitigating this risk in transactions. It is a value lever you should not ignore when planning your next transaction.

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