Integrating ESG Into Risk Management Programs

By **Brooke Hopkins, Rob Sayegh and Kora Dusendschon** (September 20, 2024)

While the recent pushback by some parties against a focus on environmental, social and governance, or ESG, issues may be viewed as a useful correction, concepts such as preventing human rights abuses, enhancing business ethics and reducing waste are foundational and noncontroversial to most companies.

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The reality is that topics addressed by ESG continue to grow and permeate the corporate structure. Yet yielding to political distractions; ignoring the many financial co-benefits embedded in ESG; and implementing sustainability with a patchwork, compliance-only mindset can prevent organizations from maximizing the value of a smart sustainability program.

This attitude can detrimentally affect companies' reputation, customer relationships, employee retention and financial health.

Addressing ESG risks requires a multifaceted approach to cover financial, legal and related issues. Companies that integrate ESG into their business models are also better prepared to implement good risk management, with the ultimate benefit of positively affecting corporate performance.

Continuing sustainability pressures are increasingly driven by the current legal and regulatory environment.

In early 2023, the European Union enacted the Corporate Sustainability Reporting Directive, a regulation formalizing corporate reporting requirements pertaining to social and environmental information. The CSRD pertains not only to certain EU-based companies, but also to non-EU companies that will have to report if they generate €150 million in the EU.

In late May, the European Parliament formally adopted the Corporate Sustainability Due Diligence Directive,[1] introducing massive requirements for companies around the world to ensure systems are in place to monitor, prevent and mitigate human rights and emissions violations throughout supply chains tracing back to source minerals and ingredients.

In July, the European Securities and Markets Authority **issued** a public statement highlighting specific areas of attention companies should consider around complying with the CSRD using the European Sustainability Reporting Standards as a reporting framework, including the importance of developing strong internal controls and governance practices and the critical role of data quality around sustainability reporting.[2]

There's an increased need for business leaders to make responsible and conscientious decisions in light of the Corporate Sustainability Due Diligence Directive, European Sustainability Reporting Standards, and other emerging regulations and standards; ineffective implementation of risk management into organizations; and evolving opportunities for bad actors to use modern technology in white collar crimes.

Organizations shielding themselves from what they perceive to be negativity related to ESG may be failing to address evolving risks that touch multiple areas inside the business and beyond.

For example, the use of innovative tools such as digital currencies, cyber systems and artificial intelligence provide companies with new ways to do business but also introduce new risks, including downstream risks with vendors and customers typically reserved for financial institutions.

Organizations must know what third parties are doing with their data, including financial information, now more than ever. This is critical to prevent corruption scenarios such as bribery, and for mitigating the facilitation of crimes such as human trafficking and child exploitation.

Today, companies experience myriad ESG pressures. These include external pressures, such as:

- Customer requirements;
- Investor pressures;
- Growing regulations;
- ESG ratings;
- Third-party behavior; and
- Use of digital currencies, cyber systems, alternative data and AI.[3]

And they include internal pressures, such as:

- Improved employee satisfaction;
- Increased valuation;
- Enhanced risk profile;
- Stronger stakeholder engagement;
- Verified ethical culture; and
- An innovative business model.

As a result, more companies than ever are integrating goals around ESG risks and initiatives to support their strategies and satisfy their stakeholders.

Importantly, considering ESG risks as part of companies' broader risk management programs provides an opportunity to identify controls and processes that address external and internal pressures, and offer defensibility for companies to meet their strategic goals and revenue targets.

ESG risks that organizations should be aware of include:

- Third parties using corporate funds, cyber systems or alternative data for money laundering;

- Third parties using corporate funds, cyber systems or alternative data for human trafficking and child exploitation;
- The launching of digital currency integration without adequate controls;
- Allowing for AI tools that could produce inaccurate, reportable information;
- Producing ESG or sustainability reports, articles or statements without adequate vetting that could be considered public disclosures;
- Lack of transparency internally and externally pertaining to labor practices; and
- Insufficient monitoring of supply chain practices, operations and employee initiatives that results in lapses in ESG controls.

Many of these risks are not new to companies; however, bearing in mind the increased external and internal pressures that companies are experiencing, several of the risks could be newly material to a company's bottom line and strategic goals.

The need to address risks to protect companies' value is imperative, but can only happen when organizations approach risk holistically and formally through corporate risk governance.

In 2004, the Committee of Sponsoring Organizations issued "Enterprise Risk Management — An Integrated Framework," which was updated in the 2017 issuance of "Enterprise Risk Management — with Strategy and Performance."[4] COSO's purpose is to proactively help companies enhance their performance through better internal controls, risk management, governance and fraud deterrence.

It provides a framework for how organizations can address risk by using their guidance to establish an enterprise risk management program. COSO consistently addresses emerging topics in risk within the ERM framework. For example, in 2018, COSO published "Enterprise Risk Management to Environmental, Social and Governance-Related Risk," applying ERM concepts to ESG risks.[5]

COSO guidance offers corporations the ability to be more integrated across business units and more preemptive about emerging ESG risks and opportunities that can materially affect reaching their strategic goals.

Considering ERM and ESG

So, what now?

Because of increasing external pressures such as regulations like the EU's Corporate Sustainability Due Diligence Directive, European Sustainability Reporting Standards, and the U.S. Securities and Exchange Commission's **Cybersecurity Risk Management Rule**, and the continued focus by investors on ESG rating agencies' scoring, many companies are beginning to develop foundational ESG, social responsibility and sustainability programs.

These programs are based on enhancing risk management, assessing areas for increased energy efficiency and alternatives, and strengthening the monitoring of existing legal and compliance governance.

The following table indicates how companies can identify ESG risks, measure the impact and likelihood of such risks to integrate into company ERM programs and risk registers, and address ESG risk considerations in mergers and acquisitions and when using third parties.

What	How	When
ESG Gap Assessment	• Review company policies, procedures and reporting against global, federal, state, and local regulations and investor requirements. • Compare public disclosures on ESG to actual company ESG performance data and internal reporting.	Perform this annually or upon business model changes, e.g., mergers and acquisitions, major product launches or geography footprint changes.
ESG Materiality Assessment	• Identify risks that affect ESG reporting: sustainability and investor reporting, as well as regulatory compliance, e.g., CSRD, modern slavery reporting requirements, state-required reporting. • Develop a materiality testing approach based on industry, product and services; stakeholder engagement; and operational and financial considerations. • As part of testing, incorporate scoring for impact and likelihood of each ESG risk to prioritize risks and integrate into the company's ERM program.	Perform this initially as part of ESG program development and upon business model changes, e.g., M&A, major product launches or geography footprint changes.
Revised M&A Procedures	• Update current M&A guidance to include (1) reviewing target companies for compliance with ESG regulations and risks related to public disclosure of ESG performance, and (2) analyzing if target companies have effective controls in place to address ESG regulations and reporting. • Update the risk register with target company ESG risks.	Perform this immediately if the company is active in M&A, or prior to its next transaction — update M&A guidance and implement into current M&A due diligence procedures.

What	How	When
Coordination With Third Parties	• Identify third parties that act on behalf of the company as agents, distributors, brokers, etc. • Request information from these third parties on their sourcing and labor practices, anti-corruption policies, and sustainability reporting, all of which can affect the company's Scope 3 footprint. • Identify risks for third parties without policies and practices that mitigate the risk of money laundering, corruption, fraud, child labor, improper labor practices, and working with Specially Designated Nationals, and that highlight effective sustainable practices, which can affect Scope 3 footprint. • Update the risk register with third-party company risks. • Consider developing guidance for third parties indicating company requirements for sustainable sourcing, appropriate labor practices and anti-corruption.	Perform this immediately if the company has third parties that act on its behalf.

Conclusion

The topics within ESG are not new, but the risks surrounding them are emerging as global regulations continue to roll out, innovation within business continues to progress, and stakeholder demands continue to call for increased ESG transparency. As such, companies might consider how to integrate ESG into more formalized risk management.

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[1] https://www.consilium.europa.eu/en/press/press-releases/2024/05/24/corporate-sustainability-due-diligence-council-gives-its-final-approval/.

[2] https://www.esgtoday.com/esma-calls-on-companies-to-get-data-systems-in-place-to-meet-new-csrd-sustainability-reporting-requirements/.

[3] Alternative data is data gathered from nontraditional sources, often to which third parties have access.

[4] https://www.coso.org/about-us.

[5] https://www.coso.org/_files/ugd/3059fc_671ed4466c0e423b93a9ef3d2e30b786.pdf.