ESG DOMINATES THE CORPORATE AGENDA IN 2021

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If 2020 was the wake-up call that thrust the ESG movement into mainstream society's consciousness, then 2021 was the year in which it came to dominate the corporate and regulatory agenda in the UK and much of Europe. This has significantly increased pressures on ESG targets and results, which will inevitably lead to a greater risk of fraud.

The rapidly evolving ESG landscape

Although it had been gaining momentum for a number of years, until recently the ESG movement was often considered the preserve of activists or niche investors. However, the Covid-19 pandemic, together with an increasing number of extreme weather events, have demonstrated how acutely an environmental crisis can impact economies, businesses, and societies at large. This awakening has extended beyond the climate crisis to social issues, embodied by movements such as Black Lives Matter.

As a result, a company's ethical values, environmental footprint and standards of governance have become defining issues for investors, consumers and regulators alike. In response, ESG issues have been top of mind for boards and managers in 2021, who have had to grapple with the rapidly evolving needs and expectations of their stakeholders.

This was reflected in a recent Grant Thornton survey of 600 UK businesses, in which respondents considered a strong ESG strategy to be a significant factor in their company's:

- **Overall value creation (92%)**
- **Ability to obtain funding (91%)**
- **Attractiveness to investors (90%)**

However, although it seems right that businesses should be rewarded for doing the right thing and making a positive contribution to society, the rapidly evolving ESG landscape has also created an environment that satisfies all three elements of the classic "fraud triangle" – pressure, opportunity and rationale.

Pressure

It is readily apparent that companies are coming under increasing pressure to meet the ESG expectations of both their internal and external stakeholders. This means that boards and CEOs have to consider the welfare of the planet, their customers and their employees in ways considered unimaginable just a few years ago. Failure to do so will be met with a wave of negative publicity, such as that which has dogged online fast fashion retailer Boohoo Group Plc for much of the past 12 months, in the wake of revelations about the working conditions in its supply chain.

NGOs and activist investors are increasingly challenging companies and holding them to account for what they consider to be sub-standard behavior, resorting to litigation if necessary. This led to a groundbreaking judgement in May 2021, in which the Hague District Court ordered Royal Dutch Shell Plc to reduce its worldwide CO_2 emissions by 45% by 2030. More recently, in October 2021, miner BHP Plc suffered a shareholder rebellion against its "climate transition action plan" [1], based on concerns regarding its scope and the alignment of its target with the latest climate science [2].

It is therefore unsurprising that boards and CEOs should feel pressure to respond to the changing demands of their stakeholders. However, actually

1 https://www.ft.com/content/09fb8916-2bda-4d8f-8f72-c0fc3198c0dd

2 https://www.ft.com/content/79c73edf-9b1e-4852-ad6e-91fdae0aca36

doing this in practice may prove to be incredibly difficult.

This is particularly true for those businesses and industries whose operating models are not intrinsically "ESG friendly", but who are still facing calls from shareholders to improve their ESG performance, while maintaining profitability.

Opportunity

Faced with the pressure to improve their ESG performance, boards and CEOs may be tempted to artificially enhance their ESG credentials. They could either do this through a concerted PR campaign ("greenwashing") or by manipulating their underlying ESG data. Two key factors create ample opportunity to do this.

Firstly, although 2021 saw both the FCA and the Department for Business, Energy & Industrial Strategy launch consultations on mandatory climate-related financial disclosures, as yet there are no common ESG and sustainability reporting frameworks in place. This makes it difficult for investors, consumers and other stakeholders to assess an organization's true sustainability and ESG performance. It also means that any ESG control environment will, by definition, be immature and vulnerable to threats.

Secondly, within whatever ESG reporting framework is chosen, there are no natural checks on the integrity of the underlying ESG data. This contrasts with the financial side of the business, for which one fundamental principle will always apply: Thanks to double-entry bookkeeping, financial crimes and manipulation will always leave a trace that can be detected and remedied. This is because, with double-entry book-keeping, every debit must have an equal and corresponding credit. This balancing mechanism is an effective fraud-detection tool, which can be used to identify and mitigate threats.

By contrast, ESG reporting and monitoring relies on a single-entry recording system (if it is properly recorded at all). As this is not a self-balancing system numbers can be easily manipulated, presenting plenty of opportunities for fraud.

Rationale

Rationale is often the most personal aspect of the fraud triangle.

The majority of people commit financial frauds on the basis of wrong treatment in the workplace, personal hardship, or because senior management is also committing fraud.

However, while all of these are applicable to ESG fraud (particularly if remuneration is linked to ESG performance) additional factors may also apply.

In situations where companies are facing pressure to improve their ESG performance, while maintaining profitability, individuals may feel that they have no choice but to resort to fraud – rather than invest in making fundamental changes to their organization's infrastructure and operating models (which would affect profit), they can simply manipulate ESG data, relying on the inherent weaknesses of sustainability reporting to do so.

Likewise, in a world where consumers are more than happy to hold corporate decision makers to account, doing whatever it takes to ensure that newly made Net Zero commitments (47 of the FTSE100 had signed up to net zero goals by the start of COP26 [3]) are achieved provides further motivation for committing ESG fraud.

Conclusion

Climate change and sustainability dominated the news for much of 2021. This culminated in the highly anticipated COP26 conference (which had just started at the time of writing), at which it is hoped a number of ambitious emission reduction plans will be presented and agreed. While this will be critical for bridging the 'Emissions Gap' by 2030, it will also place even more pressure on companies to improve their ESG performance. Looking forward to 2022 and beyond, this could well lead to an increase in ESG frauds.

3 https://www.ft.com/content/7d9cfef0-963b-487f-95a5-0e265d0eb25d