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Managing the risk of ESG misconduct

Deloitte Forensic

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Due to the rising attention and influx of ESG attention, companies are now facing higher expectations from investors, regulators, customers, consumers, employees, suppliers, business partners and other stakeholders regarding their ESG performance. The higher expectations and pressure from stakeholders, combined with increased regulatory requirements activity, trigger the risks related to ESG misconduct.

Complying with the Environmental, Social and Governance ("ESG") requirements and regulation can be challenging for many companies, and some companies may unintentionally or intentionally prepare inaccurate or deceptive ESG disclosures and statements. This can lead to claims and litigations on national and EU levels, including risks of financial and reputational damage, loss of sales and investments.

The rise of ESG requirements demands companies to pay greater attention to the ESG risks and their impact. To comply, companies must establish and continuously evaluate their approach to data disclosures, controls, reporting assumptions and methods, as ESG disclosures are to face a greater level of scrutiny by stakeholders, including public authorities.

In essence, companies must more than ever be able to demonstrate in a more robust manner how the data used in their disclosures has been validated and tested, how the risks have been managed, and which systems have been used in the disclosure process.

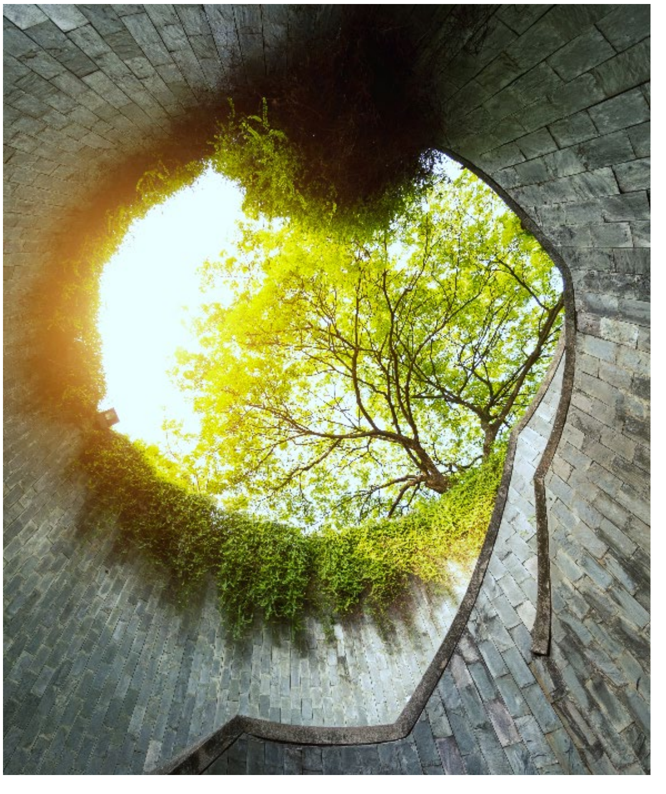
ESG misconduct risks

ESG misconduct encompasses the large range of activities and disclosures relating to environmental issues and KPIs such as pollution, deforestation and (illegal) mining, social issues such as labour and working violation or discrimination and harassments. Additionally, it includes governance-related issues such as bribery and corruption or independence and conflict of interest.

The disclosures rely on data points related to ESG risks, emissions, ecosystem and biodiversity impacts, waste management, renewable energy usage, human and employee rights, data privacy, product safety, anti-corruption and anti-bribery, governance and other ESG aspects. These are often not easily available, and companies normally need to investigate across the entire supply- and disposal chains, both upstream and downstream, from cradle to grave, to obtain all the information needed for their ESG disclosures. In a relatively immature landscape, internal ESG reporting frameworks and procedures can be less robust and have weak or non-existing controls throughout the companies' own operations and particularly in the supply- and disposal chains. Hereby pressure and inherent control weaknesses or deficiencies may lead to ESG data being manipulated.

When the compensation package for employees, including the management, is linked to the company's ESG performance in any way, there is also an increased risk of ESG misconduct at many levels of a company; from top to bottom.

Additionally, the companies' employees, directors, or management may engage in ESG misconduct or unethical activities for their own benefit or at the request of the management. The activities could include falsifying of records and data or misleading regulators, auditors, consumers or other stakeholders. The employees can rationalise their actions by reasoning that it is not a big deal, no one gets hurt, the fact they are helping the company and that the activities that may give rise to ESG misconduct protect the company's core interests or intellectual property.



ESG compliance and risk management

The actions of a company's own operations and third parties can have far-reaching impacts on for example risks of greenwashing[1] or greenhushing[2].

[1] Greenwashing: the act or practice of making a product, policy, activity, etc. appear to be more environmentally friendly or less environmentally damaging than it really is
[2] Greenhushing: the act or practice deliberately downplaying sustainability practices for fear that it will make it look less competent, or have a negative consequence

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One of the primary ESG misconduct risks is greenwashing where the mismatch between words and actions can create an impression that companies are doing more to protect the environment than they actually are.

Greenwashing is not limited to a company's internal operations but does also encompass the company's third-parties such as subcontractors, suppliers and business partners. To be able to meet the ESG requirements and expectation from stakeholders, companies are required to thoroughly examine and understand their full supply- and disposal chains. Therefore, companies are required to understand the critical importance of compliance and risk management, including assessment of key suppliers and business partners, to reduce the risk of unintentional greenwashing.

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The ESG misconduct risks can be addressed, assessed and mitigated by establishing a strong ESG framework to lay the foundation for compliance, risk management, third-party risk management, responses to regulatory matters and include areas such as governance, behavior, integrity and ethics. This allows companies to spot any ESG issues and effectively manage misconduct risks throughout the entire supply- and disposal chains. This involves scrutinising data and reports from third parties within the supply- and disposal chains, which necessitates conducting thorough due diligence and background checks on these third parties.

ESG misconduct consequences

Non-compliance with the ESG requirements can result in financial sanctions and legal consequences, leading to reputational risks and a loss of investor trust.

The legal consequences in relation to ESG misconduct can involve different stakeholders, including:

- Legal claims against companies brought by stakeholders seeking clear ESG action plans, better disclosures, or more transparency.
- Stakeholders seeking change through legal claims against companies based on for instance greenwashing.
- Financial claims where consumers, public authorities or other stakeholders seek compensation for loss and damage arisen from misleading ESG statements or disclosures.

Claims relating to greenwashing or greenhushing can be brought by stakeholders such as business partners, consumers and public authorities, and relate to social change, better transparency and financial claims based on inaccurate or deceptive information from the company.

Investigating nature and extent of ESG misconduct

As companies are facing increasing demands from stakeholders, it is crucial for them to take appropriate measures such as investigating their current situation. Measures can be performed internally but it can also be beneficial to partners with external experts to access relevant tools and expertise to reduce the risk of ESG misconduct. By doing so, companies can stay up-to-date with the ESG requirements and assess and mitigate any potential legal or reputational risks associated with unintentionally or intentionally ESG misconduct.

If there is found indications of potential ESG misconduct, it is crucial to establish clear objectives, scope and timeframe to conduct these types of investigations. Additionally, an analysis of the product characteristics, supply- and disposal chains and an evaluation of the communication of involved employees and third parties. These steps are essential to ensure a thorough and effective ESG misconduct investigation. Based on the investigation, the potential damages should be assessed.

Risks and consequences of potential ESG misconduct

Financial sanctions, such as fines and penalties, may be imposed if a company fails to report on its ESG disclosures late, incompletely, or by omitting some ESG requirements. Fines and penalties can lead to direct financial losses and affect the company's liquidity.

Non-compliance with the ESG requirements can lead to **reputational risks** that can affect the trust and confidence of customers, investors, employees and other stakeholders and has a long-term impact on the business that may damage the company's reputation.

Failure to comply with ESG requirements can lead to a **loss of investor trust**, both current and potential investors may reduce their exposure or even withdraw altogether. This can affect the company's financial stability and growth.

Companies can face **legal consequences,** if they deliberately make false statements, fail to disclose material ESG risks or fail to comply with ESG requirements. The legal consequences, such as legal costs, claims and disputes, can have a negative impact on the operating business and the company's directors and management.

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Team of experienced experts

The Deloitte Forensic practice has a team of experienced professionals who are specialised in assisting parties involved in investigations and disputes, including those related to ESG misconduct. We can provide ESG advisory services to help develop a party's stance, act as neutral and experts for both sides or serve as independent experts to offer opinions before a judge or tribunal. With the support of the broader Deloitte network, which includes ESG services professionals, industry experts and experts worldwide, we are well-equipped to meet your needs in addressing ESG risks and misconduct.

Our approach to investigating suspected ESG misconduct cases is comprehensive and systematic. We aim to uncover the type and extent of the alleged misconduct, irregularities or breaches of duty related to ESG misconduct, as well as quantify the resulting damages. To achieve this, we begin by identifying relevant information pertaining to the case and then conduct a thorough analysis. Finally, we summarise the results of our investigation. This approach allows us to provide a clear understanding of the situation and helps our clients make informed decisions. We support our clients with:

Investigation and forensic accounting: We support companies in identifying, investigating, evaluating and analysing all sorts of information, such as structured and unstructured documents and data, and provide companies with results such as a forensic report that can be used as basis for an internal assessment of potential legal consequences, claim preparation as well as in the court.

Interviews: To fully establish the causes and background of ESG misconduct, we can assist companies with preparation and documentation of interviews and everything in between. Companies can trust in our team of experienced and specially trained experts to apply the most appropriate interview techniques, ensuring the identification of valuable insights.

Forensic technology and analytics: We help our clients identify, secure, search and analyse large and complex ESG data points in a structured and efficient manner through use of the latest technology.

Support and expertise: Our team provides comprehensive support to companies in identifying, developing and implementing measures to enhance their ESG framework for processes and controls in relation to the risks of ESG misconduct.

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