



GREEN GREMLINS

The hidden fraud risks in ESG branding

BY PAUL KILBY

Having an environmental, social and governance strategy has become all-important for companies. But as criticism over misleading and fraudulent claims grow, regulators are clamping down and pushing to clarify ESG disclosure rules. As they do in financial reporting, CFEs will have a big role to play in this hot but nascent corner of the market.

When Desiree Fixler was hired in 2020 to be the first head of sustainability at DWS, she and her colleagues soon found gaps and weaknesses in how the German asset manager reported and analyzed its environmental, social and governance (ESG) capabilities.

Such problems are common across industries as companies struggle to adopt ESG models, which are often complex and still in their infancy. But on the eve of the release of the company's annual report, Fixler felt that some issues required urgent attention, particularly how DWS had reported the size of its ESG assets under management.

She quickly told top executives and raised the issues again when some of the wording in a draft of the 2020 annual report contradicted those findings. Management's response was surprising.

DWS fired Fixler on March 11, 2021, just eight months into the job and a day before the annual report was released. Fixler said she was sacked for speaking up about the faults in DWS's ESG platform and has filed an unfair dismissal claim in the German courts. (See "Fired executive says Deutsche Bank's DWS overstated sustainable-investing efforts," by Patricia Kowsmann and Ken Brown, *The Wall Street Journal* – through Fox Business website, Aug. 1, 2021, tinyurl.com/bd7n2fy9.)

"Instead of accepting my edits and the objections I had been making regarding the reporting of ESG assets under management and the description of the ESG capabilities at the firm, the misstatements stayed in the annual report," recalls Fixler during an event held late last year by Women in Sustainable Finance International. (See "ESG at the crossroads," YouTube, Nov. 22, 2021, tinyurl.com/mr3em38z.)

Fixler said that DWS was misrepresenting itself when it incorporated phrases in its annual report like "it placed ESG

at the heart of everything we do," and that it was inaccurate to say that more than half of nearly 800 billion euros in assets under management were invested using ESG criteria. (See "DWS whistleblower to fund managers: Dial down ESG 'propaganda' or risk lawsuits," by David Ricketts, *MarketWatch*, Sept. 15, 2021, tinyurl.com/2p83cwt4.)

As an example of lax ESG standards, Fixler noted in an interview with German news site Spiegel International that one of DWS's ESG funds carried Wirecard stock right up to the time of the company's collapse despite reports beforehand of large-scale fraud at the German payments processor. (See "The Sustainability Propaganda Got Completely Out of Control," by Tim Bartz, *Spiegel International*, Sept. 1, 2021, tinyurl.com/mr4cn7ez.)

"Being U.S. trained and working in the U.K. and very regulated markets, you have to be painfully accurate about all statements, financial and nonfinancial statements," Fixler said during the event held by Women in Sustainable Finance. "... We knew these were inaccurate statements and these were material inaccurate statements. And that is where management crossed the line in this case."

DWS has denied any wrongdoing and hired PwC last year to investigate the allegations, only to raise further concerns over conflicts of interest due to the consultant's earlier advisory role on the asset manager's sustainability efforts. U.S and German regulators have also initiated probes into Fixler's claims. (See "DWS statement on current coverage," DWS, media release, Aug. 26, 2021, tinyurl.com/b3bf3rze; "DWS probes signal stark new reality for ESG funds," by Elizabeth Meager, *Capital Monitor*, Sept. 7, 2021, tinyurl.com/2p8defve; and "PwC advised DWS on sustainability while investigating greenwashing claims," by Olaf Storbeck, *the Financial Times*, Sept. 26, 2021, tinyurl.com/2p88jnf4.)

COMPLAINTS ABOUT ESG CLAIMS

Accusations like those faced by DWS over the accuracy of ESG reporting are becoming increasingly common in the financial industry — where Tariq Fancy, the former chief investment officer for sustainable investments at the world’s largest asset manager BlackRock, has become a vocal critic of ESG investing. But it’s not just the financial sector. A whole range of companies are facing lawsuits for misrepresenting certain ESG pledges. (See “BlackRock hired me to make sustainable investing mainstream. Now I realize it’s a deadly distraction from the climate-change threat,” by Tariq Fancy, the *Globe and Mail*, March 30, 2021, tinyurl.com/2p8kvwxf and “Earth Day 2021: Companies Accused of Greenwashing,” *truthinadvertising.org*, April 19, 2021, tinyurl.com/2p8hcctm.)

The potentially fraudulent claims that organizations make about their ESG capabilities are also drawing the attention of auditors and CFEs who are still trying to figure out the best approaches to an industry trend that remains largely unregulated. With few clear rules and reporting standards to follow, untangling ESG claims can be complicated, and it’s often difficult to determine whether there’s a legal case for fraud.

“These are the glorious, confusing, ‘Wild West’ days of sustainability and ESG,” says Cooper Abbott, CFE, a principal of sustainability asset management firm Compound Capital. “DWS clearly misrepresented what they were doing on the ESG investment side. But one thing to keep in mind is that there are legitimate differences of opinions about what sustainability looks like.”

Abbott cites the example of the McDonald’s decision in 2018 to abandon plastic straws for paper ones in the U.K. and Ireland amid regulatory and societal pressures to protect the environment. The problem was that the paper straws, which the U.S. fast food chain described as “eco-friendly,” weren’t easily recyclable, forcing it to dump them in landfills until they

could find a solution. (See “McDonald’s paper straws cannot be recycled,” *BBC*, Aug. 15, 2019, tinyurl.com/2p879y8f.)

“There is a huge spectrum out there, whether it is companies being cynical and using ESG as marketing, or being misguided or just straight-up fraud,” says Cooper. “McDonald’s may not have been fraud, but they were certainly not telling the whole story.”

It’s clear that fraud examiners and auditors will have their work cut out for them at a time when regulators and lawmakers are making a big push to clarify rules around ESG reporting and fraud. Gone are the days when companies could simply include a few self-congratulatory paragraphs in their annual reports about their efforts to help the environment. Regulators are likely to start scrutinizing ESG claims in greater detail, much like they do with financial numbers.

“There are a lot of ways CFEs can help right now,” says Brad Preber, CFE, chief executive officer at one of the nation’s largest accounting, tax and advisory firms, Grant Thornton LLP, which has been advocating for clear standards and universal practices for ESG reporting. (See “ESG investing needs standards to prevent fraud and greenwashing,” by Brad Preber, *Fortune*, Nov. 22, 2021, tinyurl.com/2p94bx44.)

“It is very close to traditional financial fraud, except now we are reporting numbers that fall into the ESG category. But first of all, it is about getting a minimum level of acceptable knowledge around ESG and how things should be reported.”

While there are clear-cut cases of ESG fraud, such as when regulators caught Volkswagen in 2015 rigging its vehicles to cheat government emissions standards, the obligations that organizations have regarding ESG reporting and the actions that constitute fraud or other crimes are still matters for debate. Indeed, pinning down illegal behavior can be tough.

As Citibank analysts wrote following Fixler’s allegations against DWS, “We struggle to see how regulators can hold DWS to account, because sustainability requirements are subjective, making it hard to enforce, even if there was wrongdoing.” (See “DWS Selloff ‘Excessive’ as Greenwashing Hard to Prove,

Citi Says,” by Steven Arons, Bloomberg News, Sept. 13, 2021, [tinyurl.com/3k4c3dez](https://www.bloomberglaw.com/news/articles/2021/09/13/citi-says-3k4c3dez).)

In the meantime, regulators and lawmakers have been trying to think of ways to ensure that companies and other organizations stay on the straight and narrow at a time when the temptation to make exaggerated ESG claims is growing.

Concerns about climate change and a greater awareness about the need to redress social inequalities have companies and other organizations across the world rushing to brandish their ESG credentials. Whether ESG branding is well-intended or a cynical ploy, the benefits and motivations for doing so are clear. Being ESG-friendly pays dividends, not least because it draws more customers among a public that’s increasingly adamant about creating a more sustainable and equitable future. According to a survey conducted by PwC, between 76% to 80% of consumers said they’d prefer to buy from a company that stands up for either environmental, social or governance issues. (See “Beyond compliance: Consumers and employees want business to do more on ESG,” PwC, [tinyurl.com/mthbkdsy](https://www.pwc.com/us/en/issues-and-trends/esg/beyond-compliance-consumers-and-employees-want-business-to-do-more-on-esg).)

Efforts to employ good ESG practices can also help corporations obtain substantially cheaper funding in the capital markets, where trillions of dollars are now dedicated to these types of investments. The recent surge in ESG and sustainability-linked bonds speaks to the growing popularity of the asset class. And in the asset-management sector, where inflows are the lifeblood of any firm, ESG funds are also essential if asset managers wish to catch the eye of investors deciding where to place their savings. (See “Just how much money is invested in

ESG?” by Helee Lev, *goby*, Dec. 13, 2021, [tinyurl.com/2p9yrbnt](https://www.goby.com/news/2021/12/13/tinyurl.com/2p9yrbnt) and “Sustainable bonds on course to top \$1 trillion annual issuance in 2021,” Moody’s, Oct. 27, 2021, [tinyurl.com/229a4ske](https://www.moody.com/news/2021/10/27/tinyurl.com/229a4ske).)

Yet as the trend has gained momentum, so have accusations of greenwashing, the term used for companies that mislead the public by either exaggerating or providing misleading information about their ESG efforts. “Anytime people have an opportunity to make money or make claims relative to a competitor that opens that dark door into the potential for fraud,” says Cooper.

GREENWASHING TRIANGLE

In a recent academic paper, John Richard Kurpierz, a doctoral candidate at York University, Toronto, and Ken Smith, Ph.D., founder of The Accountability Group LLC/School Accountability Group, argue that greenwashing can lead to fraud, and fraud fighters can employ the same tools they have always used to detect and prevent this type of wrongdoing. This includes using a variation on the three components that comprise Donald Cressey’s Fraud Triangle — perceived unshareable financial need (often expanded to mean “pressure”), perceived opportunity and rationalizations. (See [ACFE.com/triangle](https://www.acfe.com/triangle).)

Kurpierz and Smith call this the “greenwashing triangle” where fraudsters might rationalize their actions by saying that fraud only affects financial numbers, see an opportunity because there’s a lack of harmonized reporting or come under pressure to appear ESG-friendly to garner greater profits. What distinguishes greenwashing from financial fraud is how they’re reported, they say. The reporting regime for financial numbers

is well established, while ESG reporting remains at a very nascent stage. (See “The greenwashing triangle: adapting tools from fraud to improve CSR reporting,” by John Richard Kurpierz and Ken Smith, [emerald.com](https://www.emerald.com), accepted March

16, 2020, tinyurl.com/y29u68jj and “The rising challenge of sustainability fraud, KPMG, 2020, tinyurl.com/26f8xm7r.)

“When you look at a financial report, you know what to expect — a balance sheet, an income statement, a statement of cash flows and some footnotes,” says Preber. “What do you expect to see on an ESG report? No idea, right? Somebody has to promulgate that, and that is where we are at [with ESG reporting].”

NEW RULES

Several countries are now creating rules to guide organizations on what they can and can't do on this front. In the U.K. the Competition & Markets Authority (CMA) published in September 2021 its guidelines on “environmental claims on goods and services,” laying out six principles to help businesses comply with the law. Those principles are that claims must: (1) be truthful and accurate, (2) be clear and unambiguous, (3) not omit or hide important relevant information, (4) consider the full life cycle of the product or service, (5) be substantiated, and (6) comparisons must be fair and meaningful. (See “CMA guidance on environmental claims on goods and services,” CMA, Sept. 20, 2021, tinyurl.com/4f7ztb5c.)

The Financial Conduct Authority (FCA), the U.K.'s financial regulatory body, also published in 2021 its ESG source book to guide asset managers to ensure that sustainability disclosures are consistent with recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD). The G20's Financial Stability Board created the TCFD in 2015 to improve and increase reporting of climate-related financial information. And the U.K. government plans to establish mandatory disclosures using TCFD rules by 2025. (See “Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers,” FCA, December 2021, tinyurl.com/y5y8zpt7; “A Roadmap towards mandatory climate-related disclosures,” HM Treasury, November 2020, tinyurl.com/y79apspz; and “Recommendations of the Task Force on Climate-related Financial Disclosures,” TCFD, June 2017, tinyurl.com/wrd4kmat.)

CARBON CREDITS AND THE POTENTIAL FOR FRAUD

CEOs' pledges to be carbon neutral or negative by a certain year and the growing need for carbon credits are likely to increase the potential for fraud in the decades ahead in what remains a highly unregulated market, says Brad Preber, CFE, chief executive officer at advisory firm Grant Thornton LLC.

“The reality is that fraud is going to explode around what are going to be alleged credit-worthy emission investments,” says Preber.

Concerns over climate change have a string of companies going full throttle in their attempts to brand themselves as environmentally friendly. Starbucks, Amazon, Ikea and even big traditional polluters such as oil company BP and car companies GM and Ford are setting dates for when they'll be carbon neutral in the years ahead. (See “16 Companies That Have Pledged To Go Carbon Neutral,” by Gabrielle Olya, *GoBankingRates*, April 1, 2021, tinyurl.com/2p9ckfm7.)

To get there, companies and other organizations must remove as much carbon dioxide as they're producing. Instead of taking years to upgrade infrastructure to reduce greenhouse gases, organizations will likely have to buy carbon credits or offsets from organizations that have already taken action to capture or reduce carbon emissions.

The idea is that the polluting entity is essentially funding projects to tackle global warming. The credits measure how much is being offset, come at a market-driven price and go toward nullifying some of the carbon emissions produced by companies eager to claim carbon neutrality.

“If you were to evaluate the ability of any organization to be able to get carbon emissions to zero by 2030 or by 2050, there is likely no organization that can do it without buying carbon credits,” Preber says.

The market in carbon credits is expected to grow substantially as more companies and countries come under pressure to become carbon neutral, while brokers and other investors seek to cash in its popularity. (See “More companies want to be ‘carbon neutral.’ What does that mean?” by Terry Nguyen, *Vox*, June 16, 2020, tinyurl.com/25rv45se and “What Are Carbon Credits and How do They Work?” *LandGate News*, Sept. 27, 2021, tinyurl.com/2xz433zb.)

The problem is that the market is largely unregulated. A variety of private groups have established their own accounting standards amid allegations that some projects tied to carbon credits fail to offset carbon emissions in the way they promise or simply cause damage to the environment in other ways. (See “Carbon offsets are going prime-time and they're not ready,” by Tim McDonnell, *Quartz*, May 20, 2021, tinyurl.com/mswvwzb3 and “The hollow promise of net-zero carbon pledges,” by Kristina Partsinevelos, *CNBC*, ESG IMPACT, updated Sept. 13, 2021, tinyurl.com/4tk3dn8a.)

Pressures to comply with carbon neutral targets will only increase the chances of more wrongdoing on this front. “It was already bad but will get worse with CEOs stating they are going to hit these goals and shareholders saying we are going to hold you accountable,” says Preber.

European lawmakers and regulators have also put together a whole raft of different ESG rules and reporting requirements for corporations, asset managers and other participants in the financial markets. The EU's Non-Financial Reporting Directive already requires large companies to report information related to environmental matters, the treatment of employees, anti-corruption efforts and diversity on company boards. Under a proposed Corporate Sustainability Reporting Directive, auditing of that information will also be required. ("Corporate sustainability reporting," European Commission, tinyurl.com/244532yd.)

And Europe's new Sustainable Finance Disclosure Regulation and Taxonomy Regulation are also designed to improve disclosure about corporate activities linked to environmental objectives, which is part of an effort to stop greenwashing. (See "New EU Sustainability-Related Disclosure Obligations for Investment Managers," *The National Law Review*, Dec. 9, 2021, tinyurl.com/yc87kp7y and "The EU Taxonomy: what is the impact for investors and corporates?" BNP Paribas, Nov. 16, 2021, tinyurl.com/5hsxue2a.)

In the U.S., efforts to address and prevent deceptive ESG practices also began to gather pace last year. In March 2021, the Securities and Exchange Commission (SEC) created a task force to identify ESG-related misconduct, including material gaps in misstatements in the disclosure of climate risks. The task force also has a mandate to pursue tips, referrals and whistleblower complaints. In May 2021, President Biden signed an executive order that directed government agencies, including regulators, to assess the risks of climate change. And in December, the Office of the Comptroller of the Currency, the country's bank regulator, sought feedback for a draft on principles for climate-related financial risks. (See "U.S. regulator proposes sweeping climate risk guidance for banks," by Pete Schroeder, *Reuters*, Dec. 16, 2021, tinyurl.com/yckrs79j; "President Biden Directs Agencies to Analyze and Mitigate the Risk Climate Change Poses to Homeowners and Consumers, Businesses and Workers, and the Financial System and Federal Government Itself," *The White House*, May 20, 2021, tinyurl.com/393c8jzj; and

"SEC Announces Enforcement Task Force Focused on Climate and ESG Issues," SEC, March 4, 2021, tinyurl.com/3zfa9254.)

DEFINING WHAT'S RIGHT AND WRONG

All this means that organizations may soon have to comply with more ESG-related regulations and run the risk of being accused of fraud or other types of wrongdoing if they fail to be upfront in their disclosures or find ways to skirt around these rules. Legal experts are warning that companies and government entities need to be prepared. The SEC has already started scrutinizing conflicts between lenders' practices and their policies on issues like climate change. Lawyers at Paul Hastings say that now is the time for companies to conduct ESG risk assessments, review such disclosures and develop a comprehensive ESG strategy and suitable controls. (See "Immediate Steps to Consider as SEC Task Force Targets ESG Reporting," by Tara K. Giunta, Morgan J. Miller and Caroline Wilson Roberts, *Paul Hastings*, March 15, 2021, tinyurl.com/2p9bv2sy and "SEC's Texas office probes banks over disclosures on guns, fossil fuels -sources," by Chris Prentice, *Reuters*, Jan. 5, tinyurl.com/42f3yrcc.)

Companies' public statements, such as their promises to be carbon neutral, could get CEOs in trouble for fraud, says Preber. "If you are a public company, that is a statement from management and they can be held accountable for that," he says. "If an investor in that company believes that to be true, and the CEO doesn't have a plan to get there, that could be problematic."

Indeed, experts are still debating how to measure and define ESG disclosure standards. "What is a challenge is that there isn't a scientific agreement on the types of things that are most relevant to report and what measurements are really most salient," says Cooper.

Take the concept of materiality. That's the threshold where auditors determine whether the dollar amount of a misstatement is large enough to influence an investor or anyone else to act upon it. That usually comes down to the impact on the bottom line or asset prices. Gauging materiality with ESG

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disclosure, however, is expected to be broader in its scope. Regulators are increasingly using the concept of “double materiality,” which covers how, say, climate change impacts a company’s bottom line but also how an organization’s actions affect the climate or other aspects of society. “Triple bottom line” — which measures a company’s economic (not just financial), social and environmental performance — is another concept that’s coming back into vogue. (See “‘Double materiality’: what is it and why does it matter?” by Matthias Täger, London School of Economics, April 21, 2021, tinyurl.com/2p8ep2pt and “25 Years Ago I Coined the Phrase ‘Triple Bottom Line.’ Here’s Why It’s Time to Rethink It,” by John Elkington, Harvard Business Review, June 25, 2018, tinyurl.com/57ejat7f.)

Some of these concepts are quantifiable and easily measured, such as carbon dioxide emissions, while others are more qualitative and harder to define, such as how companies might define their investments in the energy sector, says Preber. That gray area leaves the door open to deceptive practices if not outright fraud.

“Whenever you have different measures for bottom lines that aren’t well defined and overlay with Generally Accepted Auditing Standards, you end up with an easy playing field to fudge the numbers,” he says.

“We believe the SEC is going to have something forthcoming around reporting on some of these metrics. But until you get the rules on what is in and out of play, I think this is largely subjective.”

Preber hopes that clearly defined global rules on ESG disclosures will become a reality after the IFRS Foundation, which also established global commonly accepted standards for financial accounting, set out to do the same for sustainability reporting with the creation of the International Sustainability Standards Board in November of last year. (See “International Sustainability Standards Board,” tinyurl.com/2p874af8.)

Either way, the skills of fraud examiners will likely be in high demand in this nascent field. Companies should be hiring CFEs who know how to analyze ESG data and understand how it’s being used across an organization and ensure controls are in place to avoid misstatements about ESG strategies, says Cooper.

“It’s very similar to what is done on the financial side, but you’re looking at emission records instead of a report on payroll. Frankly, the core skills of the CFE are exactly the same,” says Preber.

“It’s using an experienced CFE to tell you what schemes you might see so that when you are rolling out those systems, they can report them faithfully. And

if fraud is discovered, it is seeking evidence and determining whether evidence supports an action for fraud or not.”

Companies like DWS looking to roll out their ESG platforms might be well-advised to get a CFE on board early in those discussions. “This is an area where a CFE can be involved in the process early on as a reality check,” says Cooper. “They know some of the history around this, and they have a lot to add to this discussion.” ■ **FM**

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