



Due Diligence in Impact Investing

Literature Scan

July 2019

The [Michael Lee-Chin Family Institute for Corporate Citizenship](#) at the Rotman School of Management, University of Toronto, helps current and future business leaders integrate sustainability into business strategy and practices.  

Research conducted by Lee-Chin Institute staff.

This brief provides an overview of academic and practitioner literature of due diligence in impact investing, including:

- Definitions of due diligence;
- Review of the literature on due diligence from academic and business press sources, and;
- Select impact investment practitioner approaches towards due diligence.

Definitions of Due Diligence

In general usage, “due diligence” means taking “reasonable care” when investigating a claim or making a decision. In finance, due diligence describes the process of assessing possible investments using information gathered from intermediaries or directly from a potential investment.

Due diligence in an investing context is the term given to all activities associated with evaluating a potential investment (Tuck School of Business, 2004). The term gained prominence in the US Securities Act of 1933 (Sjostrom 2006). The Act required dealers and brokers to conduct due diligence on the companies they were selling and disclose the results to investors, in which case they were not responsible for undiscovered information.

Impact investing, a fast-growing approach to investing that seeks financial returns and positive social or environment impact, has adopted many of the practices of conventional due diligence but has added additional steps to assess the overall impact of the investment. At this time there are a range of approaches surrounding due diligence for impact investing, and no consensus has emerged on the “best” approach.

Definitions used to describe due diligence (in the context of impact investing) include:

- “An iterative process that brings discipline to the investment process” (Toniic 2019).
- “Investor research into the financial, management, strategic, and impact factors for a potential investment” (MIINT 2019).

Due Diligence Literature Review

Howson, P. (2003). *Due Diligence: The Critical Stage in Mergers and Acquisitions*. Aldershot: Gower Publishing Ltd.

One of the most cited sources on the subject of due diligence is *Due Diligence: The Critical Stage in Mergers and Acquisitions*, by Peter Howson. Howson explains what the aim(s) of due diligence should be, the benefits of due diligence, and what activities must be carried out during the due diligence process. Key points include:

- “The aim of due diligence should be to give the buyer an assessment of the risks and benefits of the deal both as an aid to negotiation and as an aid to delivering value post-completion.”
- “Benefits of due diligence:
 1. Understanding the business in depth
 2. Confirming that what is going to be bought is what is thought.
 3. Know the risks of the deal
 4. Plan post-deal integration.”

- “The objective of due diligence is not just to 'audit' or verify past performance. . . [M]ore important for success, it should aim to assess future prospects and show how they can be realized. Due diligence is going to **look out for vulnerabilities**, but at least equal importance needs to be given to **identifying opportunities**. After all, that is the reason for buying a business. Not because it has done well in the past, nor because it is cheap.”
- “Due diligence must have:
 1. Verification of assets and liabilities
 2. Identification, quantification, and mitigation of risks
 3. Identification of benefits
 4. Post-acquisition planning.”
- “Due diligence is not required by law, but it is required in some cases to meet corporate governance requirements, also if the company is publicly traded, a report will be required, and lastly, it can be useful as a defense against charges of negligence in a transaction.”
- “There are different types of due diligence. The most common are shown in the table:

Table 1.1 The main due diligence topics

<i>Due diligence topic</i>	<i>Focus of enquiries</i>	<i>Results sought</i>
Financial	Validation of historical information, review of management and systems	Confirm underlying profit. Provide basis for valuation
Legal	Contractual agreements, problem-spotting	Warranties and indemnities, validation of all existing contracts, sale and purchase agreement
Commercial	Market dynamics, target’s competitive position, target’s commercial prospects	Sustainability of future profits, formulation of strategy for the combined business, input to valuation

Center for Private Equity and Entrepreneurship, Tuck School of Business at Dartmouth, (2004, December 5). Note on Due Diligence in Venture Capital.

Venture capital firms receive and evaluate many potential investments each year. Having a due diligence process facilitates the evaluation of the potential investments and avoids delays at identifying suitable investments and at executing a deal.

1) Screening Phase

- In the *screening phase* (10% to 15% of the investments pass this phase), the decision is based on investment fit and investment potential.
 - **Investment fit:** The firm evaluates if the investment under consideration is aligned with the investment thesis, and determines if it matches its investment criteria, such as the stage of the business, the geographic region, the size of the deal, the industry, etc.
 - **Investment potential:** The investment firm evaluates some aspects of the firm, such as:
 - **Management:** Quality of Management
 - **Market:** Large, high growth markets
 - **Product/service:** It is solving a problem of the customer profitably?
 - **Business model:** How the company will make money and operate over time

2) Business Due Diligence Phase

- Once an investment passes the *screening phase*, the second phase – *business due diligence* – begins. Like the *screening phase*, *business due diligence* is an investment potential evaluation, but it is performed in greater detail and depth. Factors evaluated include:
 - **Management:** Specific questions to evaluate the quality of management.
 - **Market:** Entrepreneurs must be able to clearly identify their target customers and how they will reach them. Identify the competitive landscape.
 - **Product/service:** Evaluate the scalability of the product/service.
 - **Business model:** Evaluate if the company understands the key drivers of profitability.

De Cleyn S. and Braet, J., (2007). “The Due Diligence Process-Guiding Principles for Early Stage Innovative Products and Venture Capital Investments.” *The Journal of Private Equity*. Summer, vol. 10, no. 3, pp. 43-51

The due diligence process must be organized and structured to make it more efficient and reliable in the interest of both parties (namely, the investor and the company).

De Cleyn and Braet present a four phase procedural approach to conduct due diligence in small businesses. Each phase has a different degree of confidentiality, and the depth of the deliverables also varies.

Phase I: The Non-Confidential Part

- “A small brochure containing non-confidential information about the business and/or invention must be produced. This document should be used as a teaser to motivate the other party to pursue the deal.”
- “The prospect should be sufficiently interested in going further into negotiations.”

EXHIBIT 2

Information in Phase I

One should organize the White Book according to these items. By so doing, readability and structure are assured and equally available to everyone participating in the process.

Market	General business description
	Non-confidential summary of the business plan
	Brochures and leaflets on the company’s products and services
	All press releases
Employees	Number of employees
Technology	Non-confidential description of the technology
	Scientific publications
Finance	Financial reports (if published)
Liability	Text of granted and pending patents
	Other (non-patent) IPR
Corporate records	Statutory records

Phase II: The First Piece of the Confidential Part

- A non-disclosure agreement NDA and a collaboration agreement, sometimes called Letter of Intent, should be signed prior the beginning of this phase.
- A white room/data room should be organized with these items: Market, Technology, Material Agreement, Operations, Finance, Accounting, Corporate records, Stock Records, Employee, Governmental and Liability.

Phase III: The Second Piece of the Confidential Part

- **The most important phase in the due diligence process** - A Conditional Purchase Agreement is signed, and the deal becomes legally binding.

- “This phase of the due diligence process emphasizes completeness of data transfer. Among other highlights is the future vision of the disclosing party.”
 - The data room for this phase contains much more detailed information.

Phase IV: The Finalization

- “This last phase fashions the deal flow into its final shape. Normally phases II and III will have unveiled sufficient information and commitment to arrive at fast closure of the final deal. . . . Therefore, the agreement made under phase III can be converted into a final agreement”

Galbraith, C. S., DeNoble, A. F., & Ehrlich, S. B. (2009). The Use and Content of Formal Rating Systems In Angel Group Investment Initial Screening Stages. *Journal of Small Business Strategy*. 20(2), 61-79.

The paper describes the process associated with the due diligence screening phase. While in previous academic literature, this phase is part of the due diligence process, in this paper is treated as “pre-due diligence step”. The scoring system included here presents a useful way to approach the screening phase, making it more effective and less subjective.

The findings of the paper (based on their work with 38 angel investor groups) are as follows:

- One of the more objective processes employed in early stage screening is the use of formal rating systems.
- “81.5% of the Angel Investment Groups used a committee of members to perform an early screening of submitted business plans, while the remaining relied solely upon the managing partner or senior director to perform early screening”.
- Quality/experience of management team was the most important dimension even for angel groups that doesn’t use a formal scoring system.
- “Of the Angel Groups that used a screening committee, approximately 48% also employed a formal scoring system”
- “Nine of the committee-based screening processes employed the ranking system available in the AngelSoft software program.”
- The following table indicates what dimensions were most commonly identified within the scoring system:

	Percentage Mentioned in Scoring Sheet (N=15)
Quality/Experience of Management Team	100.0%
Characteristics of Product or Service (Including IP Protection)	93.3%
Market and Competitive Characteristics	86.7%
Completeness/Quality of Business Model/Strategy	80.0%
Transaction/Valuation Characteristics	53.3%
Quality of Pro-Forma Financials	46.7%
Geographical Location	26.7%
Exit Strategy	20.1%
Prior Performance	13.4%
Stage of Technology Development	13.4%

Sammut, S. M. (2012). "What every biotech entrepreneur needs to know about VC due diligence: Research and regulation." *Journal of Commercial Biotechnology*. 18(2)

Due diligence in Venture Capital (VC)

- "Due diligence is an art and not a science; more judgment is applied than method...A better term (for due diligence) is "homework." Better indeed, because the burden of this homework weighs far more heavily on the entrepreneur than on the venture capitalist."
- "Beyond the first cut, diligence is less a "yes" or "no" process, and more a means of learning what will have to be managed."
- "Time frame of diligence has been compressed. This is not a reflection of competition for deals, but a desire to make decisions and move on to the next opportunity."
- "A few VCs use a "checklist," but most VC's rely on building an experiential inventory over time. One way of looking at diligence is that it is a recapitulation of everything that has gone wrong in prior investments... With experience, the issues all merge together, and the process becomes intuitive."
- Major areas in the due diligence process include:
 - i. Business Concept
 - ii. Capitalization Planning
 - iii. Technology/Intellectual Property Assessment
 - iv. Market Assessment
 - v. Financial Assessment
 - vi. Management Team Assessment
 - vii. Milestones and Capital Needs Assessment
 - viii. Corporate Partner Assessment.

Gilligan, J. Wright, M., (2014). *Private Equity Demystified (3rd ed.)*. ICAEW, London.

- "The private equity industry has been instrumental in the development of best practice in pre-acquisition due diligence."
- "Due diligence will cover all material relationships, contracts and assets of the target company using a combination of legal, accounting, market, insurance, environmental and any other specialist advisers".
- "Typically, full due diligence will take not less than three or four weeks to complete and will be a condition of any initial offer a private equity fund makes."
- "The outputs of the due diligence process will be extensive and have often enabled private equity purchasers to use their enhanced knowledge to negotiate from a position of strength after the completion of diligence."

Literature Review: Due Diligence in Impact Investing

Impact investment is a fast-growing part of the investment universe, meaning that many due diligence practices are in constant development. Contrary to literature concerning due diligence with “traditional” investments, the academic literature about due diligence in the impact investing space is scarce and is mostly based on testimonies of success from the “first movers” who have made use of due diligence in their impact investing activities.

Ormiston, J., Charlton, K., Donald, M. S., and Seymour, R., (2015). "Overcoming the Challenges of Impact Investing: Insights from Leading Investors" *Journal of Social Entrepreneurship*. 6 (3): 352-378.

The Importance of Established Due-Diligence Processes

- “The same professional processes and techniques for due diligence on mainstream investments are used by all investor types for impact investments. This practice is essential in meeting fiduciary obligations and appropriately analysing investment opportunities. Furthermore, these processes help investors understand where impact investment sits within their portfolio. **The consideration of social impact is an additional element integrated into this process.**”
- This is what impact investors said about their due diligence process:
 - *There is no difference in terms of due diligence in how we assess our impact investments compared to other investments. The only thing is that we are more stringent on labelling them as [impact investments] because they have to meet certain criteria to be labelled as such. Due diligence is the same but there is added due diligence to determine whether they are truly sustainable. (Tim van der Weide, PGGM)*
 - *The due diligence process is quite standard for what a fund of funds manager would do...looks and feels similar to other investment businesses at JP Morgan and, in fact, the processes are largely borrowed from our own institutional processes elsewhere. There is nothing dramatically different...the one component Overcoming the Challenges of Impact Investing 367 of our process that is unique relative to more traditional investment activities is whether or not the impact objective is being achieved. (Amy Bell, J.P. Morgan)*
 - *We treat all impact investments as ‘normal.’ The financial analysis rigour that goes into impact investments is exactly the same as other investments... (Simba Marekera, Christian Super)*
 - *It’s very straightforward for us to determine whether an organisation is investible, we look at the same things that a financial institution would look at. The organisation needs to have some track record and be able to demonstrate a commercially viable business model. One of the nuances I would add is that for us when we talk about investible social enterprises we also want to see a willingness to be held accountable for both the social and financial returns generated. (Bessi Graham, donkey wheel Foundation)*
 - *... [our due diligence] includes everything you would expect a typical venture capital firm to consider; in addition, we look at social or environmental indicators and sector impact. (Rosita Najmi, Omidyar Network)*

Principles for Responsible Investment. (2014). *Integrating ESG in Private Equity – A guide for general partners.*

In 2006, the United Nations launched the Principles for Responsible Investing (PRI) initiative, in order to elaborate a set of sustainable investment principles. The PRI developed this guide for investors to incorporate Environmental, Social and Corporate Governance (ESG) measures into their investment process in the **Screening** and **Company Deep Dive** phases.

Phase I: Screening

“The initial screening of an investment opportunity can provide an early stage assessment on how it aligns with a GP’s [general partner’s] ESG objectives.” The investor could:

- “Compile a checklist to screen for high-level ESG risks before embarking on detailed due diligence... the content of this checklist will be dependent on both LP demands and on the GP’s own strategy.”
- “A GP could periodically review this list to incorporate new developments or insights”
- **In Practice:** Bridges Ventures, an UK private equity firm, during its due diligence analysis, focuses on three aspects:
 - Thematic Impact: “Linking the investment output with the target societal outcomes”
 - Additionally: “Whether the investment will create positive change relative to what is likely to happen otherwise”
 - ESG factors: “Identifying other environmental, social and governance factors that signal both risk and opportunity for value creation”

Phase II: Company Deep Dive

“Due diligence on ESG factors (through desk research and site visits) is an iterative process with repeated interaction between the different actors (e.g. the portfolio company, investment manager, external ESG consultant and/or internal dedicated team of ESG operational specialists). Repeated interaction helps to unearth the information necessary to obtain a full understanding of all relevant ESG issues.” The investor could:

- “Hire an external advisor to conduct detailed ESG due diligence. GPs, particularly smaller GPs, may find it difficult to have in place a fully dedicated ESG professional or team due to resource constraints”.
- “The relevance and materiality of ESG factors for an investment will vary depending on its characteristics. Industry toolkits can help a GP to identify relevant ESG regulations, standards and risks and opportunities specific to a geographical region and industry sector.”
 - “The Dutch DFI FMO offers an easy-to-use tool which provides the GP with an initial assessment of E&S risk against IFC Performance Standards regarding a particular investment. The assessment is based on the sector and geography where the company is active. The tool also provides E&S opportunities/value add for the GP to look into.”
 - “The IFC ES-Toolkit offers GPs an extensive overview of templates and tools which can be deployed during the due diligence phase of the investment process. For example, the toolkit includes an overview of the eco-labels which are available in the industry. This sort of information can help GPs develop a better understanding of existing initiatives and a general sense of where a particular industry is heading with regard to environmental trends. This can in turn help focus the due diligence process.”

- “The SASB standards can be used to identify the relevant ESG issues for a company by industry and the GRI Sustainability Reporting framework includes sector guidance to identify ESG issues. A GP can review the issues highlighted in these frameworks and incorporate the consideration of these into its due diligence process, as relevant.”
- “The CDC toolkit provides a comprehensive overview of issues related to geography, sector and industry and supplies frameworks for GPs to map these out during due diligence. During the interviews, this toolkit was repeatedly referred to as a helpful resource for GPs integrating ESG into the due diligence process and their operations.”

Combs, K. (2014). More Than Just A Trend: The Importance of Impact Investing. Corporate Finance Review, 18(6), 12-18.

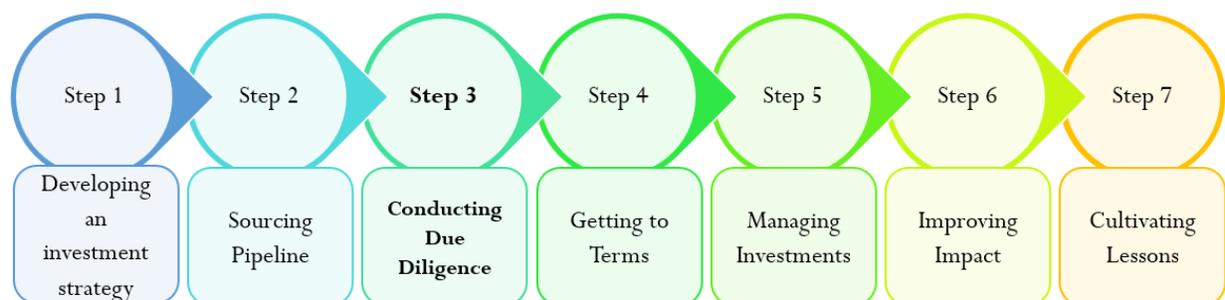
“Although (due diligence is) still a work in progress, there are resources available for investors who want to measure the effectiveness of an impact investment. These include:

- Bloomberg offers an ESG data service on thousands of public and private companies.
- There is a B Corp certification (given by the non-profit B Lab) that applies to companies that have met rigorous standards of social and environmental performance, accountability, and transparency.
- There are organizations such as the Global Impact Investing Network (GIIN), which is a non-profit with a diverse global membership of firms that want to expand the resources and information associated with impact investing.
- ImpactBase is an online searchable database of impact investing vehicles, and it includes the ability to compare characteristics of funds and products along with their track records
- There are established Impact Reporting and Investment Standards (IRIS), which are metrics that can be used to measure social, environmental, and financial performance. The Global Impact Investing Rating System (GIIRS) utilizes IRIS metrics and provides a comprehensive rating of social and environmental performance.”

Impact Investment Practitioner Approaches

[TONIIC. The 7-Step Framework. Step 3: Conducting Due Diligence.](#)

Toniic, a community of impact investors, developed “The 7-Step Framework” based on the experiences of successful investors to guide early-stage impact investors. The seven steps are:



According to Toniic, the due diligence step (Step 3) was the step which received most comments from impact investors. Practices employed are diverse; while some perform a simple due diligence, others have a more rigorous approach. Toniic members suggest the following as guidelines for the due diligence process:

- **Be the lead or empower a lead:** “Identifying a point person who manages interactions with the entrepreneur simplifies communication lines between the investors and entrepreneur and helps clarify team roles and responsibilities from the start.”
- **Stage the questions:** TONIIC suggests that instead of sending all the questions in the Information Request at once, it is better to answer some critical questions first before going more in-depth with more questions. Answering all the questions from the Information Request takes a lot of time from entrepreneurs, thus, staging the questions facilitate the job for both parties and increases efficiency in the due diligence process.
- **Conduct an on-site field visit**
- **Perform reference checks**
- **Perform an initial impact assessment:** “An initial impact assessment should aim to understand the intentions of the entrepreneur around impact, the status of their operations in terms of staying accountable to that mission, and an assessment of the tracked impact of the venture. Taking a GIIRS online assessment survey will take most English-speaking entrepreneurs 2-5 hours, and allow investors to benchmark their impact intentions and performance against global peer groups. Note that GIIRS is working on a new assessment process targeted at early-stage enterprise. For now, it recommends that start-ups (with less than one year of operation) focus on completing the Impact Business Model.”

Impact Engine, (2017, Mar 31). [Impact Due Diligence: The questions we ask.](#)

Impact Engine, an impact investing firm that manages venture capital and private equity funds, uses the following set of questions to guide the due diligence process to determine if the company they are investigating will have a positive impact:

- *ALIGNMENT*
 - “How aligned is the impact with our core areas of focus where we believe we can make the best judgments and provide the most support?” This question is to evaluate the fit of the impact created by the company with the investment thesis.
 - In Impact Engine’s case, an impact investing firm that manages venture capital and private equity funds, has a focus on education and health, and therefore, ensures that they have the resources (experience, connections, etc.) to provide support to the companies they invest in.
- *CORRELATION BETWEEN REVENUE AND IMPACT CREATION*
 - “How ‘baked into’ the business model is the impact?” This question evaluates if impact is tied to revenues, that is, if impact is an integral part of the product/service.
 - “What are the scenarios in which this company can lose its impact focus?”
- *COMPANY UNDERSTANDING OF IMPACT CREATED*
 - “How deeply does the entrepreneur and leadership team care about and understand the problem they are solving?” The firm wants to make sure that entrepreneurs have a clear understanding of the impact that the product is creating, the problem they are trying to solve and their commitment to impact.
- *MEASUREMENT*
 - “What evidence is there that the company’s product or service will lead to specific outcomes that matter?” “Companies must be able to demonstrate the potential to achieve significant social or environmental outcomes.”

- “How will the company be able to measure impact—immediately and over time?” Discuss the data that can be collected by the company not just to demonstrate and measure impact, but to demonstrate value to customers.

Luscher, D. Lower, A. (2017, Sep 17). *ADAP's Four-Hour Due Diligence*.

A Different Approach to Poverty (ADAP) is an impact investing fund that invests in early-stage entrepreneurs who are working to eradicate poverty. ADAP recently unveiled a due diligence process can be completed in four hours.

ADAP works with accelerators, incubators and others in the early – stage impact ecosystem. If a company passes the “Ten-minute take”(a quick review to evaluate if the company matches its investment criteria), ADAP has an initial conversation with the entrepreneur. In this phase of the process the company considers these three initial screens:

- Trust in the entrepreneur
- Understanding of the business model
- Caring about what the company does

“After this initial screen, ADAP evaluates the businesses around the Seven S’s:

- **Solution** - Does the company address a critical social issue?
- **Shift** - Does the solution represent a different approach to poverty?
- **Staff** - Does the company have quality leadership and team?
- **Scalable** - What is the company’s appetite and ability to grow?
- **Sustainable** - Are the unit economics viable, and does the company have a clear path to profitability?
- **Strategy** - Does the company have a well-defined strategy?
- **Series A** - Will the company be attractive to investors likely to come in on Series A?”

According to ADAP, the rationale behind the four hour approach is as follows:

- The quicker entrepreneurs can get to a yes or no decision on doing a deal, the sooner they can return their full focus to building their business. The worst decision for most entrepreneurs is a lengthy “maybe.”
- Time spent with entrepreneurs post-investment is even more important. Pre-investment, an investor is judging the entrepreneur.
- There is only so much analysis you can do on an early-stage company. The quality of the entrepreneur and the business model, and strong alignment on core values, are just as important factors in seed-stage investing

Cheney, A. L., C.P.A., Merchant, K. E., & Killins, R., Jr. (2012). *Impact investing: A 21st century tool to attract and retain donors*. *The Foundation Review*. 4(4), 45-56

Greater Cincinnati Foundation (GCF), is a 50-year-old community foundation with over \$500 million in assets and an average impact investment of \$580,000. The due diligence process in GCF consists of three phases:

- “First, GCF’s grant making committee reviews the social return of the impact-investment project. Using this committee for this purpose ensures consistency with the foundation’s community investment framework. If there is no social return, then the project will not move forward.”
- “The second phase is a high-level review by the impact investment committee, which conducts a preliminary analysis of the financial terms and structure of the proposed deal. Committee members were selected for their

legal, banking and lending, and small business and entrepreneurial expertise.” GCF’s consultants, Imprint Capital Advisors, provide a summary memo at this stage.

- The third phase: “If the opportunity looks promising as an investment, then (the consultants) will conduct a full due diligence review of the deal and produce a detailed report and recommendation for action at a second meeting of the impact investment committee. This in-depth review process takes about eight weeks.”
- “The process is iterative and nonlinear and does not always go exactly as ‘planned.’”

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