Challenges of ESG: The Importance of ESG Integrity within Corporates

As emphasized in Deloitte's first and second blog on ESG Integrity, corporate accountability regarding ESG is under scrutiny: companies are increasingly held responsible for their societal impacts, including effects throughout their supply chains.

Deloitte's recent whitepaper, "Managing and Mitigating ESG Integrity Risks," encourages companies to not focus solely on meeting their reporting obligations but also actively address potential exposure to ESG misconduct. Because what if something in the supply chain is wrong? By addressing the risk of ESG misconduct, companies can ensure supply chain integrity, which not only fulfils compliance requirements but also builds a more sustainable and ethical business model.

From Supply Chain Due Diligence to Supply Chain Integrity: What Does It Entail?

Once upon a time, supply chain issues were presumed to be beyond a corporate's control: engaging in trade, especially within the international market, did not require informing oneself about the third parties engaged. Over the past decades that changed and compliance checks on topics such as sanctions, corruption and financial integrity became the standard. Enter 2024 and companies are expected to be aware of the different 'shackles' that form their supply chain, and the potential ESG-related risks associated with these shackles, including industry risks, regional factors, sourcing and production, supply and distribution channels.

We note that third-party risk management is increasingly becoming a focal point in ensuring supply chain integrity. Corporates must expand their due diligence processes to encompass ESG-related checks on third parties. These checks should not only address traditional compliance questions such as 'is the owner a PEP?', 'is the company a front company?', or 'is the company operating in an unstable region?' but also delve into contemporary issues like 'does the company import a high risk product category?' or 'has the company been in the news for human rights violations?'. Leveraging extensive third-party risk management practices ensures that companies are fully aware of who they are dealing with, thus mitigating risks associated with ESG misconduct as well.

EU Legislation and Sustainability: The Puzzle Pieces

The first piece of the puzzle, the EU Taxonomy, is a classification system that provides corporates, investors, and policymakers with proper definitions for what economic activities can be considered environmentally sustainable. Secondly, on 5 January 2023, the Corporate Sustainability Reporting Directive (CSRD) became effective. The directive modernizes and reinforces the regulations regarding the social and environmental data that corporates are obligated to disclose. Now, an expanded group of large enterprises, along with listed SMEs, will be required to provide sustainability reports. Additionally, some non-EU companies will need to report if they generate over EUR 150 million in the EU market. The first companies will have to apply the new rules for the first time in the 2024 financial year, for reports published in 2025.

And now, in July 2024, the final piece of the puzzle was laid, as the Corporate Sustainability Due Diligence Directive (CSDDD) entered into force. At the core of the CSDDD is the requirement for corporates to perform Human Rights and Environmental due diligence and to prevent adverse impacts within their business, as well as through their supply chain. The directive is considered to be a 'game changer' regarding ESG regulations and applies to both EU and non-EU corporates operating within the European Union that achieve certain thresholds in terms of revenue turnover and employee numbers. In addition, CSDDD establishes a strict penalty framework for companies that do not adhere to its requirements.

New Legislation Leading to Corporate Accountability: Environmental Crime Directive

With the implementation of the Environmental Crime Directive, effective since 20 May 2024, new steps have been taken in order to be able to hold parties accountable for environmental crimes. The Directive provides a list of environmental offences addressing the most serious breaches of environmental obligations, in response to which Member States will have to ensure that these breaches are incorporated as criminal offences in their national law. The Directive also defines concrete types and levels of penalties for both natural and legal persons.

Moreover, the Directive states that crimes such as corruption, money laundering, and document fraud are often interconnected with serious forms of environmental crime and should therefore not be dealt with in isolation. In other words: involvement in environmental violations is often associated with involvement in financial crimes such as money laundering or even fraud and corruption, and vice versa.

This legislation underlines the importance for companies to evolve their due diligence practices to incorporate ESG Integrity.

In summary, EU legislation now requires all major corporations and publicly traded companies to report on their perceived risks and opportunities related to social, environmental, and governance issues, including the effects their operations have on individuals and the environment. The combined framework of the EU Taxonomy, CSRD, and CSDDD sets a comprehensive standard for corporate sustainability, pushing towards a more transparent and responsible business environment that contributes to a sustainable economy and society.

Now, the question arises: How do you incorporate ESG-related topics into your due diligence?

The most widely used framework for assessing and structuring risk management within corporates is the COSO Framework, ERM Model and Fraud Risk Management Guide. Recently, in 2023, COSO released a second edition of the Fraud Risk Management Guide. The guide was renewed, partly due to changes in the external environment and fraud landscape and provides information on this changing landscape, including on ESG initiatives and reporting. This demonstrates how risk management is inextricably linked to ESG Integrity and provides a solid foundation for the next steps.

We'd like to offer a few suggestions to get started:

1. **Identify Relevant ESG Integrity topics** Identify key ESG-related topics relevant for your company, for example by engaging with subject matter experts on integrity topics. Map potential ESG Integrity risks across operations and supply chains, and engage with stakeholders to understand their concerns and expectations.
   Example: Discuss your exposure to ESG misconduct by gathering knowledge on integrity risks in your company's processes and environment.

2. **Integrate ESG Integrity into Due Diligence Processes** Include ESG Integrity topics into existing (fraud) risk assessment processes, and assess ESG practices of suppliers and business parties with attention for operational regions, industry and service offerings.
   Example: Prioritize your high risk business partners.

3. **Implement Mitigation and Improvement** Plans Develop and implement plans to mitigate ESG Integrity risks and address gaps. Enhance the existing control framework and ensure ongoing evaluation and testing for effective risk management.
   Example: Add ESG Integrity clauses in contracts to ensure compliance with your standards.

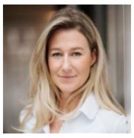
4. **Monitoring, Reporting, and Stakeholder Engagement** Incorporate pre-discussed performance indicators on ESG Integrity into existing management systems and use data analytics for efficient tracking and reporting. To effectively integrate ESG Integrity considerations, maintain open communication with stakeholders on level of integration.
   Example: Use a dashboard to regularly update stakeholders on ESG Integrity metrics and progress.

Conclusion: The Time is Now

Moving from ESG reporting to ensuring ESG Integrity is not just a regulatory necessity but a strategic advantage for building a sustainable and ethical business. As the landscape of corporate accountability evolves, proactively identifying relevant ESG Integrity topics, integrating them into risk assessments, implementing robust mitigation plans, and maintaining transparent stakeholder engagement, is imperative. Your commitment to ESG Integrity today will pave the way for a resilient, responsible, and sustainable future.

ESG Integrity Blog Series

Stay tuned for our upcoming blogs, in which we will further explore the dynamic regulatory landscape and the need for setting up an ESG Integrity governance, and which underscore the importance of embedding ESG factors within risk assessments to ensure robust, future-proof business practices. Additionally, here you will find our solution on managing and mitigating ESG integrity risks.



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