PLACE 'ESG' ON YOUR RADAR

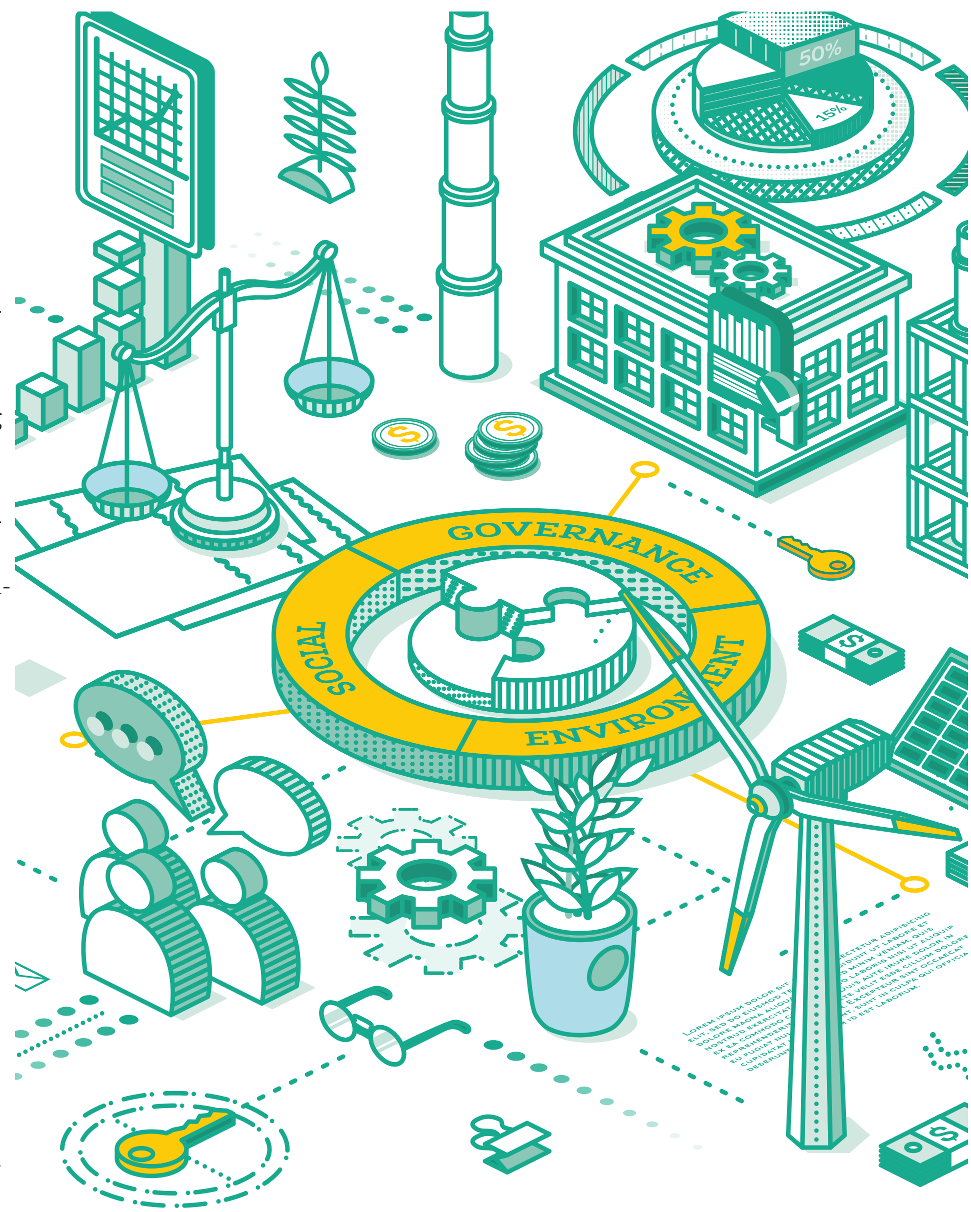
Organizations are increasingly striving to meet environmental, social and governance (ESG) standards, at least on paper. CFEs may be well versed in the "G" of ESG but they also need to know about the "E" and "S" to understand whether CEOs are truly sticking to the values they tout.

In the last few years, and especially now as we emerge from the COVID-19 pandemic, the world's economy has become increasingly values driven. Many consumers care as much or more about a company's principles (i.e., what the company stands for) as they do about its products or services. The grouping of "environmental," "social" and "governance" (ESG) to collectively represent an organization's core values and principles is interesting — as you really can't have one without the others.

A company might claim to emphasize diversity in its workforce and treat its employees, customers and communities with respect (social responsibility). But, meanwhile, it might dump waste into a river and harm the environment (environmental responsibility) with management's full knowledge (governance). The company then is deemed unethical despite its claims of social responsibility.

All three ESG elements must come together at satisfactory levels in the public's eye to render a company ESG-focused.

As fraud examiners, we're all familiar with the governance role (or the "G" in ESG) because it's a key pillar in an effective fraud risk management program. (See ACFE/COSO *Fraud Risk Management Guide*, tinyurl.com/yevf2tkd.) But maybe




COLUMNIST
VINCENT M. WALDEN, CFE, CPA
ALVAREZ & MARSAL'S DISPUTES AND INVESTIGATIONS PRACTICE

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it's time to also look a little broader and consider CFEs' roles in environmental and social disclosures along with integrity.

The ESG label is now more important than ever. Nearly one-third of all professionally managed money in the U.S., a staggering $17.1 trillion, is invested in ESG-related funds. (See the 2020 "Report on US Sustainable and Impact Investing Trends," US SIF Foundation, tinyurl.com/yz5f5yfy.) And by 2025, assets under management dedicated to ESG investments across the globe are expected to hit $53 trillion. (See "ESG assets may hit $53 trillion by 2025, a third of global AUM," Bloomberg Intelligence, Feb. 23, tinyurl.com/e7r5z86y.) Failure to articulate strong ESG programs could cause companies missed opportunities to lower their funding costs by not meeting ESG investor expectations and losing out on possible customer opportunities or sales.

The global capital markets have seen a surge of bonds linked to social responsibility, environmental goals and other good causes. Yet some investors have grown increasingly skeptical about the trend; they often see it as all show and no substance, and open to abuse. Chamath Palihapitiya, the founder and CEO of venture capital firm Social Capital, has called ESG investing a "complete fraud." (See "ESG investing is a 'complete fraud,' Chamath Palihapitiya says," by Pippa Stevens, CNBC, Feb. 26, 2020, tinyurl.com/ca88vt64.)

The temptation to demonstrate a strong ESG program through misrepresentations led to an April 9 U.S. Securities and Exchange Commission (SEC) "Risk Alert" specifically addressing management misrepresentation.

The alert calls on market participants promoting ESG investing to assess whether their public statements and claims related to ESG are accurate and consistent and subject to oversight by compliance. "Firms should also consider taking steps to document and maintain records relating to important stages of the ESG investing process," it says. (See "Risk Alert: The Division of Examinations' Review of ESG Investing," SEC, April 9, tinyurl.com/ygo5629e.)

The SEC is expected to make a further push in this direction. The regulator is planning new rules requiring public companies to disclose more information about how they respond to threats linked to climate change. Some investors say the more specific these rules, the better. From a fraud risk perspective, uncertainty and vague guidance often invite fraudulent misstatements. (See "SEC Wants More Climate Disclosures. Businesses Are Preparing for a Fight," by Dave Michaels, The Wall Street Journal, June 21, tinyurl.com/yh7a8whv.)

Using data to combat ESG reporting fraud

I spoke with Rich Goode, a colleague, industry expert and adjunct lecturer at Harvard University Extension School, about his views on ESG and related fraudulent-reporting risks. Goode teaches courses on sustainability management, the effects of climate change and how companies can use innovation to reduce their greenhouse gas emissions and boost profitability. He says that most companies struggle to even obtain data to calculate ESG metrics, such as their greenhouse gas emissions, let alone turn that data into actionable insights.

"Collecting the data is one hurdle, but inflexible or overly complex reporting tools prevent data consolidation across multiple sites," Goode says. "This results in an inability to perform consistent reporting, which increases your risk of material misstatements. In these days of intense investor scrutiny, companies need to take steps to improve the quality and internal controls around nonfinancial data. Getting your data organized in a consistent and usable format is often

the key step to reducing fraudulent reporting risks."

Maybe it's time you look at your organization's environmental and social policy statements, related disclosures and underlying supporting data. As CFEs, we're trained to take objective, data-driven approaches to organizations' ESG programs to ensure segregation of duties, proper internal controls and tracing of data sources to ensure the integrity of managements' representations and disclosures to the public and regulators.

How to look at your program

A good ESG program begins with proper disclosure, and management needs to know that transparency is as important as performance. Anti-fraud and compliance professionals can do the following to evaluate and improve an organization's ESG program:

- Conduct a gap analysis that looks at the current state of your ESG reporting as compared to your competitors' or the ESG standards of regulatory bodies.
- Complete an ESG ratings agency score evaluation. Several agencies set frameworks for ESG standards and disclosure, including the Sustainability Accounting Standards Board, Global Reporting Initiative and Task Force on Climate-related Financial Disclosures. It's important you understand what inputs and reports are included in these frameworks and how they're scored.
- Review investor disclosures to know the representations your organization is making to your investor community and test them.
- Focus on social responsibility. It's important to look at your supply chain, not only from a sanctions and trade compliance perspective, but also from a social responsibility perspective as it relates to labor, fair wages, safe working conditions and similar human rights laws in local jurisdictions.
- Seek outside experts, as needed, to help you ask the right ESG questions, align to the correct frameworks and gather the best data sources to demonstrate effective compliance.

IMPROVING YOUR ESG PROGRAM

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Expand your risk-inspection list

As you think about your fraud risk assessment this year or next, I encourage you to expand beyond financial misstatement risk and include environmental and societal misstatement risk. There's little room for error or missteps in the eyes of the public and regulators when it comes to harming the environment or carrying out socially unacceptable practices, especially when profit motives are at play. Keep innovating! ■ FM

Vincent M. Walden, CFE, CPA, is a managing director with Alvarez & Marsal's Disputes and Investigations Practice and assists companies with their anti-fraud, investigation and compliance monitoring programs. He welcomes your feedback. Contact Walden at vwalden@alvarezandmarsal.com. Walden thanks Steve Spiegelhalter, managing director and investigations leader for Alvarez & Marsal's Disputes and Investigations Practice. Contact Spiegelhalter at steve.spiegelhalter@alvarezandmarsal.com.