Managing fraud risks in an evolving ESG environment

Environmental | Social | Governance

AUGUST 12, 2022

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.

E

Environment

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.

S

Social

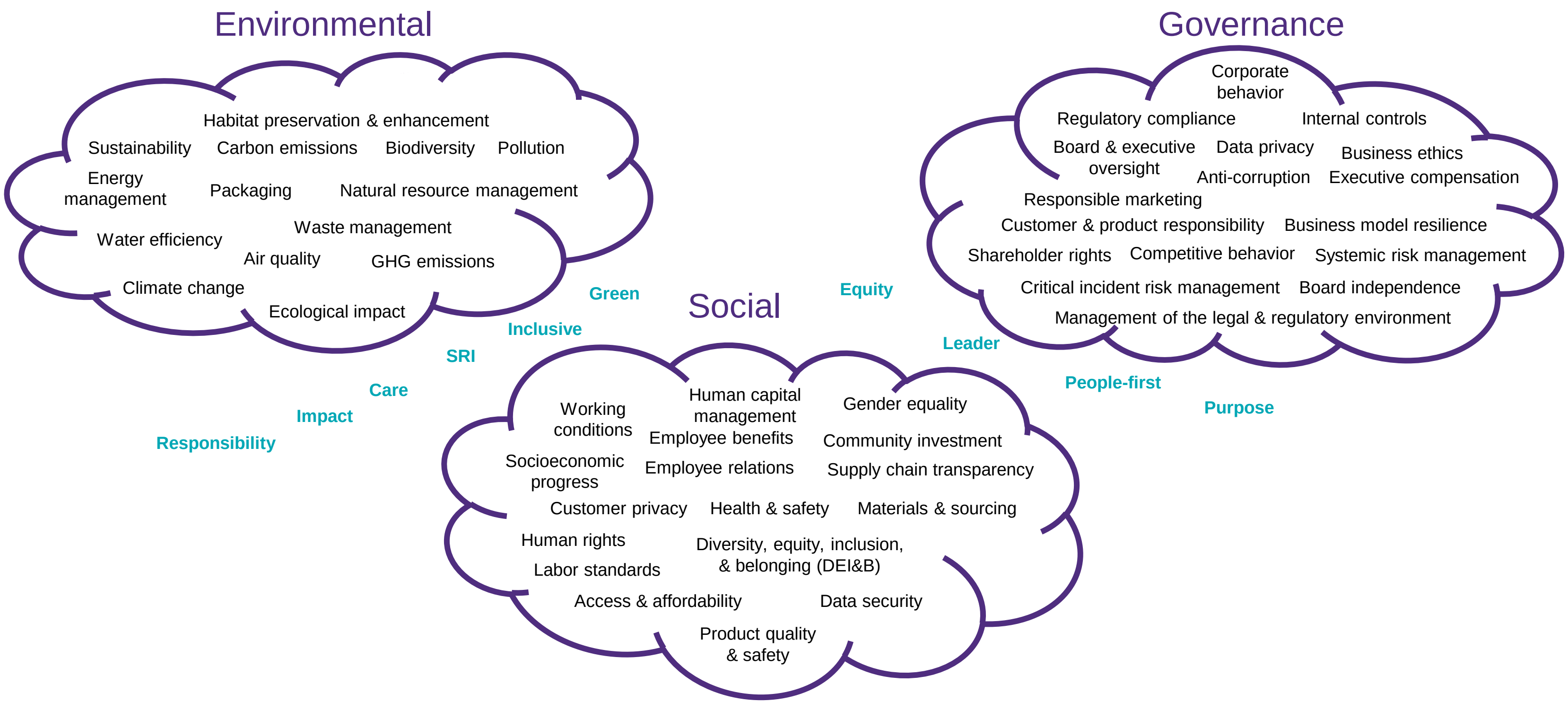
Refers to the efforts an organization endorses to show that it values people and considers things such as diversity, equity, working conditions, and social justice.

G

Governance

Refers to an organization's ethics. For example, governance includes aspects such as management behavior, transparency, and executive compensation.

ESG in action



Source: Managing Fraud Risks in an Evolving ESG Environment, June 2022, Co-authored by the Association of Certified Fraud Examiners and Grant Thornton LLP

Introduction to ESG fraud

INTERNAL FRAUD

Actors: Internal staff (management and employees)

Examples: Intentional acts of deception by reporting false or misleading ESG information, omitting material facts; or improper disclosure of ESG initiatives, programs, and metrics

Result: Reputational and regulatory consequences

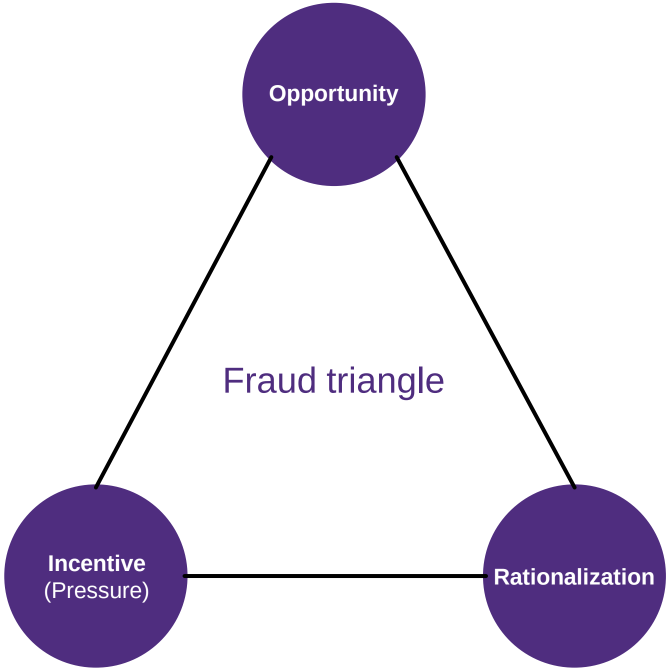
EXTERNAL FRAUD

Actors: Vendors, customers, supply chain, contractors

Examples: Vendors provide inaccurate ESG information, or a party sells fraudulent "green" investments to supply desirable carbon emission credits to offset greenhouse gasses

Result: Reputational and regulatory consequences

The fraud triangle and ESG



OPPORTUNITY

- Describes the environment that allows fraud to occur.
- Increases when an organization lacks a control environment to properly mitigate the inherent fraud risk..

RATIONALIZATION

- A fraudulent actor's ability to convince themself that the circumstances justified their illicit act.
- An organization comes close—but still fails—and rationalizes 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." .

INCENTIVE (PRESSURE)

- Describes the perceived burden potential fraud actors might experience that would incentivize them to commit fraud..
- Private equity, venture capital, pension funds, and public entities are insisting on reviewing a company's ESG policies, goals, and metrics.
- Investors are asking privately held companies about their supply chain oversight, environmental impacts, executive compensation models, and other ESG related issues.

ESG fraud taxonomy

Grant Thornton developed an ESG fraud taxonomy that considers fraud risks through an ESG lens.

ESG fraud impacts can occur anywhere in the supply chain.

The ESG fraud taxonomy includes the three ACFE Fraud Tree categories — corruption, asset misappropriation, and financial statement fraud — and includes a fourth category, nonfinancial reporting fraud.

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

Example of nonfinancial reporting fraud

Failure to disclose or report

- Failure to disclose or report an event or action
  - No plant accidents required hospitalization during the prior year
- Failure to disclose or report a fact
  - Board does not include a diverse director [not reported]

ESG fraud risk assessments

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

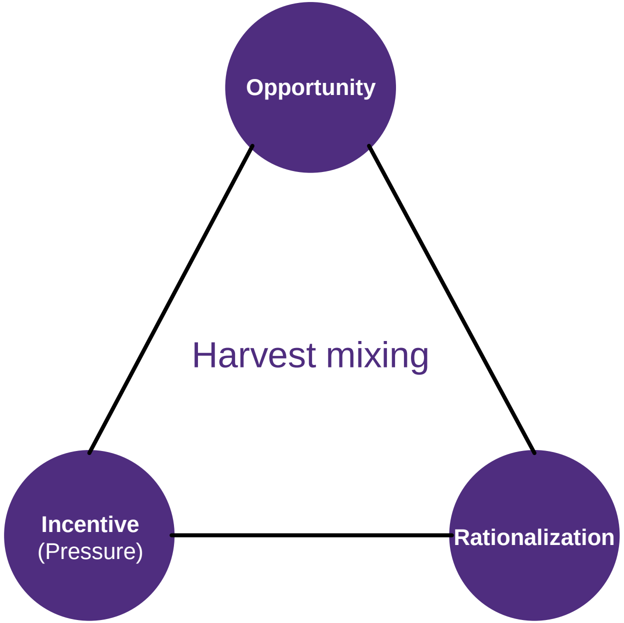
- Enhance traditional risk assessments
- Provide enterprise-wide view of fraud risk schemes
- Operate as stand-alone or broader fraud risk assessments
- Consider financial and nonfinancial fraud risks throughout supply chains
- Evaluate controls in place to mitigate inherent fraud risk

Environmental

Environmental risks can lead to operational and financial loss, such as disruptions to production and changes in asset value.

Scheme examples

- Harvest mixing
- Environmental standards manipulation
- Inflated carbon credit value
- Jurisdictional bribery



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.

RATIONALIZATION

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

INCENTIVE (PRESSURE)

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

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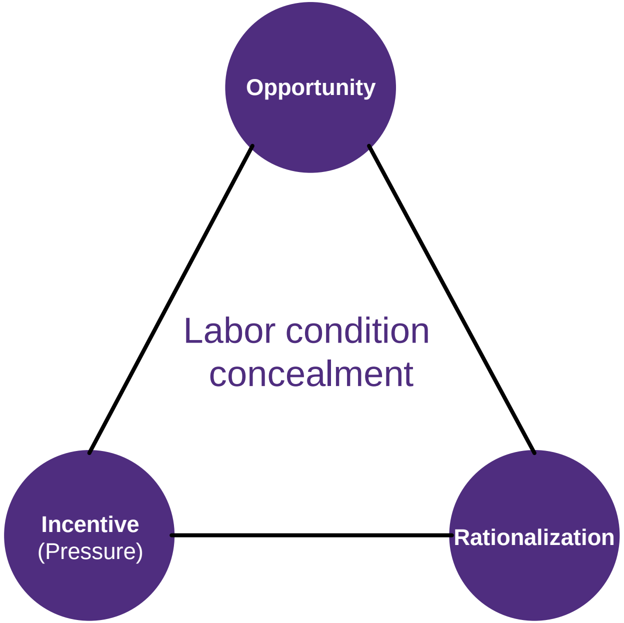
Social

Businesses face increasing pressure to demonstrate socially minded decision-making across the spectrum of their operations.

Scheme examples

- Labor Condition Concealment
- Falsified DE&I metrics
- Nonconforming social services
- Forced savings and deposit programs



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

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

INCENTIVE (PRESSURE)
The competitive market increases pressure across industries. Lower overhead costs can warrant lower product prices while increasing the bottom line.

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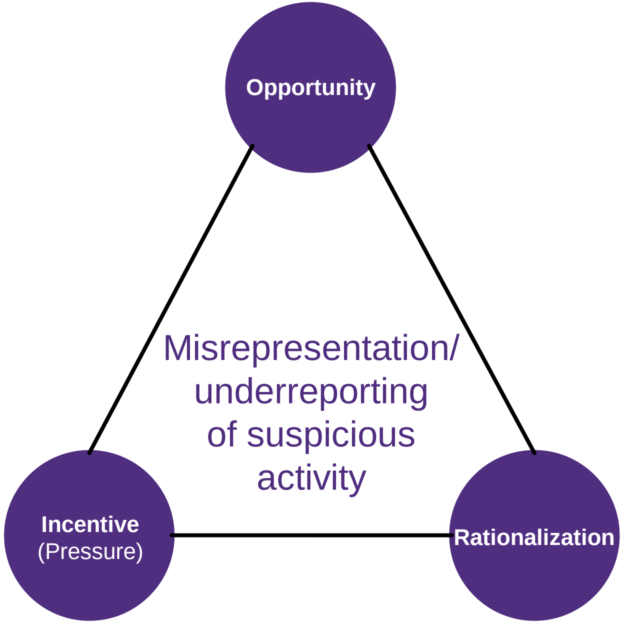
Governance

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.

Scheme examples

- Misrepresentation/underreporting of suspicious activity
- Clearing and forwarding extortion
- Violation of independence
- Capital expenditure misclassification
- Illegal tax shelters and underreporting



OPPORTUNITY

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

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.

INCENTIVE (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.

Increasing accountability

Rigorous ESG guidance should consider policies, procedures, data governance, and reporting controls, and address the traditional management assertions reflective of the principles that auditors rely upon for the assessment of financial audits.

1. **Accuracy** — The data must be authentic and free from misrepresentation.
2. **Completeness** — Organizations should disclose the full picture with thorough information regardless of the weight, including ESG information and disclosures.
3. **Rights and obligations** — Organizations should only disclose information that legally belongs to the organization and is permitted for use.
4. **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.
5. **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.

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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.

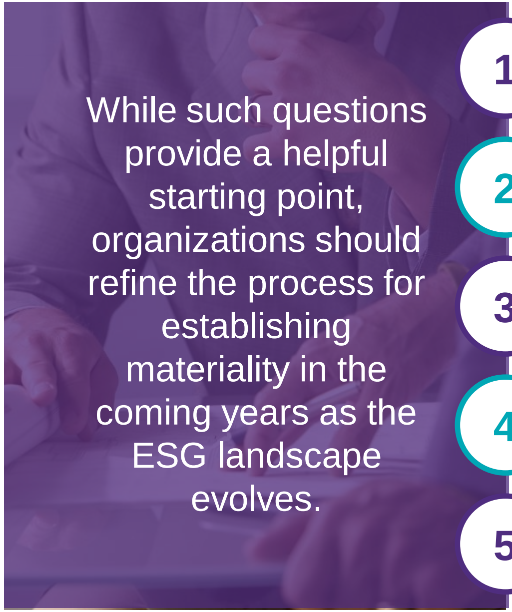
The question of what constitutes material information when it comes to ESG is still largely unanswered; however, organizations can rely on this question: **Would this affect a stakeholder's decision-making?**

In the ESG context, materiality is separate and distinct from the understanding of materiality under state and federal securities laws.

Organizations should apply a consistent process for deciding what is material and what is not.

Materiality questions

When setting up an ESG framework, considering the following types of questions could prove beneficial in determining materiality:



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.

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

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Mitigating ESG fraud risk

A strong ESG fraud risk management program should still align to these core principles.

1

Fraud risk governance

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The organization establishes and communicates a Fraud Risk Management program.

2

Fraud risk assessment

The organization performs comprehensive fraud risk assessments.

3

Fraud control activity

The organization selects, develops, and deploys preventive and detective fraud control activities.

4

Fraud investigation & corrective action

The organization establishes a communication process to obtain information about potential fraud and deploys coordinated approach investigation and corrective action.

5

Fraud risk management monitoring activities

The organization selects, develops, and performs ongoing evaluations.

ESG FRAUD TAXONOMY

- **Corruption**
  - Conflicts of interest
    - Purchasing schemes
    - Sales schemes
      - Carbon credit sales to undisclosed related party
  - Bribery
    - Invoice kickbacks
    - Bid-rigging
      - Collusion for disaster relief procurement
  - Illegal gratuities
    - Grease payment to forego safety inspection
  - Economic Extortion
    - Permit officer demands payment for logging permit
- **Asset misappropriation**
  - ESG-related inventory and other assets
    - Larceny
      - Theft of personal safety equipment
    - Misuse
      - Personal use of donated goods
- **Financial statement fraud**
  - Concealed ESG-related liabilities and expenses
    - No real estate assets are in 100-year flood plain
  - Overstated ESG-related liabilities and expenses
    - Environmental clean-up reserve used as cookie jar
  - Improper ESG-related asset valuations
    - Inflated carbon credit value
  - Improper disclosures
- **Non-financial reporting fraud**

Illustrative examples

- **False labelling or advertising**
  - Affirmative declarations or assertions
    - Made with 100% recycled materials
  - Negative declarations or assertions
    - Dolphin free tuna
- **False disclosure or representation**
  - Affirmative declarations or assertions
    - Scope 2 greenhouse gas emissions declined by 10%
  - Negative declarations or assertions
    - None of our products contain inputs resulting from forced labor
- **False/disingenuous certification or pledges**
  - Affirmative declarations or assertions
    - We are a founding member of the ______ ESG initiative
  - Out of compliance with certification or pledge
    - Fully complies with ______ certification requirements
  - Negative declarations or assertions
    - On track for net zero greenhouse gas emissions by 2035
- **Failure to disclose or report**
  - Failure to disclose or report an event or action
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Illustrative examples

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OUR LATEST PUBLICATION WITH THE ACFE

Managing Fraud Risks in an Evolving ESG Environment

ESG efforts are in the crosshairs. One false ESG move can go viral in an instant and leave your organization in a maelstrom.

Understanding and controlling ESG fraud is vital in this environment.

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