ESG and the risks of having good intentions

Brad Preber, CEO, Grant Thornton LLP

The rise of ESG-focused investing should, on its face, be a movement defined by trust, good governance and accountability. After all, the movement to promote corporate action on environmental, social and governance (ESG) standards is aimed at making progress on values and shared prosperity.

It should be easy for anyone to tell what a company's ESG policies are and whether the company is delivering against those expectations. If there is one thing that a company should do to affirm its ESG bona fides, it should be to report its efforts honestly, transparently and accurately.

Sadly, ESG reporting is as fraught as financial reporting, if not more so. When companies make claims about their ESG performance, it is very difficult for investors to verify those claims and to detect fraud. It pains me to say this, because I'd like to think that ESG issues should be championed without fear of fraudulent reporting.

But even though that's not the reality we live in right now, there are steps we can take to increase investor confidence in ESG. Addressing this problem will take a systematic approach that includes the work of the entire ESG reporting ecosystem — directors, management, the audit profession and the regulatory community, as well as academics, investors and the news media.

The present-day system of standards and practices that govern financial reporting took decades — even centuries — to take shape. We can't wait that long to set standards around ESG reporting. Moreover, we can't expect that work to be done overnight.

This is a challenge to anyone who cares about ESG outcomes, as well as economic fairness, honest trade and transparent governance. But it is a challenge no one can afford to ignore: If ESG reporting is not trusted, those outcomes are at grave risk.

> "If someone makes an ESG claim about empowering women, for example, that means something quite tangible and real to the ESG community — a community that provides corporations with ample means for validating ESG claims. Knowing that, and understanding how that works, is the first step on the path toward good reporting."

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The stakes

Understanding the risk of fraudulent ESG reporting starts with understanding the stakes. People don't typically fudge their numbers unless they have a compelling reason to do so. In the case of ESG reporting, that reason starts with the growing investor interest in ESG issues.

Just look at a few data points:

- ESG-driven investment is estimated at greater than $35 trillion in assets under management and is on track to exceed $53 trillion by 2025.
- Global sustainability investments now surpass $30 trillion, up 68% since 2014.
- Nearly nine out of ten Millennials report that they want their money to go to sustainable investments.
- Goldman Sachs has pledged to take public only those companies that have diverse boards, while NASDAQ has issued rules requiring its member companies to include some directors who come from underrepresented demographic groups.
- Harvard's endowment is divesting itself from fossil fuel companies. So are Columbia, Georgetown, Rutgers and the University of California.

If investors are studying what companies say about their ESG programs, so too are regulators.

The Biden administration created the Climate and ESG Task Force, which is developing initiatives to identify ESG misconduct and analyze data to identify potential violations. It also created a website to receive tips, referrals and whistleblower complaints for ESG-related issues.

In addition, the SEC's Division of Examinations issued a Risk Alert detailing observations of ESG-related deficiencies and internal control weaknesses – and those related to investment advisers and funds making ESG claims. All of which is to say that ESG-related fraud is under the microscope.

The internal drivers of ESG interest

Investors and regulators are hardly the only ones seeking higher ESG standards and performance. We are also seeing employees, young and old, become more mission- and purpose-driven. Two out of three millennials say they will not work for a company unless it is focused on social responsibility.

They want to be proud of the organizations they work for. That means they want to work for companies that promise ESG outcomes, whether they are certain environmental standards, specific social and diversity goals or accomplishments in other policy areas. It's no longer enough to have good intentions. You have to show meaningful and verifiable results.

That means that ESG is not just an investor relations issue. It's also an HR issue. To be sure, the focus on environmental and social aims didn't emerge in the last few months or even the last few years. ESG elements have been a part of corporate action for means there have been more than a few notable incidents of unmet promises.

For example:

- A vast carbon credit fraud perpetrated on people in the UK led to the arrest and extradition of perpetrators.
- A massive Ponzi scheme was based on the fraudulent claim that something called "biochar" — waste from tires and household garbage — would be a future source of green energy.
- The Volkswagen diesel engine emissions scandal remains one of the most notable incidents of business fraud in history for which the company paid $2.8 billion in criminal fines.

We should not be completely dispirited by these high-profile incidents. In fact, these may be an indication of the rising value of ESG as a corporate outcome.

The fraud triangle

When someone is willing to lie about something, it tends to be worth it: Art masterpieces are forged; miracle cures are pitched to the sick; quarterly earnings results are fudged to meet lofty expectations. They all occur because so much is at stake. ESG has joined that exclusive club. These notable incidents share a few things in common, something we in the profession call the 'fraud triangle.' The fraud triangle, first described by the criminologist Donald R. Cressey, defines fraud risk using opportunity, pressure and rationalization as the three legs of a triangle.

The first leg of that triangle is opportunity. Opportunity is present when the audience – the target – lacks a full awareness of what is being presented to them. If you don't know about the distinctive brushstrokes and paints used by Renoir, it is hard to discern a fake from a real Renoir painting.

So, too, with ESG reporting. Most ESG audiences — even sophisticated ones — lack a full understanding of what is being reported. They also have a limited ability to compare ESG claims across companies, which is often essential to identify intentional misstatements.

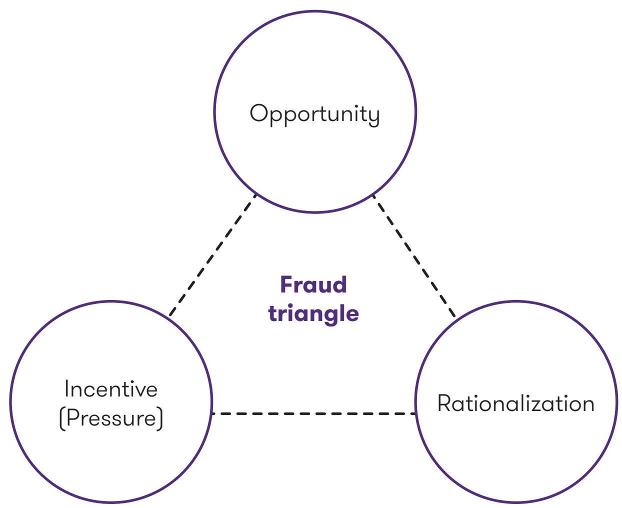
The second leg of the fraud triangle is pressure. There is enormous pressure on the C-suite to make and meet ESG promises. Think about how hard executives work to avoid disappointing Wall Street on their earnings. The same is increasingly true for ESG outcomes.

The pressure is particularly intense when it comes to raising capital. Increasingly, private equity and venture capital — not to mention major pension funds and public entities, insist on reviewing a company's ESG policies, goals and metrics. This is true for large-cap companies, as we know, but it's also true for mid-cap companies and those that might not be household names. Even smaller companies have to raise capital — and when they do, they are increasingly being asked about their supplier diversification efforts, their environmental impacts and other ESG issues.

When the pressure is great enough, people will do and say the most outrageous things. Because it's worth it to them to risk it.

The third leg of the fraud triangle is perhaps the most dangerous one, because it coexists with many ESG issues — rationalization. Everyone rationalizes, and we probably do it multiple times each day. "I'll have this cookie because I went for a walk this morning." Or "I'll drive above the speed limit because I need to get my kid from soccer practice on time." Rationalization is normal, human — and in the case of ESG, a fertilizer for a fraud garden.

ESG represents many social virtues. Making ESG promises, and making progress towards those promises, should be rewarded, not punished, right? If an organization comes close to — but still fails – to deliver on an ESG promise, it could be tempted to rationalize a misstatement. After all, some progress is better than none, right? So, with the best of intentions, with the highest possible moral mindset, fraud is perpetrated.



- **Opportunity**
  - Relatively new field with mainly voluntary reporting frameworks
  - Rigorous ESG regulatory landscape doesn't currently exist
- **Incentive (Pressure)**
  - Increased pressure from investors to see ESG disclosures
  - Calls for companies to deliver decision-useful information
- **Rationalization**
  - Current environment creates multiple ways to rationalize fraudulent activity

How to avoid it

Despite the power and lure of misstating ESG reporting, fraud is not inevitable. ESG fraud can be resisted — and in fact, it often is. The key is to maintain guardrails, ask hard questions and invest constantly in better reporting, better controls and more developed approaches to integrating ESG reporting into all other kinds of reporting.

In fact, these more prosaic tasks may be more powerful as a deterrent and a corrective than regulatory action and litigation.

Meanwhile, we will need a greater understanding of what constitutes material information when it comes to ESG issues. Materiality is a central idea in financial reporting. When something is material, it is treated as information or events that would affect the judgment of an informed investor.

Auditors, regulators and the courts have long agreed upon traditional definitions for financial materiality — and most people understand how to apply and evaluate an item for its financially materiality. For example, if a company's executives know that one of their most important products has a flaw built into it, that's material information that must be disclosed accurately and without delay.

But the concept of materiality begs an important question: Should companies be required to disclose activities in areas beyond those directly affecting their financial performance, such as their impacts on the climate, human rights, income inequality, or some other measure of social well-being? That is what is known as double materiality, and may further cloud ESG reporting, if required.

And there is the concept of the triple bottom line, which focuses on how a corporate matter affects people, the planet and profits.

As a reporting issue, these enhanced definitions of materiality can conflict with, or at a minimum confuse, the way most corporations have traditionally done things. For companies that have focused exclusively on reporting how they are maximizing shareholder value, the addition of ESG metrics is a challenge.

Adding to that challenge is this: We lack standardized frameworks and definitions for a range of ESG reporting measures and metrics. So, in the coming months and years, it's critical that the SEC, accounting standards boards and others sharpen their focus on materiality assessments and standardized disclosures. Companies, too, have a role to play. They may simply apply a consistent process to determine what is material and what isn't, and they should be prepared to refine that process in the coming years.

Creating an ESG culture

Even if materiality isn't clearly defined yet, some definitions do exist — and we should be using them. ESG standards-setting boards have done important work out various key categories and definitions, and all corporations should seek to standardize their reporting to align with this work.

If someone makes an ESG claim about empowering women, for example, that means something quite tangible and real to the ESG community — and they have provided corporations with ample means for proving the claim. Knowing that, and understanding how that works, is the first step on the path toward good reporting.

Corporate leaders will also need to ask some hard questions, starting: Are my company's ESG disclosures subject to the same rigor as our financial disclosures? If not, what are our management assertions about ESG, and are controls in place to make faithful assertions? Finally, corporations should decide — in the abstract, not as situations arise — what they should do if they see a problem in their ESG reporting. They need to have a plan for disclosure and corrective action.

Investing in better controls around ESG objectives will ultimately be a matter of corporate culture. All organizations with ESG claims and issues will have to integrate ESG reporting and disclosure across their operations, in the same way that financial considerations drive all enterprise decisions.

ESG can't be left to a single department or a single reporting chain. It has to be treated as central to all parts of the business — both to drive better outcomes and to create more procedural controls and cross-enterprise discipline.

Think about how focused most organizations are on their financial reporting and related functions. The budget process is closely watched. Incremental results and financial performance metrics are widely shared. People are incentivized to meet or exceed their budget and performance numbers — and they watch to see how others are doing as a comparison.

Now, imagine if this same kind of culture of performance present for ESG goals. Not only would ESG results improve, there would be a natural focus on the accuracy of reporting and results.

Of course, creating this kind of culture is going to take meaningful support. Third-party providers with experience in ESG fraud prevention can help ensure complete accuracy in disclosures. We will also need to build an ecosystem of academic departments, coursework and training, ongoing certification and standards, and literature capturing the kind of experiences that shape future professional judgment.

Let's not forget, these issues are never settled for good. Accounting standards and practices are constantly evolving, and companies on the leading edge of our dynamic economy will always be testing new ideas about valuation and performance.

The same is true of ESG issues. For a company that has recently set new ESG goals or strengthened its ESG commitments, it will take effort, investment and repetition to get to a maturity level that stakeholders and investors will increasingly expect.

That process is manageable — it is doable — and most important, it is necessary. There really is no alternative, because the stakes, as we have seen, are incredibly high. People care about ESG, want ESG outcomes and will make major decisions on where to invest, where to work, and what to buy based on those outcomes. In that sense, ESG has already proven to be valuable and worth the investment. Making it trustworthy is therefore essential to ESG's success — and to the overall success of a company.

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