ACFE
Association of Certified Fraud Examiners

Grant Thornton

Managing Fraud Risks in an Evolving ESG Environment

ENVIRONMENTAL | SOCIAL | GOVERNANCE

TABLE OF CONTENTS

FOREWORD

Environmental, social, and governance (ESG) issues are some of the most important topics discussed in the boardroom today. In an increasingly interconnected world where information flow is measured in nanoseconds and trends go viral in a heartbeat, organizations can quickly find themselves in the center of a maelstrom. An executive posts personal views regarding a controversial topic on social media, evidence surfaces about unfair labor practices, a supplier is discovered to have been polluting the environment. In the age of cancel culture, the possibility of these headlines strike fear into the hearts of executives everywhere.

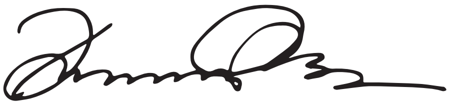
As consumers, employees, and investors are paying more attention to these topics, ESG issues have become a major consideration for individual and institutional investors. The rise of ESG-focused investing should, on its face, be a movement defined by trust, good governance, and accountability. After all, the movement to promote corporate action on environmental, social, and governance standards is aimed at making progress on values and shared prosperity.

But, as with many new trends, the regulatory and reporting frameworks related to ESG are struggling to keep up with the pace of change. Without consistent standards, the opportunity for fraud is increased. At the same time, organizational leaders feel pressured to make commitments and to report positive progress toward ESG goals. For example, 40% of major companies have issued a public commitment to reduce emissions. The pressure to achieve those goals will rise as investors rely more heavily on such ESG-related metrics, on par with traditional financial reporting.

Anti-fraud practitioners have a critical role to play in the future of ESG programs. They can help organizations understand the internal and external fraud risks presented by this paradigm. They can also implement new internal controls to prevent material misrepresentations and fraudulent reporting of ESG metrics. In addition, they can help protect the company against ESG-related external frauds by unscrupulous suppliers.

Understanding how ESG programs impact your organization and getting a clear look at new and emerging fraud risks in this area are paramount. Leveraging existing frameworks such as the *Fraud Risk Management Guide*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and the Association of Certified Fraud Examiners (ACFE), can help organizations better prepare to address those risks in a structured and holistic manner.

Organizations that take a proactive approach to mitigating their ESG-related fraud risk will have a unique advantage in the marketplace. They will be better protected and prepared to navigate the ever-changing landscape to tackle complex environmental, social, and governance issues head-on.



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INTRODUCTION TO ESG

ESG BACKGROUND

Environmental, social, and governance (ESG) refers to nonfinancial factors that may influence how investors, donors, consumers, and workers choose to engage with an organization. ESG management and reporting focuses on tangible measures and intangible values of an organization. Those measures reflect standards of sustainability, ethical management, and quality of employment within an organization.

ENVIRONMENTAL

The "E" in ESG refers to the "environment." Specifically, it reflects the goals and objectives an organization has established to protect and conserve the natural world. It considers things such as sustainability and carbon reduction efforts.

SOCIAL

The "S" refers to the "social" efforts an organization endorses to show that it values people and considers things such as diversity, equity, working conditions, and social justice.

GOVERNANCE

The "G" refers to organizational "governance" and specifically relates to an organization's ethics. For example, governance includes aspects such as management behavior, transparency, and executive compensation.

FIG. 1 **EXAMPLE ESG FACTORS**

Historically, investor and donor decision-making relied heavily on a company's financial performance. However, ESG has increasingly become an important consideration when deciding to invest or donate. Likewise, consumers and workers are increasingly looking to patronize and work for companies that better align with their ESG values.

While the popularity of ESG has risen sharply over the last few years, it is not a new concept. A 2004 report first used the term ESG, referencing "recommendations by the financial industry to better integrate environmental, social, and governance issues in analysis, asset management, and securities brokerage."[1] That report laid the groundwork for the popular interpretation of ESG. That is, the way a company manages ESG issues may reflect on its overall management quality and correlate to the company's reputation, performance, and shareholder value.

An increasing focus on ESG should not come as a surprise given the increasingly globalized, interconnected, and competitive global market. As individuals, many of us are adopting conscious consumer buying habits, such as choosing a shoe brand in part because the company donates shoes to disadvantaged groups, or a grocery store that donates portions of its proceeds to a food bank. These examples offer a glimpse of some of the nonfinancial ways that consumers may perceive "value" in their business encounters.

Investors, donors, consumers, and workers make choices based on the ethical decisions of the businesses with which they engage. Companies have taken notice and realize that strong cultural awareness and positive ESG-related policies have gone from a fringe specialty to a core necessity. This focus is required to secure a strong brand and market presence that influences decision-makers, from investors and donors to consumers and employees.

According to Just Capital, **over 40%** of Russell 1000 companies have announced a commitment to reduce emissions with a **quarter** of those companies disclosing a Net Zero emissions commitment by 2050.[2]

[1] www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/sustainability-at-ifc/publications/publications_report_whocareswins__wci__1319579355342
[2] www.justcapital.com/news/more-corporate-climate-commitments-are-essential-to-limiting-the-effects-of-global-warming

Additionally, the increase in "sustainable investing" has driven asset managers to expand their portfolios of ESG-related assets. From 2018 to 2020, ESG assets under management grew from $22.8 trillion to $35 trillion, with estimates that they will make up a third ($53 trillion) of all assets under management by 2025.[3] The social and economic consequences of not investing in ESG—or appearing to not invest—are larger now than ever.

Due in part to media coverage of climate initiatives, the environmental component of ESG receives significant attention. Savvy, climate-conscious investors are looking for organizations and businesses that demonstrate climate-conscious initiatives. Furthermore, internationally mobilizing sustainability initiatives, such as the Race to Zero Campaign[4] and the Paris Agreement,[5] have accelerated the importance placed on climate for both the producer and consumer of goods and services. As such, organizations experience severe pressure to adopt specific measures that show they are conducting business in a way that supports the environment.

Over the last few years, social- and governance-related issues have also been in the public eye. For instance, there is increased focus on forced or child labor used in manufacturing production. In 2019, the U.S. Customs and Border Protection detained 12 shipments that it believed to hold merchandise linked to forced or child labor. Detainments increased to more than 1,400 shipments in 2021 and are on pace to surpass 3,000 shipments in 2022.[6] This trend has increased pressure on organizations to confirm the integrity of their manufacturing production and supply chains.

[3] www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum
[4] www.unfccc.int/climate-action/race-to-zero-campaign
[5] www.un.org/en/climatechange/paris-agreement
[6] www.cbp.gov/newsroom/stats/trade

INTRODUCTION TO ESG FRAUD

Pressure is mounting on the C-suite to prove meaningful progress in setting and achieving ESG goals. This pressure has resulted in the creation of a business climate where the real risk is *not* adopting the principles of ESG. The development and implementation of ESG-friendly programs can be costly, both financially and logistically. Pressure to adopt principles of ESG creates an environment ripe for fraud, and fraud thrives wherever the stakes are high.

INTERNAL ESG FRAUD

Internal ESG fraud is fraud committed by management or employees. It often involves intentional acts to deceive others by the reporting of false or misleading ESG information; by omitting material ESG facts; or by the improper disclosure of ESG initiatives, programs, and metrics. Internal ESG fraud may also involve corruption. Examples of internal ESG fraud include the failure to disclose the use of child or forced labor, harvesting resources from illegal sites, or illicit trade and trafficking.

Internal ESG fraud often occurs due to a lack of supervisory oversight, poor accountability, and/or a weak internal control environment. Additionally, as organizations increasingly link more executive compensation to ESG progress, certain ESG fraud schemes may be unintentionally incentivized.

EXTERNAL ESG FRAUD

External ESG fraud is fraud conducted by parties outside an organization, such as vendors in an organization's supply chain, contractors, customers, or other third parties. External ESG fraud often involves an intentional act to deceive an organization by omitting material facts or disclosing false or misleading information relating to ESG programs. As suppliers feel the pressure to adopt ESG policies consistent with their key customers, external fraud schemes may develop relating to the reporting of intentionally false and misleading representations about ESG policies and adoption. Alternatively, unscrupulous ESG-related vendors could take advantage of an organization by supplying inaccurate ESG information that results in the organization fraudulently reporting ESG-related data.

One significant example of external ESG fraud is the sale of fraudulent "green" investments to supply desirable carbon emission credits to offset greenhouse gasses. The sale of these fraudulent investments represents fraud risk for companies and their investors. Companies that buy these credits may unknowingly misreport their carbon position and suffer reputational and regulatory consequences, while investors who buy stakes in either the companies selling or buying fraudulent credits may be subjecting themselves to traditional Ponzi or other investment schemes that exploit uninformed investors.

QUICK FACTS

- Estimates place ESG-driven investment at greater than $35 trillion in assets under management, and ESG-driven investments are on track to exceed $53 trillion by 2025.[7]
- Global sustainability investments now surpass $30 trillion, up 68% since 2014.[8]
- Nearly nine out of ten millennials report that they want their money to go to sustainable investments.[9]
- Goldman Sachs pledged to take public only those companies that have diverse boards.[10]
- Harvard's endowment is divesting itself from fossil fuel companies, as are those for Columbia, Georgetown, Rutgers, and the University of California.[11]
- NASDAQ issued a rule requiring member companies to publicly disclose board-level diversity in a standardized method and explain if they do not have at least two diverse directors.[12]

[7] www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum
[8] Ibid.
[9] www.usatoday.com/story/money/2018/05/11/millennials-socially-responsible-investing/580434002
[10] www.goldmansachs.com/our-commitments/diversity-and-inclusion/board-diversity
[11] www.npr.org/2021/09/10/1035901596/harvard-university-end-investment-fossil-fuel-industry-climate-change-activism; https://news.columbia.edu/news/university-announcement-fossil-fuel-investments; www.georgetown.edu/news/fossil-fuels-divestment-continues-georgetown-commitment-to-sustainability; www.rutgers.edu/news/rutgers-divest-fossil-fuels; www.universityofcalifornia.edu/press-room/ucs-investment-portfolios-fossil-free-clean-energy-investments-top-1-billion
[12] listingcenter.nasdaq.com/assets/Board%20Diversity%20Disclosure%20Five%20Things.pdf

THE FRAUD TRIANGLE AND ESG

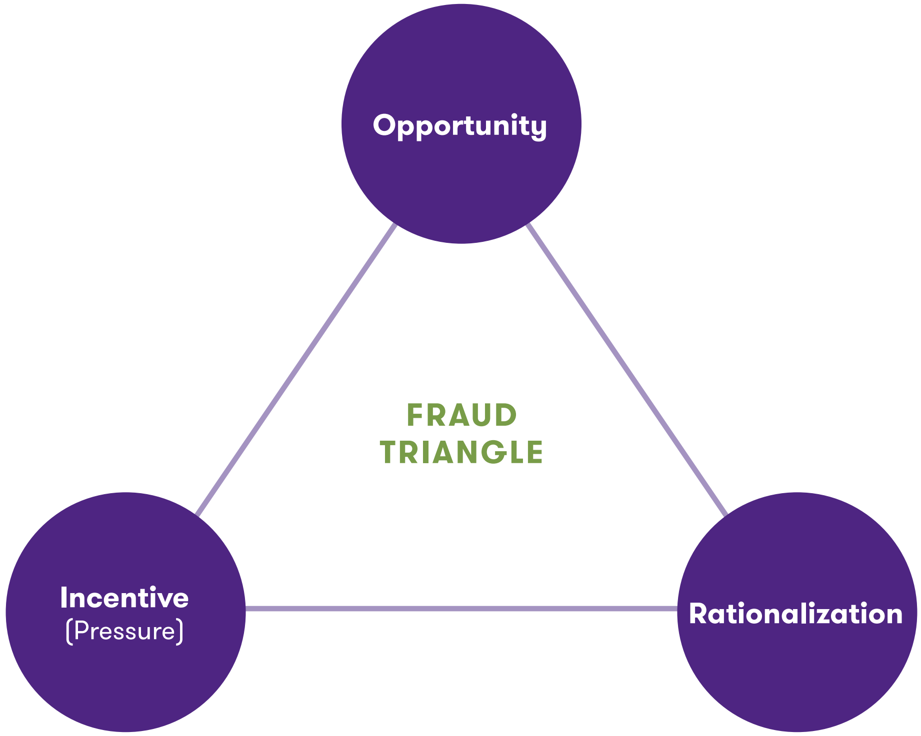
The Fraud Triangle (Figure 2) is a framework describing the conditions that allow fraud to thrive. The three elements of the Fraud Triangle—opportunity, incentive (pressure), and rationalization—are all easily recognizable in the ESG landscape.

OPPORTUNITY

Opportunity describes the environment that allows fraud to occur. The opportunity for fraud to occur increases when an organization lacks a control environment to properly mitigate the inherent fraud risk. In the ESG context, such a control environment could include clear policies that establish ESG metrics, as well as oversight of internal and external actors to ensure compliance with these policies.

With respect to ESG reporting today, benchmarks are limited, and consistent guidance is lacking. Many audiences—even sophisticated ones—lack a full understanding of company-reported metrics. These audiences also have a limited ability to compare ESG claims across companies and sectors, which is essential to find intentional misstatements. Without the proper tools to compare ESG claims, a real opportunity to manipulate metrics exists and opens the door for fraudulent ESG-related vendors and suppliers to exploit immature programs.

FIG. 2 **FRAUD TRIANGLE**



INCENTIVE (PRESSURE)

Pressure describes the perceived burden potential fraud actors might experience that would incentivize them to commit fraud. There is enormous pressure on the C-suite to make—and achieve—ESG promises. The pressure is particularly intense when it comes to raising capital. Increasingly, private equity, venture capital, pension funds, and public entities are insisting on reviewing a company's ESG policies, goals, and metrics. Even privately held companies must raise capital—and when they do, investors are increasingly asking these companies about their supply chain oversight, environmental impacts, executive compensation models, and other ESG-related issues. Increasing investment focus on ESG raises the stakes and increases the pressure to commit fraud. This pressure could also result in reduced scrutiny of suppliers or third parties, as uncovering ESG fraud in the value chain would negatively implicate the company.

RATIONALIZATION

Rationalization is a fraudulent actor's ability to convince themself that the circumstances justified their illicit act. ESG represents many social virtues. Therefore, bad actors may rationalize that making progress on ESG promises is worthy of a reward, not punishment. For example, if an organization comes close—but still fails—to deliver on an ESG promise, the organization may rationalize a misstatement with the justification that "some progress is better than none." In other instances, individuals may justify their actions because the "ends justify the means." If the choice is between providing honest and transparent reporting of poor ESG performance resulting in market losses and layoffs, or cooking the ESG books to show a positive result, it becomes clear how some organizations might rationalize fraud.

DEFINING ESG FRAUD RISK

ESG FRAUD TAXONOMY

Grant Thornton developed an ESG fraud taxonomy (Figure 3), inspired by the ACFE Occupational Fraud and Abuse Classification System, also known as the Fraud Tree.[13] Traditional fraud taxonomies typically look at categories of fraud that internal and external actors perpetrate directly against an organization, such as billing schemes, cyberattacks, or fraudulent reporting. Grant Thornton's ESG fraud taxonomy considers fraud risks through an ESG lens.

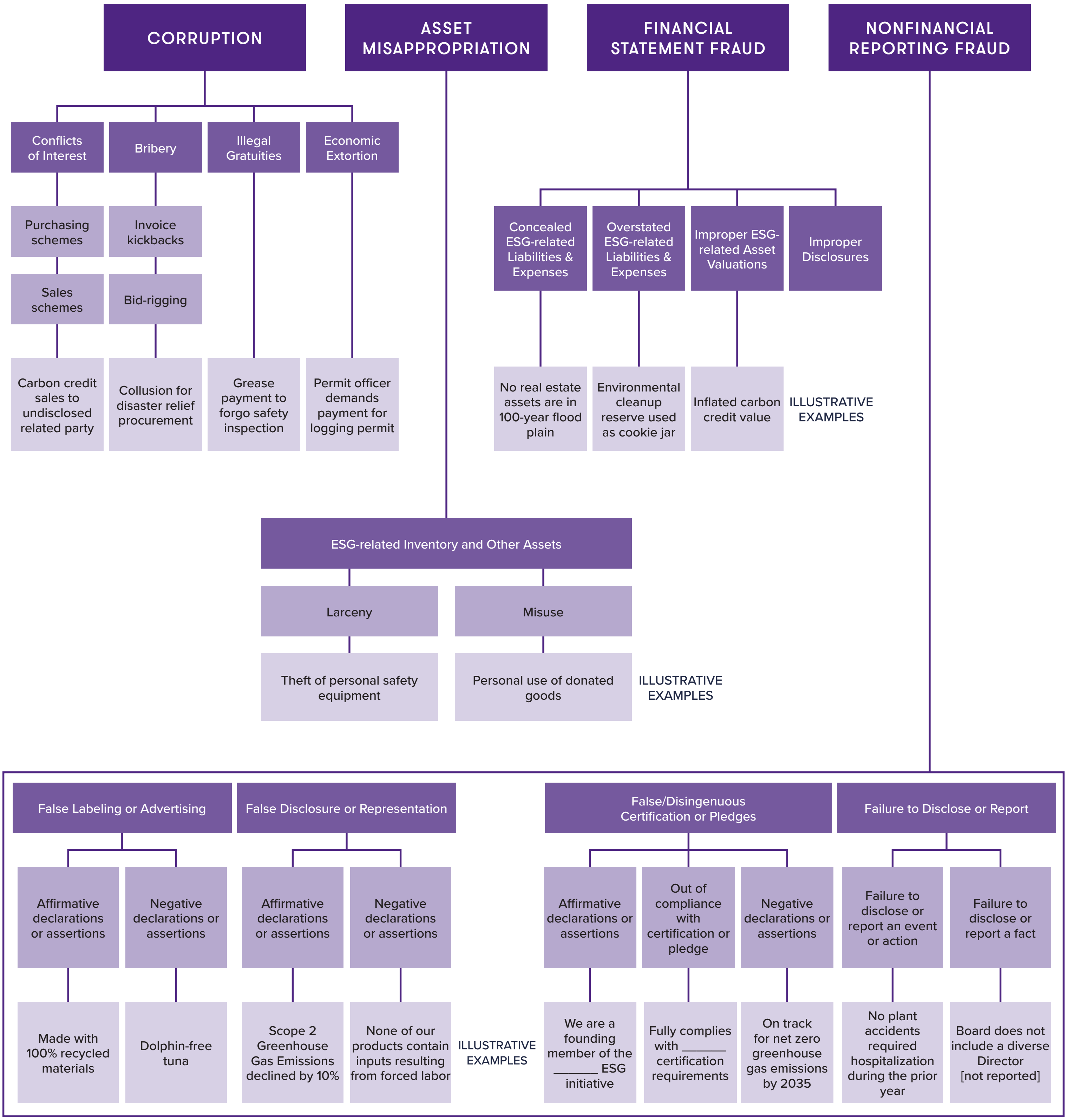
Examples of identified ESG fraud schemes include inflating the value of carbon credits, using modern slavery for production, making illegal political donations, and paying bribes to forgo specific regulation meant for the well-being of the environment or people, among many others.

Some fraud schemes, such as modern slavery violations, affect the perpetrator and the organization receiving goods or services from the perpetrator. ESG fraud and misconduct impacts can occur anywhere in the supply chain.

In addition to the three ACFE Fraud Tree categories—corruption, asset misappropriation, and financial statement fraud—**the ESG fraud taxonomy includes a fourth category called *nonfinancial reporting fraud***, which introduces ESG-reporting-related fraud risks.

[13] www.acfe.com/-/media/files/acfe/pdfs/2022-rttn-fraud-tree.ashx

FIG. 3 **GRANT THORNTON'S ESG FRAUD TAXONOMY**



NONFINANCIAL REPORTING FRAUD

In addition to the three ACFE Fraud Tree categories—corruption, asset misappropriation, and financial statement fraud—the ESG fraud taxonomy includes a fourth category called *nonfinancial reporting fraud*, which introduces ESG-reporting-related fraud risks. This includes schemes in which organizations intentionally omit, falsify, or misrepresent material nonfinancial information to deceive and attract investors, funding, loans, or other benefits. Organizations can make material falsehoods, misrepresentations, and omissions for any ESG Key Performance Indicators (KPI) or related operations. All organizations should integrate ESG reporting metrics and disclosure requirements across their operations, in the same way that financial considerations drive enterprise decisions. Much like financial considerations, these metrics must have rigorous controls around the disclosure and assessment process.

ESG FRAUD RISK ASSESSMENT

Organizations use the ACFE Fraud Tree to conduct traditional fraud risk assessments. They can also use the ESG fraud taxonomy to conduct an ESG fraud risk assessment or to enhance a traditional risk assessment by considering the entirety of an organization's operations, including third parties. Third parties within the supply chain are a vital piece of an ESG ecosystem, as organizational leadership is accountable for its own business practices and for those of its value chain. For this reason, it is crucial to consider the ESG risks posed by suppliers and customers, in addition to the risks faced directly by the organization.

During a fraud risk assessment, organizations characterize fraud schemes to allow for an enterprise-wide view. This categorization helps to organize a comprehensive approach to assessing fraud risks. To illustrate using an example from the ESG fraud taxonomy, the following is the categorization of a nonfinancial reporting fraud risk:

- **Category:** Nonfinancial Reporting Fraud
  - **Subcategory:** False Disclosure or Representation
    - **Sub-subcategory:** Negative declarations or assertions
      - **Scheme:** Harvest mixing

Harvest mixing occurs when agriculture and fishing entities mix valid goods with illicit goods while declaring all goods valid. For example, a fish supplier might disclose the fish as legally caught when in fact only a small portion of the fish were legally harvested, allowing the bad actors to generate extra profit.

The ESG fraud taxonomy serves as a useful foundation on which to build a tailored fraud scheme library that is appropriate for a specific industry or company. Organizations can then leverage this information during a fraud risk assessment to evaluate the controls in place to mitigate the inherent fraud risk associated with each scheme. In this example, we might evaluate whether disclosures by suppliers are subject to the proper controls to mitigate the likelihood of a harvest mixing scheme.

Organizations should periodically evaluate ESG fraud risks and corresponding internal controls that mitigate those risks by conducting ESG fraud risk assessments. ESG fraud risk assessments can be conducted as stand-alone exercises or combined with broader fraud risk assessments. Either way, the assessments should consider both financial and nonfinancial ESG fraud risks throughout the entire supply chain.

Organizations should periodically evaluate ESG fraud risks and **corresponding internal controls** that mitigate those risks by conducting **ESG fraud risk assessments.**

FRAUD-ABUSE SPECTRUM

When discussing fraud and fraud risk related to ESG activities, it is important to convey there is a spectrum of wrongful or potentially fraudulent behavior that may occur that threatens the integrity of an organization's financials, operations, and reputation. The term *fraud* denotes a criminal act to be proven in a court of law. For the purposes of this guide, we use the term *fraud risk* to mean the possibility that fraudulent activity could occur.

For example, inadvertent mismanagement and negligence when vetting third-party vendors or suppliers may lack malicious intent but still negatively impact the organization's ESG goals. Especially in situations where the pressure to deliver is high, executives may be tempted to avoid asking too many questions about their supply chain or adding rigor to their ESG metric reporting process. This intentional avoidance—or willful blindness—can have disastrous impact.

Perhaps less egregious, organizations might engage in misleading behavior by putting a positive spin on otherwise questionable information. Organizations might be accused of greenwashing—the marketing of environmentally sustainable activity intended to attract ESG-conscious investors and consumers with material omissions or misrepresentation—by making their environmental claims sound more beneficial than they really are.

Likewise, when it comes to social initiatives, many groups have been accused of virtue signaling—a pejorative term for expressing a moral viewpoint with the intent of communicating good character by jumping on a social bandwagon, just for the purposes of inflating their reputation even if their position is disingenuous.

Abusive activities like these do not necessarily rise to the level of fraud. Especially in times of lacking or conflicting regulatory guidance, it is important to understand that such activities fall along a spectrum of behavior. As with any fraud investigation, anti-fraud practitioners need to be mindful of whether these misstatements or omissions are material and if they were made with intent.

ENVIRONMENTAL

With the global spotlight on environmental impacts, companies have more incentive than ever to appear environmentally conscious. Environmental risks, such as increased frequency and impact of natural disasters, have a strong connection to economic and financial instability. Environmental risks can lead to operational and financial loss, such as disruptions to production and changes in asset value.

Over the last decade, environmental decline has been a topic of major discussion from classrooms to boardrooms to Congress and the United Nations. In March 2022, the Commissioner of the U.S. SEC issued a proposal to require public companies to report climate risks and greenhouse gas emissions.[14] Consequently, organizations and anti-fraud professionals alike must be aware of how environmental fraud might occur.

The following are some example schemes of how environmental-related fraud might occur:

- **Harvest mixing:** Mixing of valid and illicit goods while declaring all goods are valid to generate additional profit and nondisclosure gain
- **Environmental standards manipulation:** Falsifying or rigging environmental tests (e.g., emissions software) to falsely claim adherence to standards
- **Inflated carbon credit value:** Inflating the value of a carbon credit, contradicting a fair market value analysis[15]
- **Jurisdictional bribery:** Bribing jurisdictional authorities for a license or clearance to harvest or transport protected wildlife and flora

ENVIRONMENTAL

HARVEST MIXING AND THE FRAUD TRIANGLE

Opportunity: Regulators have difficulty monitoring the fishing behavior of a large and diverse set of actors spread across the globe, which makes it difficult to determine valid goods versus counterfeit goods.

Pressure: Stakeholders have expectations for the fishing companies to meet the seafood demand of consumers (markets, restaurant industry, etc.), creating increased pressure.

Rationalization: Companies may rationalize their behavior by observing their market—“All my competitors are doing it.”

[14] www.sec.gov/news/statement/lee-climate-disclosure-20220321
[15] www.ec.europa.eu/clima/eu-action/eu-emissions-trading-system-eu-ets_en. The EU developed a cap-and-trade system for the fair value of emission allowances (credits) in an effort to decrease total emissions.

SOCIAL

Consumers, investors, and potential employees are all looking at social factors. Thus, businesses face increasing pressure to demonstrate socially minded decision-making across the spectrum of their operations. For example, human trafficking and modern-day slavery have been a focal point in the review and adoption of policies that promote due diligence in sourcing. Likewise, companies are increasingly expected to establish diversity, equity, and inclusion (DE&I) initiatives to show they are committed to a diverse and inclusive workplace.

With regard to modern-day slavery, although international reporting and due diligence standards have been mostly voluntary, companies will likely begin to bear the legal weight of their supply chain relationships in the future. Recently, the EU proposed legislation for a social taxonomy.[16]

As social consciousness expectations rise, companies must ensure they consider the fraud risks inherent in these initiatives. The following are some example schemes of how social-related fraud might occur:

- **Labor condition concealment:** An organization's officers collude with supply chain actors to conceal and misrepresent unsafe and noncompliant labor conditions.
- **Falsified DE&I metrics:** An organization knowingly misrepresents data on DE&I initiatives.
- **Nonconforming social services:** A vendor contracts to provide socially conscious services to support social-wellness programs but is not capable of performing such services.
- **Forced savings and deposit programs:** A supplier withholds a portion of a worker's salary and deposits it into a savings account to which the worker does not have access until their term of work is complete, creating an element of servitude over fear of losing the withheld assets.

SOCIAL

LABOR CONDITION CONCEALMENT AND THE FRAUD TRIANGLE

Opportunity: Limited standards in foreign territory and citizenship states create the opportunity for companies to exploit workers in retail manufacturing companies.

Pressure: The competitive market increases pressure across industries. Lower overhead costs can warrant lower product prices while increasing the bottom line.

Rationalization: Companies may use the rationalization of providing employment opportunities, which decreases the unemployment rate.

[16] www.simmons-simmons.com/en/publications/cl09csqlp16110a47u4pcg3zb/eu-esg-developing-the-social-taxonomy

GOVERNANCE

Corporate governance is a top priority for consumers and investors, as it sets the tone and expectations for how a company interacts with stakeholders. An ethical corporate governance structure provides reassurance to consumers, employees, and investors that the organization has a strong culture that aligns with its core values.

The following are some example schemes of how governance-related fraud might occur:

- **Misrepresentation/underreporting of suspicious activity:** A company willfully disregards suspicious transactions passing through operations with clear indications of illicit activity; a company violates policy and banking regulations for greater cash flow.
- **Clearing and forwarding extortion:** A clearing agent demands payment from an organization for additional bond on top of an existing contract to expedite the import of goods.
- **Violation of independence:** Audit committee members violate conflict of interest standards when engaging in decision-making or do not vet conflict of interest relationships before engaging in decision-making.
- **Capital expenditure misclassification:** An organization misclassifies capital expenditures as ESG-related for the purposes of company reputation, or to meet executive compensation incentives.
- **Illegal tax shelters and underreporting:** An investment management firm unlawfully hides assets and income in overseas tax shelters and sanctioned jurisdictions to generate a higher return and embezzle funds without disclosing to the organization that is investing.

GOVERNANCE

MISREPRESENTATION/UNDERREPORTING OF SUSPICIOUS ACTIVITY AND THE FRAUD TRIANGLE

Opportunity: Money transfer companies might have a reckless disregard for illicit transactions at a heavily trafficked transfer location.

Pressure: A pressure exists at money transfer locations, specifically those that are heavily trafficked, to provide or receive timely support to individuals in need. Money transfers also have cash flow needs they have to maintain.

Rationalization: Money transfer companies might justify ignoring potentially suspicious transactions by rationalizing they are providing opportunities to individuals in other countries who may need the support.

IMPACT

Discussions of fraud most often focus on the financial losses that result. ESG fraud certainly carries financial risks. But the impact of ESG fraud also carries additional compliance, reputational, and other risks. When creating a program to monitor and manage ESG fraud risk, it is important to consider all the risk factors.

With the enormous pressure brought on by ESG programs, executives might be tempted to avoid inspecting their supply chain and internal programs for fear of finding something undesirable. Whether this qualifies as willful blindness, sticking their head in the sand, or turning a blind eye, the problem is unlikely to resolve itself. Unfortunately, in cases where a reasonable person *should have known* about these factors, the consequences can be magnified.

FINANCIAL RISKS

ESG frauds may result in typical financial losses. If, for example, a carbon-offset provider charges for services not rendered, those dollars would be considered a fraud loss. In an internal scheme, if an intentional material misstatement is made during ESG reporting and subsequently discovered, the financial impacts to the organization could be enormous.

As noted in the following discussions, there are additional risk factors to consider. These risk factors may combine to create a vicious cycle that causes the financial loss to multiply.

REPUTATIONAL RISKS

Perhaps a larger risk for many organizations is reputational risk. If a company is thought to have intentionally misled or "looked the other way," it can suffer significant reputational consequences. Investors lose confidence and call into question the accuracy of all company reporting. Customers boycott the brand. High-performing employees abandon the company for an employer that better aligns with their values. These reputational consequences will soon translate into negative financial impacts.

COMPLIANCE RISKS

While regulatory frameworks relating to ESG are still being formed, several types of ESG fraud schemes covered in the ESG fraud taxonomy carry their own compliance risks. For example, some fraud schemes may involve bribery or extortion, the discovery of which can expose the organization to anti-bribery and anti-corruption (ABAC) compliance violations. Such violations carry financial penalties and may invite additional regulatory action and requirements for costly remediation programs. These findings also carry a negative connotation, further exacerbating the reputational costs.

The combined effect of these risks shows that it pays to be proactive. Organizations that preemptively identify ESG fraud risk issues, establish appropriate controls, and take swift remedial action when necessary will fare much better than those who take a more reactive stance.

Organizations that **preemptively identify ESG fraud risk issues**, establish appropriate controls, and take swift remedial action when necessary will **fare much better than those that take a more reactive stance.**

MITIGATING ESG FRAUD RISK

INCREASING ACCOUNTABILITY

As stakeholders demand increased ESG accountability, they must develop tailored ESG frameworks with fraud risk management components that withstand scrutiny. Incorporating proper checks and balances to mitigate the risk of ESG fraud and misconduct is vital.

Despite the lure of misstating ESG reporting, fraud is not inevitable. The key is to install and maintain guardrails; ask hard questions; and consistently enhance reporting, controls, and approaches to integrate ESG reporting into other reporting that undergoes scrutiny. To do this, companies must conduct ESG program activities and reporting with oversight and accountability; ESG reporting should adhere to the same rigor applied to financial reporting.

Rigorous ESG guidance should consider policies, procedures, data governance, and reporting controls. Additionally, an ESG framework should address the traditional management assertions of accuracy, completeness, rights and obligations, existence, and comparability, which are reflective of the principles that auditors rely upon for the assessment of financial audits.

- **Accuracy:** ESG reporting disclosures should have the same rigor as financial statement reporting. The data must be authentic and free from misrepresentation.
- **Completeness:** Organizations should disclose the full picture with thorough information regardless of the weight. This includes reporting all ESG information and disclosures.
- **Rights and obligations:** Organizations should only disclose information that legally belongs to the organization and is permitted for use. This information includes obligations that organizations will have to settle in the future.
- **Existence and occurrence:** Organizations should only report ESG matters that have occurred during the period(s) or that relate to conditions that exist at the time of reporting.
- **Comparability:** Organizations should seek a standardized reporting framework appropriate for their industry to allow for comparability from one reporting period to the next and across organizations within their industry.

Despite the power and lure of misstating ESG reporting, fraud is not inevitable. The key is to **install and maintain guardrails; ask hard questions;** and consistently **enhance reporting, controls, and approaches** to integrate ESG reporting into other reporting that undergoes scrutiny.

MATERIALITY CONSIDERATIONS

Materiality is a key part of protecting organizations from ESG fraud risks. Something is considered material if it would affect the judgment of an informed stakeholder. For example, if an organization's executives know that one of their most important products has a design flaw, that knowledge is material information the executives must disclose accurately, completely, and without delay. The question of what constitutes material information when it comes to ESG is still largely unanswered; however, organizations can rely on this question: *Would this affect a stakeholder's decision-making?*

In the ESG and sustainability context, materiality is separate and distinct from the understanding of materiality under state and federal securities laws and under Generally Accepted Accounting Principles (GAAP). Items thought to be material in ESG programs are not necessarily material for securities law and GAAP purposes. Nonetheless, in the absence of standardized frameworks and definitions for ESG reporting, organizations should apply a consistent process for deciding what is material and what is not. When setting up an ESG framework, considering the following types of questions could prove beneficial in determining materiality:

- Are my company's ESG disclosures subject to the same rigor as our financial disclosures?
- What are our management assertions about ESG, and are controls in place to make faithful assertions?
- Have we considered the risks posed by our suppliers and vendors?
- Have we conducted adequate due diligence with our suppliers and vendors to confirm that their practices align with our ESG objectives?
- What is the plan to disclose and correct any ESG reporting problems?

While such questions provide a helpful starting point, organizations should refine the process for establishing materiality in the coming years as the ESG landscape evolves.

RECOMMENDATIONS FOR MITIGATING ESG FRAUD RISK

It can be difficult for companies to structure an ESG anti-fraud program when they are just starting out, especially with the ESG landscape evolving so rapidly. While there may be challenges, traditional fraud risk management guidance can help. In collaboration with the ACFE, Grant Thornton published the *Anti-Fraud Playbook*[17] to provide organizations with actionable guidance on how to develop and mature a fraud risk management program in alignment with the five key fraud risk management principles outlined in the COSO/ACFE *Fraud Risk Management Guide*. This methodology provides a strong foundation upon which organizations can build a holistic fraud risk management program. While ESG introduces new fraud risks and may require new controls and reporting mechanisms, a strong ESG fraud risk management program should still align to these core principles.

With this approach in mind, the following are recommendations for organizations to consider when building an ESG-informed fraud risk management program, aligned to these five principles.

FIG. 4 **COSO/ACFE FRAUD RISK MANAGEMENT PRINCIPLES**

FRAUD RISK GOVERNANCE: The organization establishes and communicates a Fraud Risk Management program.

FRAUD RISK ASSESSMENT: The organization performs comprehensive fraud risk assessments.

FRAUD CONTROL ACTIVITY: The organization selects, develops, and deploys preventive and detective fraud control activities.

FRAUD INVESTIGATION AND CORRECTIVE ACTION: The organization establishes a communication process to obtain information about potential fraud and deploys a coordinated approach to investigation and corrective action.

FRAUD RISK MANAGEMENT MONITORING ACTIVITIES: The organization selects, develops, and performs ongoing evaluations.

[17] www.grantthornton.com/services/advisory-services/risk-compliance-and-controls/ACFE-global-fraudcon-and-playbook.aspx

FIG. 5 **ESG FRAUD RISK MANAGEMENT RECOMMENDATIONS**

COSO/ACFE Fraud Risk Management Principle	ESG Fraud Risk Management Recommendations
Fraud risk governance	• Define ESG materiality thresholds. • Identify and apply relevant ESG frameworks (see Appendix). • Establish the "tone at the top" by communicating the importance of an ESG-related control and reporting program. • Incorporate ESG-related risks into the organization's risk appetite. • Prepare internal ESG-related policies and procedures to measure employee and vendor actions against objectives. • Define roles and responsibilities related to ESG programs and disclosures. • Advance a culture of integrity, reinforcing the importance of accuracy and transparency.
Fraud risk assessment	• Conduct recurring, targeted ESG-focused fraud risk assessments or incorporate ESG components into the current fraud risk assessment methodology. This should include an ESG-focused supply chain risk assessment. • Solicit feedback from key stakeholders using questionnaires and interviews. • Leverage existing guidance including the ESG fraud taxonomy. • Conduct interactive workshops with key stakeholders to review controls and specific areas of opportunity for risk mitigation. • Tailor the ESG fraud taxonomy for organization-specific risks.
Fraud control activity	• Establish or ensure a strong supply chain control environment. • Establish or ensure strong ESG disclosure reporting controls. • Conduct supply chain mapping and integrate into third-party risk management programs. • Leverage analytics and automation to enhance control systems for evolving ESG fraud risks.
Fraud investigation and corrective action	• Confirm whistleblower reporting and investigation capabilities are in place for ESG-related fraud schemes. • Provide ESG-related anti-fraud training. • Revisit anti-bribery and anti-corruption programs to ensure coverage of ESG-related fraud risks. • Establish partnerships with collaborative organizations to support ESG-related fraud investigations.
Fraud risk management monitoring activities	• Establish Key Performance Indicators (KPIs) and Key Risk Indicators (KRIs) for the ESG fraud risk program. • Build management reporting around ESG fraud risks. • Establish ESG fraud risk board/commission-level reporting. • Build advanced/predictive analytics to monitor the program.

CONCLUSION

For corporations, ESG factors have quickly become as important as financial metrics. With this rapid rise to prominence comes increased pressure and wide opportunity for exploitation. Organizations need to take stock of their ESG programs, update their reporting standards, enhance their controls, and establish capabilities to mitigate ESG-related fraud risk.

The COSO/ACFE *Fraud Risk Management Guide* provides a useful framework to ensure a holistic approach to addressing these risks. Begin by setting the right tone for your ESG anti-fraud program by assessing new internal and external risks. Use the findings from that assessment to drive your prioritization of enhanced controls and investigations procedures. And finally, establish the right reporting metrics to monitor your program over time.

Organizations that quickly adopt these recommendations will be ahead of their peers, resulting in an important advantage. As new risks appear, they will be better prepared to address these challenges.

Environmental, social, and governance fraud issues will be faced by most organizations. While these risks may be inevitable, fraud losses and reputational damage are not. Anti-fraud and risk management practitioners can help protect against these new vulnerabilities, and they can establish a strong foundation for navigating the complex ESG environment for years to come.

ABOUT THE ACFE

Founded in 1988 by Dr. Joseph T. Wells, CFE, CPA, the ACFE is the world's largest anti-fraud organization and premier provider of anti-fraud training and education. Together with more than 90,000 members in more than 180 countries, the ACFE is reducing business fraud worldwide and providing the training and resources needed to fight fraud more effectively.

The positive effects of anti-fraud training are far-reaching. Clearly, the best way to combat fraud is to educate anyone engaged in fighting fraud on how to effectively prevent, detect, and investigate it. By educating, uniting, and supporting the global anti-fraud community with the tools to fight fraud more effectively, the ACFE is reducing business fraud worldwide and inspiring public confidence in the integrity and objectivity of the profession.

The ACFE offers its members the opportunity for professional certification. The Certified Fraud Examiner (CFE) credential is preferred by businesses and government entities around the world and indicates expertise in fraud prevention and detection. CFEs are anti-fraud experts who have demonstrated knowledge in four critical areas: financial transactions and fraud schemes, law, investigation, and fraud prevention and deterrence.

Members of the ACFE include accountants, internal auditors, fraud investigators, law enforcement officers, lawyers, business leaders, risk/compliance professionals, and educators, all of whom have access to expert training, educational tools, and resources. Whether their career is focused exclusively on preventing and detecting fraudulent activities or they just want to learn more about fraud, the ACFE provides the essential tools and resources necessary for anti-fraud professionals to accomplish their objectives.

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ABOUT GRANT THORNTON

Grant Thornton LLP (Grant Thornton) is the U.S. member firm of Grant Thornton International Ltd, one of the world's leading organizations of independent audit, tax, and advisory firms. Grant Thornton, which operates more than 50 offices in the United States and operates in more than 135 countries, works with a broad range of dynamic publicly and privately held companies, government agencies, and organizations.

Grant Thornton is a leader in fraud risk management. Our fraud risk professionals are progressive thinkers with a wealth of experience developing robust anti-fraud programs across a wide range of industries and across organizations of varying missions and sizes. Our proven fraud risk management solutions are based on proprietary methodologies. We have developed industry-leading benchmarking tools, maturity models, and customizable, scalable fraud risk assessment methodologies to address the evolving risk landscape. Further, Grant Thornton was instrumental in the development of the fraud risk frameworks used both in government and in the private sector. This insight into leading guidance combined with our deep pool of expertise provide insights that we bring to our clients to help them combat fraud and focus mitigation efforts where it matters most. With the scale to meet evolving needs, Grant Thornton specializes in personalizing solutions to help address today's problems and anticipate tomorrow's challenges.

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APPENDIX:
EXAMPLES OF ESG GUIDANCE AND FRAMEWORKS

A variety of organizations have issued guidance or are developing frameworks for ESG programs and disclosures. These frameworks and guidance are intended to promote continuity by advocating for consistent, transparent, repeatable, and accurate ESG reporting.

Listed below are examples of organizations that have issued relevant guidance or published ESG reporting guidelines as of the time of publication of this guide. This list is not intended to be comprehensive, and changes are anticipated as the ESG landscape evolves. Check with these organizations directly to obtain their most up-to-date guidance.

ORGANIZATION	URL
American Institute of Certified Public Accountants (AICPA)	www.aicpa.org
CDP Worldwide	www.cdp.net
European Commission (EC)	www.ec.europa.eu
Financial Accounting Standards Board (FASB)	www.fasb.org
Global Reporting Initiative (GRI)	www.globalreporting.org
International Auditing and Assurance Standards Board (IAASB)	www.iaasb.org
International Sustainability Standards Board (ISSB)	www.ifrs.org/groups/international-sustainability-standards-board
International Financial Reporting Standards (IFRS) Foundation	www.ifrs.org
Value Reporting Foundation (VRF)	www.valuereportingfoundation.org
Sustainability Accounting Standards Board (SASB)	www.sasb.org
International Integrated Reporting Council (IIRC)	www.integratedreporting.org
U.S. Securities and Exchange Commission (SEC)	www.sec.gov

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