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Understanding the "G" in ESG: The critical role of compliance

By Andra-Aurora Horwat, CFE; and Jan Meyer, CPA, Swiss Certified Accountant

Octavia Butler, a pioneering American writer, once wrote: "There is nothing new under the sun, but there are new suns." Can this analogy also be applied to the concept of environmental, social, and governance (ESG)?

While ESG has gained significantly increased attention over the last years, it is not an entirely new concept—socially responsible business as a notion has been around for decades.

However, what is new is the growing emphasis on the importance of ESG factors not only in the public's perception (e.g., consumers) but also in the shareholder's investment decision-making process and the broader context of the stability of global financial systems. This renewed focus on ESG factors has led to a proliferation of ESG funds and investment products, as well as a growing awareness of the importance of connecting corporate values and missions with operational excellence, effective management of capital, and good governance.

While environmental and social factors often steal the spotlight, governance is equally important. A lack of proper attention to this area leads to myriad unaddressed risks, impacting not only the organization itself—including its talent—but also investors, customers, suppliers, and the broader business community.

Governance is a cornerstone of sustainable businesses, and hence this article further explores its importance in this context: the "G" in ESG (the terms ESG and sustainability are used interchangeably in this article).

Risks of weak corporate governance

In the current dynamic realm of corporate governance, the risks posed by weak governance are profound and multifaceted and can impact organizations in many ways.

One of the key risks of weak governance is financial mismanagement. Poor governance practices can have severe financial consequences, such as inaccurate financial reporting, mismanagement of funds, or insufficient internal controls over financial processes. These issues can result in financial losses, a decline in shareholder value, heightened scrutiny from investors and regulators, and—in the worst case—insolvency of a company.

Moreover, the lack of robust governance opens the door to an increased fraud risk. Without stringent controls and oversight mechanisms in place, individuals may exploit vulnerabilities within the organization, siphoning funds and damaging the company's financial integrity.

Ultimately, failure of corporate governance—at least from a past perspective—was mainly associated with a

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company’s financial failure.

However, over the years, additional risks outside the financial mismanagement and asset misappropriation realm emerged, such as potential conflicts of interest. This can occur when board members or management executives have personal or financial interests that conflict with the company’s and its stakeholders’ interests. This leads to decisions that prioritize the interests of a few individuals over the interests of many—which is not only ethically questionable but also impacts an organization’s relationships with these internal and external stakeholders.

Furthermore, regulatory noncompliance emerges as a significant concern in the absence of effective governance. Failure to adhere to legal standards invites punitive measures and fines but also tarnishes the company’s reputation, impacting investor trust and market standing.

And lately, questionable emerging business practices—such as the alleged over-issuance of nature-based carbon credits by a leading global company—have demonstrated public concerns around “greenwashing” (deceptively claiming products or services to be environmentally friendly) are real. Even if critics claim that overly focusing on greenwashing concerns may discourage companies from making real progress in the area of sustainability, greenwashing needs to be taken seriously.[1]

In the face of these financial or reputational risks, cultivating a culture of accountability and transparency becomes paramount. By implementing strong governance frameworks, companies can mitigate vulnerabilities and fortify their resilience in an increasingly complex business and regulatory environment. And this is where boards play a significant role.

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