The Rise of ESG Reporting – The IFA's Role in Prevention and Detection of ESG Washing

Research Project for Emerging Issues/Advanced Topics Course

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2 Introduction

The demand for Environmental, Social, and Governance ("ESG") practices and reporting is growing and rife with pressures and opportunities to engage in fraudulent reporting of ESG performance or "ESG washing" as it will hereafter be referred to in this paper. This paper will explore the current ESG reporting landscape and the role that Investigative Forensic Accountants ("IFAs") will play in building trust in ESG practices and reporting.

2.1 Objective

The purpose of this research paper is to map the existing body of knowledge with respect to ESG practices and reporting across the three legs of the Fraud Triangle to create a framework for assessing the risk ESG washing. This research paper will provide IFAs with a foundational knowledge in ESG topics as well as the factors that increase the risk of ESG washing and how the skills of an IFA can be leveraged to prevent and detect intentional misrepresentation of ESG performance. This paper will explain the rationale behind why the fraud triangle is an appropriate tool to use in order to understand the drivers of ESG washing followed by an explanation of the methodology used in compiling the relevant literature and providing a background on ESG and ESG washing. This paper continues by explaining the pressures, opportunities, and rationalizations applicable in ESG reporting and disclosures as well as potential interventions for each from a regulatory and IFA perspective. This paper concludes with an overview of an IFA's role with respect to ESG washing, a discussion of an ESG washing case, and areas for further research.

2.2 Why the Fraud Triangle?

The fraud triangle is foundational to an IFA's work. It is how IFAs understand what factors drive a person to commit fraud and therefore enables them to design and implement controls to prevent and detect it. For the purposes of this research paper, the definition of fraud as set out by

CPA Canada will be used as most IFAs are also accountants thus this definition will help bridge the gap between the current world of IFAs and the developments in ESG reporting.

CPA Canada defines fraud to mean "a deliberate and intentional act to misrepresent or deceive for financial or personal gain"[1]. This definition parallels that of ESG washing which is when an organization intentionally misrepresents its performance across ESG metrics to appear more positive in order to secure the favour and financial resources of stakeholders such as customers, investors, and lenders who may base their purchasing, investing, and lending decisions on these representations. These representations could be to the detriment of their stakeholders from a financial perspective or, more broadly, to the detriment of the environment and/or their community.

As ESG washing fits within the definition of fraud, it is appropriate to consider the fraud triangle when examining the drivers of ESG washing.

3 Methodology

A review of academic journals, professional publications, standards, frameworks, and guidance, and popular press was undertaken in the preparation of this research paper.

Academic Journals

The following academic journals were consulted in the course of preparing this research paper:

- Accounting, Organizations and Society
- California Management Review
- SSRN Electronic Journal
- Harvard Business School

[1] CPA Canada Policy Document FN-12 Fraud Policy (page 1)

- Issues in Accounting Education
- Journal of Business Ethics
- Organization Science
- Sustainability
- Sustainability Accounting, Management, and Policy Journal
- The Journal of Economic Perspectives

These journals were relied upon for various reasons such as containing research specifically linked to sustainability (e.g., Sustainability, and Sustainability Accounting, Management, and Policy Journal), being listed in the Financial Times 50 list (e.g., Journal of Business Ethics and Accounting, Organizations and Society), or containing research that could be generalized to be applicable to ESG reporting or was relevant to ESG reporting but the research was in respect of a foreign jurisdiction (e.g., SSRN Electronic Journal, California Management Review, Organization Science).

Professional Publications

Publications from the following bodies and trade journals were consulted in the course of preparing this research paper:

- Accounting for Sustainability
- CFA Institute
- Ciri
- Compensation Governance Partners
- CPA Canada
- Credit and ESG Rating Agencies (Fitch Ratings, ISS)
- European Commission

- Government of Canada
- International Capital Market Association
- Lexpert
- Millani
- Principles for Responsible Investment
- Public Accounting Firms (KPMG, EY, PwC)
- Responsible Investment Association
- The CPA Journal
- United Nations
- Value Reporting Foundation

Publications from these bodies and trade journals were relied upon for varying reasons such as the body or publication was specifically created as a result of demand for ESG reporting (e.g., Accounting for Sustainability and Principles for Responsible Investment), the body is well respected and trusted (e.g., professional accounting firms, European Commission, United Nations, etc.), studies were conducted by the body that provided insight into ESG reporting (e.g., Millani, Compensation Governance Partners), and the body is a part of the ESG reporting ecosystem and it was relevant to understand how they function for the purposes of this research paper (e.g., Fitch Ratings)

Standards, Frameworks, & Guidance

The *Competition Act* and Staff Notices issued by the Canadian Securities Administrators were consulted in the preparation of this research paper to understand the legal and regulatory landscape for ESG reporting. Further, the Global Reporting Initiative Standards ("the GRI

Standards") and the Sustainability Accounting Standards Board Standards ("the SASB Standards") were consulted as these are the most widely adopted standards within Canada.

Popular Press

The following sources of popular press were consulted in the course of preparing this research paper:

- BNN Bloomberg
- Harvard Business Review
- The Globe and Mail
- The Guardian

These sources were relied upon due to their reputation as being generally unbiased and reliable sources of news.

Search terms used to identify relevant literature are as follows: sustainability, CSR, Corporate Social Responsibility, ESG, ESG washing, greenwashing, bluewashing, rainbowwashing, pinkwashing, whitewashing, purplewashing, environmental disclosure, sustainability reporting, sustainability reporting fraud, CSR reporting, responsible investment, sustainability bonds and credit risk, Global Reporting Initiative, Sustainable Accounting Standards Board.

4 Background

4.1 ESG Disclosures

As previously mentioned in this research paper, ESG stands for Environmental, Social, and Governance which are non-financial metrics meant to capture the sustainability of an organization and its activities. ESG disclosures share the relevant data with respect to an organization's performance across these metrics and may be in a separate ESG report, listed on the organization's

website, or embedded within an organization's annual report. Globally, formalized ESG reporting is generally not mandatory nor is there a standardized framework to provide guidance and ensure comparability across different organizations with respect to how these metrics are being reported. This will be discussed further in the Section 6 of this research paper. This paper also includes a discussion with respect to the three ESG pillars and the topics covered therein.

Environmental

The environmental pillar represents the impact that an organization has on the environment and includes issues such as what the organization is doing to be a steward of the environment, actions the organization is taking to combat climate change, how the organization is reducing its environmental footprint, and how the organization is preserving biodiversity.[2] The challenge presented by this pillar is how an organization's environmental impact should be measured. There are two types of impacts that an organization may have: 1) direct impact, and 2) indirect impact. Direct impacts, as the name suggests, are impacts that the organization has directly on the environment with their primary activities and that the organization has control over. Indirect impacts would include environmental impacts of up- or down-stream organizations such as an organization's supply chain, their business partners, retailers, and consumers.[3] To illustrate, consider financial institutions and their carbon emissions. Stakeholders may be interested in more than the financial institution reporting on and minimizing the carbon emissions solely from their operations (direct impact). Stakeholder may call for financial institutions to report on the carbon emissions they are financing through lending activities and their client base (indirect impact).

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[2] ESG investing and analysis
[3] Climate business: Business climate 2015

Social

The social pillar represents the impact that an organization has on the lives of its stakeholders. This includes issues such as employee engagement, workplace safety, inclusion and diversity, data protection and privacy, labour standards, and community involvement.[4] This pillar, similar to the Environment pillar, includes direct and indirect impacts which require organizations to be cognizant of the impacts their policies have on their employees and the communities within which they operate as well as the impacts of the organizations that are within their supply chain. For instance, consider an organization in the fast fashion industry, an industry characterized by rapidly mass-produced affordable clothing, and their relationship with their clothing manufacturers. For such an organization to be able to claim their business practices are aligned with the Social pillar of ESG, stakeholders would be interested in knowing whether this organization partners with clothing manufacturers that pay an unlivable wage or make use of child labour.

Governance

The governance pillar represents the actions that the organization has taken to prevent corruption. This includes issues such as internal controls, policies and procedures that govern leadership, executive compensation, board composition and audit committee structure, whistleblower programs, and bribery and lobbying.[5] The Governance pillar is primarily an internal pillar compared to Environmental and Social which consider both internal and external impacts though stakeholders may also be interested in understanding the governance practices along an organization's supply chain, their business partners, and their agents in foreign jurisdictions. For

[4] ESG investing and analysis
[5] ESG investing and analysis

instance, whether the organization of interest has partners in other countries that may be engaging in bribery in order to achieve the organization's business goals.

Figure 1 below summarizes some of the issues covered by each of the pillars of ESG.

Figure 1[6, 7]: ESG Issues		
Environmental	**Social**	**Governance**
• Climate change and carbon emissions • Air and water pollution • Biodiversity • Deforestation • Energy efficiency • Waste management • Water scarcity	• Customer satisfaction • Data protection and privacy • Gender equity • Diversity, and inclusion • Employee engagement and satisfaction • Community relations • Human rights • Labour standards • Indigenous peoples and communities	• Board composition • Audit committee structure • Bribery and corruption • Executive compensation • Lobbying • Political contributions • Whistleblower channels

Some of the issues displayed in Figure 1 under the Governance pillar will be familiar to IFAs given that the Governance pillar is where many IFAs have traditionally delivered proactive advisory work or performed investigations into fraud/misconduct allegations. However, as further discussed in Section 8, IFAs can leverage their skills in investigation, assessing control environments, quantifying losses/damages, and assessing compliance with regulations and standards to perform work relating to the Environmental and Social pillars as well.

4.2 ESG Disclosure Typologies

To understand the different typologies in reporting versus carrying out sustainable behaviours within organizations, Delman and Burbano (2011) proposed a 2 x 2 matrix where the dimensions were "positive communication/no communication" and "good environmental

[6] ESG investing and analysis
[7] The rise of the Social Pillar: The 's' in ESG 2022

performance/bad environmental performance"[8]. Kurpierz and Smith (2020) proposed an altered 2 x 2 matrix where the dimensions would be "false claims/true claims" and "harms/does not harm" in an environmental context.[9] This paper proposes expanding the scope of these matrices to apply to all ESG metrics, not just environmental impact, and incorporate a dimension to demonstrate that ESG disclosures are generally voluntary and therefore organizations may opt not to disclose information. This proposed matrix is shown in Figure 2.

Figure 2: The Disclosure/Performance Matrix

	True Claims	**No Claims**	**False Claims**
No harm	**1.** Vocal ESG organization	**2.** Silent ESG organization	**3.** Cheap talk (ESG washing) organization
Harm	**4.** Responsible organization	**5.** Irresponsible organization	**6.** Fraudulent (ESG washing) organization

What this matrix demonstrates is that there are 6 potential typologies with respect to ESG disclosures:

- **Typology 1 – Vocal ESG Organization:** This is an organization with good ESG performance and makes truthful disclosures about their performance.
- **Typology 2 – Silent ESG Organization:** This is an organization with good ESG performance but makes no disclosures about their performance, possibly due to lack of resources to navigate the voluntary disclosure frameworks.

[8] Delmas & Burbano, 2011
[9] Kurpierz & Smith, 2020

- **Typology 3 – Cheap Talk (ESG washing) Organization:** This is an organization with ESG performance that does not cause harm, but the claims made about their ESG performance are overstated.
- **Typology 4 – Responsible Organization:** This is an organization whose ESG performance needs to be improved and the organization openly discloses the shortcomings of their current practices and plans to address these issues.
- **Typology 5 – Irresponsible Organization:** This is an organization whose ESG performance needs to be improved and the organization is unwilling to make disclosures about its ESG weaknesses.
- **Typology 6 – Fraudulent (ESG washing) Organization:** This is an organization where their business practices cause harm in an ESG context, yet their disclosures indicate that they are an ESG conscious organization.

Of interest to IFAs is Typology 6 outlined in the disclosure/performance matrix, the fraudulent (ESG washing) organization, where an organization's performance across the ESG metrics causes harm, be that environmental harm, perpetuating social discrimination, labour and human rights violations, or corrupt governance practices and the organization makes false claims about their ESG performance in order to maintain or improve its reputation, delay regulatory penalties or litigation, improve access to financing, or attract more customers.

4.3 ESG Washing

At a high level, ESG washing refers to situations where an organization's marketing, public relations, or ESG disclosures indicate a higher level of performance across ESG metrics than the organization's actual performance. Specific types of washing that fall within the umbrella of ESG washing are discussed further.

Greenwashing

Greenwashing, a term coined in the 1980s, is the practice of falsely advertising or promoting a product or making misleading disclosures that would lead stakeholders to believe that the product and/or the organization are environmentally conscious[10] and thereby attracting consumers, investors, and potentially employees. Some cases of greenwashing may be more egregious than others such as spending more money on "green" marketing than on environmentally conscious initiatives compared to using vague terminology to describe a product and leaving the extent of the product's eco-friendliness up to consumer interpretation.

Social Washing

Social washing is the practice of an organization falsely promoting itself as a socially conscious organization with respect to employee rights, labour standards, inclusion and diversity, and community impacts.

A subset of social washing is pinkwashing. Pinkwashing may relate to one of two types of misleading communications. The first deceptively uses the breast cancer pink ribbon to market goods or services[11] while engaging in business activities that have been proven to increase the risk of breast cancer (e.g., manufacturing and selling products with carcinogenic ingredients). The second, also referred to as "rainbow washing" is another type of deceptive communication where the organization presents itself as supportive of the LGBTQIA+ community[12] to gain favour with certain consumers and investors while detracting attention from business activities that are controversial such as labour standards violations, gender equity concerns, or even discrimination against LGBTQIA+ employees within the organization.

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[10] Oxford Languages
[11] WordSense Dictionary
[12] WordSense Dictionary

Another subset of social washing is purplewashing which is the use feminism in an organization's marketing strategies and/or reporting to appear as a supporter of gender equity and women's rights[13]. This may be used to divert attention away from other types of discrimination or may be feminism "lip service" when the organization's business practices do not support gender equity such as failing to address gender wage gaps or lack of women in leadership roles.

Whitewashing

Whitewashing is the practice of covering-up or glossing over misconduct and criminal behaviour[14] in an organization by misleadingly presenting data or conducting a perfunctory or biased investigation. For instance, if there are allegations of misconduct in respect of an executive of an organization, the organization may conduct a superficial internal investigation. The intention of this investigation would be to say that an investigation into the allegations has been conducted and no evidence was found to substantiate those claims. This would be done with the view of mitigating any reputational damage the organization may have faced as a result of the allegations. That is, until evidence of whitewashing is found by external parties.

Bluewashing

Bluewashing is where organizations overstate their commitment to responsible social practices[15]. Bluewashing was first used where organizations have signed onto the United Nations Global Compact ("the UN Global Compact") with the intention of using the United Nations flag for public relations purposes and not taking action in accordance with the UN Global Compact's 10 principles for human rights, labour, environment, and anti-corruption.[16] This is largely possible due to the lack of effective monitoring and enforcement of performance against the UN Global

[13] WordSense Dictionary
[14] Oxford Languages
[15] WordSense Dictionary
[16] Cleaning up the global compact: Dealing with corporate free riders 2012

Compact by the United Nations. The FAQ page of the UN Global Compact indicated that the UN Global Compact is not a legally binding initiative and the United Nations "does not police or enforce the behaviour or actions of companies"[17].

4.4 Market Trends

ESG is gaining increasing importance in the eyes of stakeholders. From a regulatory perspective, Canada's 2022 budget indicated a commitment to implementing mandatory reporting of climate-related financial risks across a broad spectrum of the Canadian economy that will require federally regulated financial institutions to collect and assess information on climate risks and emissions from their clients starting in 2024.[18] The reporting is expected to be aligned with the Task Force on Climate-Related Financial Disclosures framework ("TCFD Framework") and will be regulated by the Office of the Superintendent of Financial Institutions ("OSFI").[19] While the regulation will apply to federally regulated financial institutions, it is expected to have far-reaching impacts on Canadian businesses as they will be required to manage and report their climate-related risks to federally regulated financial institutions.

From an equity market perspective, there has been a rise of Responsible Investment ("RI"). RI is the practice of incorporating environmental, social, and governance performance metrics into investor's decision making and management of equity portfolios.[20] In Canada, RI represented 61.8% of the investment industry in 2019 with $3.2 trillion in RI assets under management.[21] ESG integration is by far the dominant RI strategy in Canada with $3.0 trillion assets under management or about 95% of all reported RI assets under management in 2019.[22] One of the current challenges

[17] Frequently asked questions: UN global compact
[18] Government of Canada, 2022
[19] Government of Canada, 2022
[20] Responsible investment, RIA
[21] 2020 Canadian RI trends report
[22] 2020 Canadian RI trends report

facing RI is a lack of reliable ESG data. This was cited as the top deterrent to growth in RI, followed by mistrust and concerns about greenwashing.[23] This indicates that there are concerns with respect to the reliability of ESG reporting and that there is an appetite for assurance and compliance related services with respect to ESG reporting.

Further, the sustainable bond market in Canada is growing with annual issuance from $1.2 billion in 2014 to $12.2 billion in 2019.[24] Sustainable bonds are fixed income securities where the proceeds of the bonds will be used to finance projects that contribute to sustainable environmental or social development.[25] According to the Canadian Chapter of Accounting for Sustainability, as of 2020, 94% of investors and 93% of issuers regard environmental and social issues as important and only 6% of issuers expect to make no change in their allocation of capital towards positive environmental or social outcomes over the next 5 years. [26] Further, 63% of investors expect to either start buying sustainable bonds seriously for the first time in the next two years or to increase their buying of them.[27] This increasing flow of capital towards positive environmental or social outcomes creates motivation for organizations to adjust their business practices to be more aligned with ESG goals, or in the worst-case scenario, fictitiously represent that their business activities are either not detrimental to ESG goals or create positive outcomes from an environmental or social perspective. The practice of issuing sustainability bonds is further legitimized in Canada as a result of the Government of Canada's announced intention to issue green bonds in order to raise capital for the development of a greener economy and to meet Canada's emissions targets.[28] On

[23] 2020 Canadian RI trends report
[24] Sustainable Finance Bonds: 2020 Canadian Market
[25] Sustainability Bond Guidelines (SBG)
[26] Implementing a sustainable finance framework: Top tips
[27] Implementing a sustainable finance framework: Top tips
[28] Canada's Green Bond Program 2022

March 23, 2022, the Government of Canada issued its first green bond to finance investment in green infrastructure and fight climate change.[29]

With this increasing focus on sustainable development and ESG, there are arguments that there are gaps between the claims and commitments made by organizations and their actions with respect to sustainability.[30] There is research suggesting that voluntary ESG disclosures are self-serving rather than a method to accurately communicate the organization's progress on ESG metrics.[31] The following sections of this research paper will explore the pressures, opportunities, and rationalization for ESG washing.

5 Pressure

The Fraud Triangle initially proposed by Donald R. Cressey defined pressure as a non-shareable financial problem.[32] As the body of knowledge around the drivers of fraud advanced, pressure was expanded to include motivations and incentives to commit fraud; not just a financial problem that needed to be alleviated. This expanded scope could include targets, goals, or expectations that need to be met that are perceived by the individual or organization to be more easily achievable through fraud than through legitimate means. Through this lens, we will explore pressures currently relevant to ESG reporting, the intention of which is to drive positive substantive changes towards sustainable business practices, but which may have the adverse effect of driving organizations towards ESG washing. The pressures discussed in this research paper include pressures faced by organizations as well as pressures faced by members of sustainability departments within organizations where the organization has such a department.

[29] Canada issues inaugural green bond 2022
[30] Cho, Laine, Roberts, & Rodrigue, 2015
[31] Cho, Laine, Roberts, & Rodrigue, 2015
[32] Dorminey, Fleming, Kranacher, & Riley, 2012

5.1 Pressure from Investors

There is increasing market evidence to suggest that ESG reports have informational value. As such, organizations will face pressures to meet the market's expectations on performance across the ESG pillars.[33] Such evidence includes a 2020 survey conducted by EY which found that 72% of institutional investors surveyed around the world indicated that they conduct a structured evaluation of ESG disclosures as part of their investment decision making and 43% indicated that nonfinancial performance played a pivotal role in their investment decision making.[34] As such, it appears that institutional investors are placing pressures on public companies to increase their focus on and disclosure of their ESG performance and risks as this information plays an important role in the investment decision making process.

The United Nations Principles for Responsible Investment outlines a model for integrating ESG into investment decision making which is broken down into four stages and highlights that investors will gather relevant information about an organization's ESG performance from multiple sources, including reports issued by the company. [35] A review of the literature did not find studies with respect to the level of reliance investors placed on particular sources of ESG data and whether reports issued by the organization are more heavily relied upon than external sources of data. Greater reliance on disclosures from the organization would suggest greater pressure faced by the organization to meet market expectations with respect to its ESG performance.

These pressures may be conducive to positive change. However, where there are barriers to making substantive changes to the way the organization does business such that it aligns with the

[33] Rodrigue, Magnan, & Cho, 2012
[34] How will ESG Performance Shape Your Future? Climate Change and Sustainability Services EY July 2020
[35] ESG integration techniques for equity investing 2016

ESG performance requirements, organizations may face pressure to exaggerate or misrepresent their ESG performance in order to meet market or stakeholder expectations.

5.2 Access to Financing

Other pressures organizations may face relate to access to financing. As ESG performance increases in importance to a wide variety of stakeholders, it may begin to impact an organization's ability to obtain favourable financing, such as impacting an organization's credit rating or the terms or structure of their debt.

Credit Ratings

The United Nations Principles for Responsible Investment issued a Statement on ESG in Credit Risk and Ratings ("the Statement") which currently has support from nearly 180 investors and 27 credit rating agencies.[36] The 27 credit rating agencies currently supporting this statement include the four major credit rating agencies in Canada; Fitch Group, Inc., DBRS Morningstar, Moody's Organization, and S&P Global Ratings. At a high level, the Statement indicates that the credit rating agency signatories commit to consider ESG factors in their assessment of issuers' creditworthiness. Each of these credit rating agencies publishes how ESG factors are integrated into assessing creditworthiness. These agencies have indicated that the integration of ESG factors into the credit rating are independent of ESG performance and the agencies score ESG factors based on their relevance to the issuer's creditworthiness. That being the case, the credit ratings include an analysis of ESG risks and opportunities faced by the issuer that may be relevant to the issuer's financial performance. For instance, carbon emissions are an indicator of environmental performance, but this may not be relevant to the credit analysis unless the issuer operates in a jurisdiction where there are costs associated with carbon emissions.[37] This could create a pressure

[36] Statement on ESG in credit risk and ratings (available in different languages) 2016
[37] ESG whitepaper (English) 2021

for issuers to either omit disclosures of ESG risks to maintain a more favourable credit rating or intentionally misrepresent their risk mitigation strategies for ESG risks that would be relevant to their financial performance.

Sustainability-Linked Bonds

There is also potential for a new source of financing in the Canadian market; namely Sustainability-Linked Bonds ("SLBs"). In 2021, two major Canadian organizations issued around US$1.6 billion in SLBs and have realized lower financing costs compared to an issuance of conventional bonds, saving around 5 or 6 basis points.[38] SLBs are bonds where the financial or structural feature of the bond are directly linked to predetermined ESG metrics.[39] Positive performance across those metrics can result in lower financing costs, and negative performance can result in the reverse. Though the bonds are linked to ESG metrics, the proceeds are available for general purpose use.[40] The intent behind this instrument is therefore to encourage organizations to achieve ESG outcomes and be rewarded with a lower cost of financing.

Under the Sustainability-Linked Bond Principles, the metrics linked to the bond must be ambitious yet realistic, performance on this metric must represent a material improvement, and performance on the metrics must be externally verified every year as well as prior to any changes being made to the financial or structural characteristics of the bond.[41] Due to the characteristics of these bonds, organizations may feel incentivized to issue SLBs in order to access lower cost financing and subsequently overstate their performance across the metrics tied to the SLB if they were unable to achieve the performance targets required to maintain the lower cost of financing.

[38] Duarte, 2021
[39] Sustainability-linked bond principles (SLBP)
[40] Sustainability-linked bond principles (SLBP)
[41] Sustainability-linked bond principles (SLBP)

5.3 Pressure from Competitors

Research has shown that organizations tend to model themselves after similar organizations and this trend holds true for ESG practices as well.[42] In cases where a competitor in the industry is leading in terms of performance across the ESG pillars, other organizations may feel the need to achieve a similar performance or outperform the market leader. In some cases, this could create substantive changes in the way that an organization manages their supply chains, their employees, their impact on communities, and their governance policies. In other cases, an organization may find it easier to falsify their performance in their ESG disclosures as opposed to committing the necessary resources (e.g., financial, human capital, time) to bridge the gap between their own actual ESG performance and that of the market leader or the standard in their industry.

Pressure from competitors may also arise in the form of prevalent ESG washing. Where there is inadequate government regulation, competitive pressures faced by organizations may drive them to engage in illicit activities[43], one of which may be ESG washing. Such pressures would be particularly effective if organizations believed that their competitors would also be willing to engage in ESG washing. What is therefore concerning is the European Commission's findings that in 42% of the cases they analysed of organizations making "green" claims, there was reason to believe the claims were exaggerated, false, or deceptive.[44] This indicates that organizations are willing to engage in ESG washing and, as will be further discussed in Section 6 of this paper, the Canadian regulatory environment is lacking with respect to ESG reporting which can contribute to organizations feeling pressured to engage in ESG washing in order to be able to compete with others in their industry.

[42] Delmas & Burbano, 2011
[43] Bennet, Toffel, Snyder, & Pierce, 2012
[44] Screening of websites for 'greenwashing': half of green claims lack evidence - 2020

5.4 Sustainability-Tied Compensation

As multiple studies have demonstrated, tying financial incentives to desired behaviours and outcomes doesn't always have the intended consequences.[45] An interesting, and particularly relevant area of study for ESG performance incentives is the impact that incentives have on prosocial behaviour. Prosocial behaviours are behaviours that contribute to the public good; the underlying intention behind the ESG movement. Gneezy, Meier, and Rey-Biel argue that explicit incentives imposed by a principal to an agent may signal distrust which is detrimental to engaging in prosocial behaviours as demonstrated by studies performed by Fehr and List and Fehr and Gachter.[46] As such, organizations planning on tying compensation to ESG metrics need to do so with caution to reduce the risk of the metrics being corrupted by self-interested behaviours and creating incentives for management to cheat in order to benefit from the compensation structure.

A survey conducted by Compensation Governance Partners in 2019 found that 61% of the 196 companies in the S&P/TSX surveyed measured ESG metrics in their incentive plans and that ESG metrics were significantly more prevalent in short-term incentive plans with only 9% of the disclosed metrics/goals being part of a long-term incentive plan.[47] There is clearly a disconnect between the short-term nature of the incentives tied to ESG metrics and the medium- to long-term nature of ESG issues. This creates an incentive for managers to sacrifice long-term ESG performance in favour of short-term gains. At the time the survey was conducted, ESG metrics typically did not represent more than 10% of total compensation which indicates that the incentive to manipulate ESG performance data to meet short term demands or to mitigate the impacts of short-term decisions that sacrifice long-term performance exists though it may not be significant

[45] Gneezy, Meier, & Rey-Biel, 2011
[46] Gneezy, Meier, & Rey-Biel, 2011
[47] Begun & Chen, 2022

in the compensation structure of management. Though there is generally less of an incentive to be unethical when only a small portion of compensation at stake[48] the misalignment between compensation structure and desired ESG performance needs to be addressed in order to mitigate the risk of ESG washing.

Though the survey conducted by Compensation Governance Partners does not indicate the specific ESG metrics tied to compensation, where incentives are tied to communications that positively portray the organization's ESG performance there is an increased likelihood that an organization that is not performing well will engage in ESG washing by driving management into taking shortcuts when validating the truth of ESG performance communication or disregard evidence that would otherwise make them question the validity of the organization's ESG messaging.[49]

5.5 Conflicting Stakeholder Demands

ESG has expanded the scope of an organization's stakeholders beyond shareholders and each group of stakeholders may place different and conflicting demands on the organization that the organization must manage in order to avoid potential negative consequences ranging from loss of customers to regulatory discipline. For instance, shareholder groups have traditionally been interested in maximizing profitability and investment returns whereas environmental activist groups may demand that an organization improve their environmental stewardship which would require significant investment and changes to an organization's supply chain and business practices. One example of this is the fast fashion industry which is faced with conflicting demands of growth and affordable fashion[50] and environmental and social stewardship in their clothing

[48] Harris & Bromiley, 2007
[49] Delmas & Burbano, 2011
[50] Pucker, 2022

manufacturing practices. Demand for growth and affordable fashion may pressure organizations within the fast fashion industry to cut costs by moving clothing manufacturing to jurisdictions with low costs of labour which would be in direct contradiction with the Social pillar of ESG or may lead organizations to improperly dispose of waste created during the clothing manufacturing process in order to save costs which could lead to negative environmental consequences and would be in contradiction with the Environmental pillar of ESG.

Cho, Laine, Roberts, and Rodrique (2015) argue that in order to navigate these conflicting demands, organizations may engage in organized hypocrisy which is defined as managing conflicts by reflecting them in inconsistencies between an organization's communications, their decisions, and their ultimate actions.[51] For instance, organizations may market themselves as committed to sustainable development to meet expectations from sustainability-conscious stakeholders yet will lobby against legislation and regulation that would enforce progress on that end to protect their current business practices.

5.6 Reputational Threats

With increasing awareness about the climate crisis, racial inequalities, and the need for organizations to be accountable for the impacts their ways of doing business have on humanity's way of life, organizations face increasing reputational threats with respect to their ESG practices from various stakeholders including consumers, employees, activist groups, and regulators. With such a focus on sustainability, organizations may feel unwilling to disclose that they are contributing to the overconsumption of earth's resources so as not to risk portraying the impression that the public's best interest would be served if the organization's activities were ceased.[52] Following this logic, barring regulatory pressure to disclose all relevant positive and negative ESG

[51] Cho, Laine, Roberts, & Rodrigue, 2015
[52] Cho, Laine, Roberts, & Rodrigue, 2015

impacts, in order to protect its reputation in an ESG-conscious market, an organization's ESG disclosures may be, at best, optimistic about their ESG performance and, at worst, ESG washing.

5.7 Pressures Faced by Sustainability Departments

A study conducted by Steinmeier that involved interviewing 12 experts in ESG reporting found that sustainability managers within organizations face numerous pressures that may lead them to engage in fraudulent ESG reporting. The experts interviewed as part of this study indicated that there is an increasing focus on meeting ESG targets though, at the time the interview was conducted (2016) there were no significant consequences if targets were not met.[53] Experts also indicated experiencing pressures to maintain or move up in the ESG rankings though not all experts agreed that this was a direct pressure they faced.[54] Experts that worked as sustainability managers indicated that they faced pressures to justify the existence of their team and the need to deliver success stories.[55] Such pressures to justify the existence of one's job can create the temptation to modify results, particularly in times when targets are almost reached or during corporate cost cutting.

5.8 Possible Interventions

What many of the pressures highlighted above have demonstrated is that there are multiple financial-related pressures for organizations to engage in ESG washing. These include pressures in respect of access to financing as well as competitive pressures, conflicting stakeholder demands, and reputational pressures that would impact a corporation's profitability. Following the theory that organizations are rational decision makers, they will consider the costs and benefits of ESG washing when determining whether or not to engage in it. As such, there is a need for greater

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[53] Steinmeier, 2015
[54] Steinmeier, 2015
[55] Steinmeier, 2015

consequences with respect to ESG washing such that the "cost-benefit" analysis conducted by these organizations weighs heavily in favour of remaining honest and compliant with sustainable development goals and the disclosure frameworks currently available with respect to ESG disclosures. It is therefore incumbent on regulators and government bodies to be committed to enforcing regulations against ESG washing and to establish appropriate financial penalties where it is found that an organization engaged in ESG washing.

With respect to internal pressures placed on individuals charged with managing the organization's sustainable development, organizations will need to reform how compensation is tied to sustainability targets. IFAs, leveraging their knowledge in respect of designing and implementing controls, can assist organizations with reforming the compensation structure such that the compensation structure is more aligned with ESG goals. This would involve aligning the time horizon of the compensation with the time horizon of ESG impacts to reduce the incentive to sacrifice long-term progress for short-term self-interested gains. Further, IFAs can advise on how ESG targets tied to compensation should be set and measured and developing controls to mitigate the risk that these targets would be manipulated. This would involve identifying targets that align with the intention of sustainable development and are reasonably within the control of the individual whose compensation is tied to the target and determining the data that needs to be collected and identifying the relevant stewards to ensure the data's integrity.

6 Opportunity

Opportunity, in the context of the fraud triangle, includes knowledge of the workings of a business or industry and the opportunity to violate a position of trust and existing weaknesses in

the systems and control environments that can be exploited by the potential fraudster.[56, 57] As ESG is a fairly new phenomenon, the term being coined in 2006 in the United Nations Principles for Responsible Investment[58], the regulatory and control environments around ESG disclosures are still being developed which may create ample opportunities for organizations to misrepresent their ESG performance.

6.1 Regulatory Landscape

In Canada, there are several pieces of legislation and regulatory guidance that address aspects of ESG and ESG washing. These include the *Competition Act*, the *Consumer Packaging and Labelling Act*, and the *Textile Labelling Act* which all set out requirements pertaining to accurate and meaningful labelling and marketing practices; and Staff Notice 51-333 *Environmental Reporting Guidance*, Staff Notice 51-358 *Reporting on Climate Change-Related Risks*, and Form 58-101F1 *Corporate Governance Disclosure* whereby the Canadian Securities Administration sets out guidance, or proposed guidance, with respect to the disclosure of material ESG risks faced by public organizations.

Legislation

Part VII.1 of the *Competition Act* outlines the provisions with respect to deceptive marketing practices which includes representations made to the public that are false or misleading in a material respect.[59] The Competition Bureau's guidance is that claims can include "messages, pictures, or verbal communications, including online and in-store advertisements, social media messages, promotional emails, among other things"[60]. The use of the phrase "among other things"

[56] Dorminey, Fleming, Kranacher, & Riley, 2012
[57] Wolfe & Hermanson, 2004
[58] An introduction to responsible investment | PRI
[59] Consolidated federal laws of Canada, Competition Act 2022
[60] Environmental claims and greenwashing 2022

may include claims made in ESG reports issued by organizations however, the two cases[61] of enforcement by the Competition Bureau did not make specific reference to claims made in ESG reports issued by the organizations.

The *Consumer Packaging and Labelling Act* and the *Textile Labelling Act* also address false or misleading representations however the scope of these Acts is limited to product packaging and labelling and does not appear to extend to ESG disclosures made by organizations.

Regulatory Guidance

Staff Notice 51-333 *Environmental Reporting Guidance* requires listed companies to disclose environmental risks, trends and uncertainties, environmental liabilities, asset retirement obligations, and financial and operational effects of environmental protection requirements.[62] It also sets out that only such information that is material should be disclosed whereby materiality is defined to mean information that would impact a reasonable investor's decision to purchase, hold, or sell securities and is fairly consistent with the definition set out in the CPA Handbook. The Staff Notice does not provide guidance with respect to which environmental risks are material however, it requires listed organizations to submit disclosure information to the Audit Committee for review which may provide a control to ensure that material items are not accidentally or intentionally omitted from disclosure.

Staff Notice 51-358 *Reporting of Climate Change-Related Risks* builds on Staff Notice 51-333 and outlines disclosure obligations related to the Management Discussion and Analysis and the Additional Information Form. This notice also indicated that of the 78 issuers reviewed by the Canadian Securities Administration in 2019, 22% provided boilerplate disclosures and a further

[61] Since 2017, when the Competition Bureau issued a News Release warning businesses about greenwashing, there have been only two greenwashing cases publicized: 1) Keurig Canada and 2) Volkswagen, Audi and Porsche
[62] Staff Notice 51-333 Environmental Reporting Guidance

22% provided no disclosure at all with respect to their environmental risks.[63] This demonstrates that just less than half of the issuers reviewed did not provide adequate disclosures of the environmental risks which suggests that there are opportunities for misrepresentation due to insufficient guidance with respect to disclosure requirements and a lack of controls over the disclosures made by listed organizations.

Form 58-101F1 *Corporate Governance Disclosure* provides guidance with respect to disclosures that listed organizations are required to make relating to the representation of women on Boards and in other leadership positions. The guidance provided is that the disclosure should explain that a metric or policy has been adopted to measure the number of women in leadership positions or explain why such a metric or policy was not adopted. Where there are metrics, the guidance requires that progress made should be quantified against a set target.[64] This guidance does not include requirements to report on representation of other minority groups in leadership positions and thus is lacking as a source of guidance for accurate and complete disclosures of relevant topics within the Social pillar of ESG.

The guidance provided by the Canadian Securities Administration appears to be limited in scope to environmental and climate change risks, topics relating to governance, and representation of women in positions of leadership. This guidance is lacking comprehensive coverage over several ESG topics such as those under the Social pillar. Absent regulatory guidance on disclosures relating to these topics, organizations may choose to follow voluntary disclosure frameworks which have weaker control environments creating opportunities for misrepresentation.

[63] Staff Notice 51-358 Reporting of Climate Change-Related Risks
[64] Proposed OSC amendments to form 58-101F1 corporate governance disclosure of NI 58-101 disclosure of corporate governance practices - proposed disclosure requirements regarding the representation of women on boards and in senior management

6.2 Voluntary Disclosure Landscape

According to a guide published by Accounting for Sustainability, an organization established to drive sustainable business development, there are 614 sustainability reporting requirements across 84 countries.[65] There is no standardized regulatory framework for ESG reporting and ESG reporting is generally voluntary however, there is progress being made towards a standardized reporting framework with a Statement of Intent issued in 2020 by five leading sustainability reporting organizations committing to provide guidance on how existing standards can be integrated[66] and the merger of the Sustainable Accounting Standards Board ("SASB") with the International Integrated Reporting Council to create the Value Reporting Foundation in 2021[67]. Globally, the Global Reporting Initiative Standards ("the GRI Standards") was the most used reporting standard in 2020, being used by 2/3 of the top 100 companies in 100 countries and around ¾ of the world's 250 largest companies.[68] In Canada, a study conducted by Millani found that, in 2020, 61% of corporate issuers on the S&P/TSX used the GRI Standards. This was closely followed by the Sustainable Accounting Standards Board Standards ("the SASB Standards") with 56% of corporate issuers adopting this framework (up 20% from 2019). The United Nations Sustainable Development Goals and the TCFD Framework were adopted by 44% and 42% of corporate issuers respectively.[69] This adoption of various standards for ESG disclosures creates an environment of inconsistent and incomparable ESG disclosure data, obscures a user's ability to navigate and interpret ESG information, and creates opportunities for unscrupulous organizations

[65] Navigating the Reporting Landscape
[66] Statement of Intent to Work Together Towards Comprehensive Corporate Reporting
[67] SASB Standards & other ESG Frameworks
[68] Richard Threlfall, 2020
[69] Millani's 5th Annual ESG Disclosure Study: A Canadian Perspective

to misrepresent their performance across ESG metrics. This is further exacerbated by the fact that few Canadian issuers are in strict compliance with any given ESG framework.[70]

This research paper will discuss in further detail the two most widely adopted voluntary reporting frameworks in Canada; the GRI Standards, and the SASB Standards.

Basis for Reporting

Both the GRI Standards and the SASB standards are rules-based standards. Rules-based standards are very prescriptive with respect to what and how information should be reported however, in situations where the content is complex and highly variable, rules-based standards may lose their effectiveness as they cannot contemplate every eventuality. Due to the highly complex and inter-related nature of the issues within ESG, the fact that the prevailing voluntary reporting standards being used are rules-based creates opportunities for misrepresentation due to the lack of sufficient guidance to address ESG issues a reporter under these frameworks may face.

In the case of the SASB Standards, the topics that should be reported upon in a given industry and the accounting metrics and units of measurement to be used in the reporting process are outlined in the standards. This makes ESG reporting more comparable across reporters within an industry however, there are few topics covered in a particular industry, as previously discussed. This may create "blind-spots" as not every potentially material topic is covered in an industry specific standard. These guidance "blind-spots" create opportunities for reporters to develop biased metrics or misrepresent performance with respect to a topic for which there is no specific guidance.

In the case of the GRI standards, there are topic specific standards however, these standards do not cover all potentially material topics within ESG that an organization may encounter. GRI

[70] Bloomer & Pollock, 2022

1: *Foundation* provides an example of a material topic not covered by the GRI topic standards; namely freedom of speech.[71] The guidance provided by the GRI Standards in cases where a material topic is identified but no standard exists to provide guidance is that the reporting organization should develop its own disclosures to address this topic.[72] Allowing an organization to self-govern its disclosures creates opportunities for metrics to be manipulated and relevant disclosure information to be misrepresented.

Materiality

The concept of materiality within the GRI Standards differs from that set out in the CPA Handbook that accountants are familiar with. GRI 1: *Foundation* sets out that an organization must identify and prioritize "material topics" which are defined to be "topics that represent the most significant impacts on the economy, environment, and people"[73]. Material topics under the GRI Standards are topics identified as material based on an assessment of the impacts of those topics on relevant stakeholders and the significance of those impacts. Two of the potential weaknesses with this concept of materiality is the definition and scope of "stakeholders" and the time frame considered. an organization may intentionally limit the scope of their stakeholders or consider only shorter-term impacts in order to avoid making a disclosure on a topic that would otherwise be material under the conceptual framework of the GRI Standards.

The concept of materiality under the SASB Standards, referred to as financial materiality, is currently undergoing an update and the proposed definition is similar to the concept of materiality in the CPA Handbook. In the SASB Exposure Draft, SASB defined financial materiality as information that, if omitted, misstated, or obscured could reasonably be expected to impact users'

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[71] GRI 1: Foundation 2021
[72] GRI 1: Foundation 2021
[73] GRI 1: Foundation 2021

investment or lending decisions based on their assessment of short-, medium-, and long-term financial performance and enterprise value.[74]

The differences between the concept of materiality in the GRI Standards and the SASB Standards between impact on all stakeholders versus impacts on firm value create opportunities for reporting entities to selectively report under a particular standard in order to be able to avoid having to disclose information that may be perceived negatively by stakeholders.

Standard Structure

The GRI Standards comprise of universal standards, industry specific standards, and topic specific standards however, the GRI Standards are predominantly topic driven with 32 topic specific standards and just two industry specific standards. Organizations reporting in accordance with the GRI Standards are required to determine material topics and the industry specific standards support organizations in performing this assessment. Currently, there are only industry specific standards for the Oil and Gas Sector and the Coal Sector. Absent framework guidance on what the material topics are for a particular industry, organizations operating within that industry are left to use their judgment and may experience conflicts of interest when determining what are material topics for their industry. The lack of an industry specific standard creates an opportunity for organizations to be selective in determining to which topic specific standards they will adhere.

In contrast, the SASB Standards are fully industry driven with standards available for 77 industries spanning consumer goods, extractives and minerals, financial, food and beverage, healthcare, infrastructure, renewable resources, resource transformation, services, technology and communications, and transportation. The SASB Standards outline which topics are financially material with respect to the 77 industries for which there are standards and a review of these

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[74] SASB Conceptual Framework

standards found that the number of financially material topics per industry ranged from 2 to 12 (average of 6 across the 77 industry standards). This suggests a limited scope of financially material topics for each industry for which there is guidance on the types of reporting metrics organizations should be using. If an organization makes an assessment that another topic not included in the relevant industry specific standard is material, there is no guidance on how that should be reported which creates opportunities for misrepresentation.

Scope of Reporting

The scope of disclosures covered in each of the voluntary disclosure standards also varies. The GRI Standards consider the concept of "impact" which is defined in section 2.1 of GRI 1: *Foundation* to include impacts on the economy, environment, and people as a result of the organization's activities or business relationships. The inclusion of business relationships indicates that organizations reporting under the GRI Standards must consider their direct and indirect impacts across the ESG pillars when determining material topics for disclosure.

The SASB Standards, in contrast, restrict the reporting boundaries to all parent and subsidiary entities that are consolidated for financial reporting purposes.[75] This indicates that the disclosure of ESG performance will be focused on direct impacts and may not include indirect impacts. A review of the industry specific standards indicates that there is consideration for supply chain management, a topic that may include indirect impacts, however, the metrics associated with this topic are limited. For example, in the standards for the Air Freight & Logistics industry, supply chain management metrics only relate to carriers complying with the Federal Motor Carrier Safety Administration intervention threshold and total greenhouse gas footprint across carriers[76]. Similarly, there is some consideration for material sourcing however this too is limited. For

[75] SASB Standards Application Guidance
[76] Air Freight & Logistics Standard

example, in the Electrical & Electrical Equipment industry standards, there is just one metric associated with material sourcing and it relates to a description of the management of risks associated with the use of critical materials[77]. Further guidance on the reporting of this metric does not mention inclusion of risks associated with environmental impacts from obtaining the critical material; the risks contemplated are more aligned with business risks rather than ESG risks.

Other Potential Weaknesses

Section 5.1 of GRI 1: *Foundation* indicates that organizations aligning with the GRI Standards should align their GRI disclosures with their other statutory and regulatory reporting. The use of the word "should" indicates that it is recommended though not a requirement in order to be able to state that an organization's report is in accordance with the GRI Standards. This creates an opportunity for organizations reporting under the GRI Standards to delay the release of potentially negative information while still being able to claim that they are reporting under the GRI Standards.

The GRI topic standards are not a comprehensive list of all possible material topics. Though GRI 1: *Foundation* indicates that material topics not covered in the standards should be disclosed in accordance with GRI 3: *Material Topics*, it raises a question of whether a topic would be identified as material if there is no specific guidance for reporting on that topic.

The GRI standards do not require external assurance of the disclosures made. In GRI 2: *General Disclosures*, Disclosure 2-5 which deals with external assurance indicates that "if" an organization's ESG reporting is externally assured, they should provide disclosures on what has been assured[78]. The use of the word "if" indicates that the GRI Standards do not require a report to be externally assured in order for an organization to claim that their ESG report was prepared

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[77] Electrical & Electronic Equipment Standard
[78] GRI 2: General Disclosures

in accordance with the GRI standards. This creates opportunities for organizations to misstate their ESG performance and give the impression that they are ESG compliant by issuing a report under a recognized framework.

SASB Standards are limited in scope to ESG issues that are likely to impact corporate ability to create value over the long term. This definition is vague and open to interpretation. It does not specifically consider impacts of business activities on the ESG pillars and leaves the determination of financially material topics up to the discretion of the organization.

6.3 Lack of Assurance

In Canada, assurance over ESG information is voluntary and the assurance requirements over ESG information as part of the financial statement audit are limited. Canadian Auditing Standards ("CAS") 720, *the Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*, require auditors to read the other information included in the annual report, in this case information regarding performance across the ESG metrics, and consider whether there is a material inconsistency between this information and the financial statements or the auditor's knowledge obtained during the audit.[79] Where an organization chooses to report their ESG performance in a separate ESG report or on their website, this standard would not apply and the auditor would have no responsibility over that information. If organizations choose to obtain assurance over their ESG reports, they may engage an auditor to perform an attestation engagement under CSAE 3000 *Attestation Engagements Other than Auditors or Reviews of Historical Information*. Thus, in Canada, there are standards in place to accommodate assurance over ESG information. The question is whether they are or will be adopted.

[79] Sustainability Assurance Alert: Third-party assurance over Sustainability Information 2022

A study conducted by PwC in 2021 on publicly available ESG data for the top 150 Canadian companies based on market capitalization and revenues found that across all sectors, only 20% of ESG reports were externally assured with only 11% of organizations in the manufacturing, transportation, and engineering sector obtaining external assurance over their ESG reports.[80] This demonstrates a significant control deficiency, and therefore an opportunity, as external assurance is a necessary control for the prevention and detection of material misstatements in information that will be used by decision makers.

6.4 Discrepancies Among ESG Performance Ranking Agencies

Another potential control over ESG reporting are ESG performance ranking agencies. There are multiple such sources of ESG ranking in Canada including Bloomberg Professional Services ESG Data, the S&P Global ESG Scores, the MSCI ESG Rating, Sustainalytics ESG Risk Ratings, and ISS ESG Ratings & Rankings. These agencies collect ESG performance data from various sources including dialogue with the organization and stakeholders[81], news and other public sources, and voluntary corporate disclosures[82] and publish a rating of the organization's performance across the ESG pillars. These ratings may be included in the ESG analysis performed by investors when assessing in which securities to invest.

An investigation conducted by the Globe and Mail found that there were discrepancies between the ratings provided by different ESG ranking agencies for the same organization. They compared the rating provided by Bloomberg, S&P Global, MSCI, Sustainalytics, CDP Climate, and ISS for a sample of companies that were ranked by most, if not all, agencies. They found that

[80] Exploring the ESG reporting maturity of Canada's top companies
[81] Sanchez, 2020
[82] What if ESG disclosures become standardized?

the same organization can be labelled an ESG leader by one ranking agency and a lagger by another.[83]

The MIT Sloan School of Management is investigating these discrepancies and has published *Aggregate Confusion: The Divergence of ESG Ratings* where they have found that, on average, the correlation among ratings for individual companies was 61% (correlations ranged from 38% to 71%) compared to an average of 92% for credit rating agencies.[84] This raises concerns about the reliability of the rankings provided by the rating agencies and consequently obscures stakeholders' abilities to evaluate and understand an organization's ESG performance. Where the reliability of the rankings provided by rating agencies is questionable, the effect of ESG ranking agencies as a control mechanism is weakened. Further, ESG ranking divergence may disincentivize organizations from improving their ESG performance as there is no external consensus on the organization's current performance.

6.5 ESG Data Validity

Opportunities for ESG washing also arise from the types of ESG data available and the process of collecting and disclosing relevant ESG data. Studies have shown that there are several issues with respect to ESG data that include "(1) a lack of relevance or materiality; (2) a lack of accuracy for evaluating companies' actual sustainability performance including 'integrity, correctness; completeness and methodological consistency of the information reported'; (3) a lack of reliability in the self-assessment of ESG performance by companies because of the increasing risk of whitewashing; and (4) a lack of comparability, because the standards for ESG performance evaluations are misaligned".[85]

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[83] Jones & Milstead, 2022
[84] Berg, Kölbel, & Rigobon, 2019
[85] Jonsdottir, Sigurjonsson, Johannsdottir, & Wendt, 2022 (pg. 2)

Sustainability managers interviewed in a study performed by Steinmeier indicated that reporting systems for ESG information were not as reliable as the systems in place for financial reporting and that the control environments in sustainability departments are relatively weak.[86] Another indicated that ESG data could be manipulated at any point in the data's lifecycle within the organization (i.e., from the point where the data is produced up to the point where the data gets reported).[87] This study also identified that there was a lack of quality control over the ESG data as a result of either lack of resources within the sustainability department to perform this function or a formal process is put in place but there are barriers to carrying it out effectively.[88] These barriers were not discussed in the study though they may have been a function of lack of resources be that time to undertake the review or availability of sustainability department team members with the qualifications to carry out an effective quality control of the data, poor tone at the top that did not effectively communicate the importance of reliable ESG data, and ineffective training or guidance with respect to how the quality control should be performed.

6.6 Possible Interventions

In order to minimize the opportunities for ESG washing, regulators should standardize ESG reporting in order to reduce the noise and ambiguity in the reporting landscape. This standardization should involve standardization of definitions for ESG metrics to reduce ambiguity of how these terms are used, how data should be collected for those metrics, what information should be contained in the disclosures, specific guidance on how materiality should be determined, and the format for ESG disclosures such that there is comparability across companies and industries in terms of where stakeholders can find ESG information. Further, external assurance

[86] Steinmeier, 2015
[87] Steinmeier, 2015
[88] Steinmeier, 2015

of ESG disclosures should be mandatory as this information is increasingly being used by stakeholders to make decisions. External assurance is a necessary control in order to assist with the prevention and detection of ESG washing and build trust among stakeholders that the information disclosed is materially complete and reliable. It is also suggested that ESG performance ranking agencies be subject to regulation to ensure there is a consistent and validated approach to assessing ESG performance which can be leveraged for decision making by stakeholders and can improve their effectiveness as a control over an organization's ESG performance.

From an internal control perspective, organizations should implement controls around how ESG data is collected for relevant performance metrics including controls to ensure that data integrity is maintained throughout the data lifecycle (i.e., collection, analysis, and reporting) and conducting quality control assessments over the data. To ensure that these controls are operating effectively and there are no gaps in the control environment, these controls should be subject to external assurance. It is suggested that, where an organization has a sustainability department, the sustainability department is included in fraud risk assessments to provide the organization with a holistic understanding of the pressures and opportunities that may lead to misconduct within their organization.

IFAs can leverage their understanding of what can go wrong, their high degree of skepticism, and their understanding of potential areas of manipulation to assist organizations with performing ESG washing risk assessments. These assessments would identify the opportunities for ESG washing that exist within an organization and lead to the design and implementation of controls to minimize these opportunities.

7 Rationalization

Rationalization is the process through which the fraudster is able to alter their perception of their behaviour such that they perceive it as acceptable. It is proposed that some individuals may engage in fraudulent behaviour without being aware that they are committing fraud, sometimes at the direction of an authority figure in their organization.[89] Others may rely on moral intuition to determine if they believe the fraudulent behaviour is acceptable.[90] Where this intuition does not arrive at a clear outcome, individuals may perform a cost-benefit analysis and determine whether the benefits of committing fraud outweigh the costs of being caught.[91] If this decision-making process leads the individual to commit fraud, assuming they are not predisposed to fraudulent behaviour, studies show that they will experience negative affects which they will attempt to minimize through numerous strategies which largely fall under rationalization.[92] Possible rationalization strategies will be reviewed in further depth through the lens of ESG reporting.

7.1 Organizational Ethical Culture

Organizational ethical culture may influence an individual's likelihood to engage in fraudulent activity, particularly, the tone at the top can dictate how committed leadership of the organization is with respect to their ESG practices and reporting. Based on interviews conducted by Steinmeier of sustainability managers, three of the interviewees indicated that if the company's executives did not show support for the sustainability department or ESG initiatives, that signalled to the rest of the organization that these initiatives are not a high priority and that there would be little interest if ESG performance results were manipulated.[93]

[89] Murphy & Dacin, 2011
[90] Murphy & Dacin, 2011
[91] Murphy & Dacin, 2011
[92] Murphy & Dacin, 2011
[93] Steinmeier, 2015

7.2 Organizational Inertia

Organizational inertia refers to the persistence of established norms in an organization's modes of doing business and hampers strategic change.[94] In the context of ESG reporting, in order for an organization to report on positive performance across the three pillars, one of two things must occur: 1) there is heavy investment of time and resources into strategically changing operations to align with the United Nations Sustainable Development Goals and working against organizational inertia, or 2) there is a gap in the positive ESG performance that is reported upon and the actual ESG performance achieved by the organization. In situations where a gap exists between reported performance and actual performance, it may be the case that the performance reported upon was an optimistic view of where the organization should be, and actual performance would "catch up". Alternatively, the necessary strategic changes may take longer than expected due to how difficult it is to change an organization's policies and processes as set out through the concept of organizational inertia. Organizational inertia may be a demotivating factor in the presence of pressures from external market forces therefore management may find it easier to alter their communication rather than work against organizational inertia in order to achieve the ESG performance demanded by stakeholders.

7.3 Individual Psychological Drivers

While this research paper has focused more heavily on an organizational level, rationalization generally happens at an individual level and the rationalization techniques used will depend on individual psychological characteristics. One such technique may be to use narrow decision framing whereby decisions are made in isolation such as considering only the short-term benefits of ESG misrepresentation without the long-terms costs.[95] Similarly, hyperbolic

[94] Delmas & Burbano, 2011
[95] Delmas & Burbano, 2011

intertemporal discounting is a tendency to pursue short-term gratification at the expense of long-term goals. In an ESG context, this could be an executive heavily communicating and potentially over-promising on sustainable development initiatives to achieve the short-term benefit of meeting market expectations and appeasing stakeholders demanding sustainable action. When it comes time to deliver on those promises however, the organization may be unable to meet the market expectations set by the executive's communications and therefore turns to ESG washing in order to minimize the negative impact of disclosing that sustainable development targets were not met.

Individuals may also experience optimistic bias which is a tendency to over-estimate the likelihood and magnitude of a positive outcome and underestimate the likelihood and magnitude of a negative outcome. An example of this in ESG reporting may be that decision makers in the reporting process may overestimate the positive impact of ESG washing (e.g., obtaining customers, improved reputation, access to additional financing, increase in market capitalization, etc.) while underestimating the negative impacts of ESG washing (e.g., reputational damage, litigation, punitive action, etc.). This bias is assisted by the fact that currently prosecution of ESG washing, greenwashing in particular, falls under the *Competition Act*, as misleading advertising and the Competition Bureau does not appear to be strongly enforcing this act. Since the Competition Bureau of Canada issued a News Release on January 23, 2017[96] warning businesses about greenwashing and the Competition Bureau's intention to take aim at such practices, there have been only two cases of allegations relating to false or misleading environmental claims.[97] This is based on the list of cases and outcomes made publicly available by the Competition Bureau.

[96] It's not easy being green. Businesses must back up their words. 2017
[97] Deceptive marketing practices-cases and outcomes 2022

7.4 Deterrence Theory

According to deterrence theory, deterrence is a function of the probability of detection and the level of punishment associated with detection. Neo-classical deterrence theory proposes that anyone considering a fraudulent act would use the probability of detection and the financial value of the associated penalties in performing a cost-benefit analysis of whether to pursue this course of action.[98] As such, when contemplating whether to engage in ESG washing, an analysis of the likelihood of being caught and the potential financial penalties is undertaken. On the basis that the Competition Bureau has only made two cases of allegations of greenwashing public, this creates the perception that there is a low likelihood of ESG washing being detected and ultimately punished. As a result, the current regulatory and enforcement environment may not be sufficient to deter ESG washing.

7.5 General Rationalization Strategies

According to a series of interviews with sustainability managers conducted by Steinmeier, the general impression was that despite the potential for sustainability managers to be predisposed towards altruism, everyone has the ability to rationalize under specific circumstances.[99] On this basis, this paper will consider some of the general rationalization strategies that may be applicable in the context of ESG washing.

Denial of Injury

Denial of injury is a rationalization strategy that helps an individual manage their perception of their own behaviour by claiming that their actions didn't harm anyone and therefore they are not inherently bad. This rationalization strategy may be particularly effective where the harm is indirect or there is a timing delay between the misconduct and the resulting harm to the victim

[98] Murphy & McGrath, 2013
[99] Steinmeier, 2015

which would enable the perpetrator to separate the cause and effect of their actions. Thus, this strategy may be particularly effective in the context of ESG washing where the negative effects of a company's poor ESG performance accumulate slowly over time and harm is incremental and diffused across various stakeholders. Consider, for instance, claims that a product is biodegradable when, in fact, the product does not degrade within a reasonably short period of time. One's perception of the environmental harm caused by such products can be minimized by comparing the incremental waste created by this product to the scale of total waste production globally and the victims harmed by increased waste production can be discounted by the perpetrator of ESG washing as they are not a clearly defined and identifiable group.

Appeal to Higher Loyalties

This rationalization strategy involves an individual arguing that they are helping "the group" and they feel that loyalty to this group is more important than loyalty to victims.[100] This rationalization strategy could be applied in the context of ESG washing as it may be easier to employ due to the diffuse nature of the victims of ESG washing compared to the more clearly defined group within the organization. This paper hypothesizes that individuals may be more loyal to groups that are in closer proximity and are well-defined, such as the members of their company, versus those that are farther in proximity and more abstract, such as all stakeholders that may be impacted as a result of poor ESG performance. Consider, for instance, practices surrounding unsustainable fishing that are touted as sustainable in order to continue garnering demand for their fish products in a climate of increased environmental consciousness. How much loyalty would a person feel towards the ecosystems being disturbed by overfishing, the marine animals unintentionally harmed as a result of the fishing methods employed, or the contributions of the

[100] Murphy & Dacin, 2011

fishing fleet's carbon emissions to the raising temperature of the oceans compared to their fellow employees that are able to support themselves and their families as a result of the jobs available in the fishing industry?

Diffuse Responsibility

Perpetrators that diffuse responsibility in order to rationalize their behaviour will claim that their behaviour is acceptable because everyone engages in similar behaviours.[101] This would be particularly applicable where ESG washing is perceived to be widespread and therefore it is easier to take the position that "everyone is doing it". As previously discussed, the European Commission identified that there was reason to believe that almost half of the sustainability claims they reviewed could be false or misleading which creates the impression that ESG washing is prevalent and fairly widespread.

Pioneer Status

Though the "Pioneer status" rationalization is not widely documented in the literature reviewed in this course of this research paper, this was identified as a potential rationalization technique in the interviews conducted by Steinmeier.[102] This rationalization technique would involve rationalizing self-interest ESG washing by counterbalancing it against the fact that the sustainability manager was the one that integrated ESG into the organization and therefore deserves to receive compensation for it. It could also involve a sustainability manager believing that absent their contributions, the organization would not have integrated ESG into their business therefore, engaging in manipulating the ESG performance results may not be as bad as if the organization did not consider ESG in their practices. In practice, this rationalization might involve a sustainability manager convincing themselves that had there been no integration of ESG in the

[101] Murphy & Dacin, 2011
[102] Steinmeier, 2015

organization's business practices, the carbon emissions, for example, would have been higher therefore, manipulating data so that the emissions target that were almost achieved appeared to have been achieved to meet market expectations may appear to be acceptable.

7.6 Possible Interventions

As rationalizations are driven by personal psychological characteristics, there are limited interventions available. In order to reduce the risk of rationalizing ESG washing, organizations need to ensure strong communication about the importance of ESG compliance. This can be accomplished by implementing and communicating a code of conduct or code of ethics that specifically addresses ESG reporting and sustainable development. This is one of the first steps of ensuring alignment with a particular set of values and conducts across the organization.

Another would be to incorporate ESG and general ethics screening in the hiring process such that organizations hire individuals that are already aligned with the organization's ESG goals and dedicated to implementing sustainable development.

A further strategy to make rationalization of ESG washing more difficult is to conduct awareness training on the importance of sustainable development and the far-reaching impacts the organization's business activities have on the world. This would combat the ability of individuals to rationalize ESG washing by denying injury or by appealing to higher loyalties.

IFAs, leveraging their understanding of potential rationalizations as well as the principles of ethics, can assist with the development and delivery of ESG reporting ethics and awareness training to assist organizations with developing a culture that would be less conducive to engaging in and rationalizing ESG washing.

8 The IFA's Role

IFAs are skilled at assessing fraud risks and identifying weaknesses in control systems, performing investigations, and quantifying losses/damages. Additionally, IFAs work in an environment where there are no rules-based standards for how to perform work across various types of engagements. The IFA's ability to be flexible, problem solve, and come up with a unique plan for each engagement encountered is a skill set that is necessary in the context of ESG reporting and disclosures where assurance standards across ESG metrics are lacking and there is minimal standardization in how ESG disclosures are reported. There are opportunities within ESG reporting and disclosures for IFAs to engage in both proactive and reactive work that leverages their unique skill set.

8.1 Proactive

IFAs' proactive work generally revolves around fraud risk assessment, identifying and implementing controls to prevent and detect fraud and misconduct, leveraging corporate intelligence to perform due diligence, and assessing compliance with regulatory frameworks. In the context of ESG washing, IFAs can leverage their skills in fraud risk assessment to assist a Board of Directors with understanding what types of ESG misrepresentation may be more likely to occur in their organization and how those misrepresentations may be perpetrated and concealed to avoid detection. This would assist with the design and implementation of controls to prevent such misrepresentations from occurring and to identify if the controls have been circumvented.

Further, IFAs can leverage their understanding of control environments to assess the control environment around measuring performance and reporting upon ESG metrics. In doing so, IFAs can also provide recommendations on how the controls, documentation, and reporting lines can be improved using the IFAs understanding of how fraud can be perpetrated and how controls can be

circumvented. Along this same vein, IFAs can assess the policies and procedures around internal investigations conducted by the organization to identify weaknesses and provide recommendations on how to make the internal investigation process more robust. IFAs can also assess the effectiveness of controls with respect to ESG data integrity throughout the data lifecycle within the organization and provide recommendations on how to make the data systems more robust.

There are opportunities for IFAs to leverage their investigative and due diligence skills in a corporate intelligence capacity as well. IFAs may be called upon by organizations interested in creating and reporting upon ESG performance within their supply chain to assist with performing due diligence on potential supply chain partners to identify if they have engaged in ESG washing and to assess their compliance with relevant ESG regulations and frameworks. IFAs may also be engaged to develop whistleblower policies and general ethics and compliance programs in an organization's efforts to improve their ESG performance.

8.2 Reactive

IFAs may be called upon to assist with investigations into allegations that an organization engaged in ESG washing. Such investigations would leverage the IFA's understanding of how a business operates, their reporting processes, and how misconduct can be concealed as well as an IFAs' skills in document and email review and conducting interviews with persons relevant to the investigation. Other avenues of investigation could relate to determining the use of funds with respect to sustainability bonds issued by an organization to ensure that the funds were used for the stated purpose.

As ESG litigation becomes more prevalent, IFAs may be called upon to quantify damages suffered by stakeholders as a result of ESG misrepresentation. Such damage quantification could relate to class action lawsuits brought by shareholders of an organization as a result of ESG

misrepresentation or environmental remediation costs as a result of poor environmental stewardship and related misrepresentations in ESG reporting. Alternatively, if the litigation relates to whitewashing, IFAs may be called upon to critique the investigation performed internally by the organization and testify as to the weaknesses identified and reliability of the internal investigation's findings.

9 ESG Washing Case Study

9.1 The Facts

In Canada, the Competition Bureau enforces laws surrounding deceptive marketing practices, an area in which ESG washing fits. In 2022, the Competition Bureau came to a settlement agreement with an organization around it's marketing practices in respect of the recyclability of its product packaging which resulted in a $3 million penalty among other costs.[103] A review of this organization's Corporate Responsibility Reports found that this organization published Corporate Responsibility Reports in compliance with the GRI Standards and the SASB Standards. In the 2020 Corporate Responsibility Report, the latest report publicly available, the organization disclosed that it had achieved 100% recyclability of its product packaging[104]: in contradiction with the ultimate findings of the Competition Bureau in the 2022 settlement agreement. This organization had also engaged a sustainability assurance provider to provide limited assurance over its 2020 Corporate Responsibility Report and received a conclusion stating that nothing came to the attention of the sustainability assurance provider to indicate that the information in the Corporate Responsibility Report was not fairly presented in all material respects. The assurance was provided in accordance with ISAE 3000 (revised).

[103] Deceptive marketing practices-cases and outcomes 2022
[104] 2020 Corporate Responsibility Report

9.2 Discussion

The following discussion considers the fraud triangle to propose potential gaps that may have contributed to the outcome outlined in the facts above: namely the discrepancy between disclosures and actual performance. This discussion is not meant to imply that the organization intended to misrepresent the recyclability of the product's packaging, and is based on publicly available information

Pressure

A potential pressure that may have applied in this case is consumer demand. The packaging in question related to a single-use product that a typical consumer may use regularly and would add to a consumer's average waste production if the packaging was not recyclable. As consumers are becoming more environmentally conscious, the organization may have perceived a pressure to market their product's packaging as recyclable in order to protect against potential loss of demand for their product should their consumers aim to reduce their waste production. This pressure could have resulted in a less thorough consideration of how recyclability of the packaging should be defined and measured and could have contributed to a reduced willingness to question the results of the testing done to assess the recyclability of the packaging.

Opportunity

The GRI Standard applied by the organization in respect of the recyclability claim was GRI 302 *Materials* which only provides guidance in respect of a metric to calculate recycled input materials used. There is no guidance in this standard outlining how to determine end-use recyclability which was the metric that was reported in the Corporate Responsibility Report. The SASB Standard for the industry in which the organization operates did provide guidance for disclosing the percentage of packaging that is recyclable, which is defined, in part, as packaging

that can be diverted from the waste stream through available processes and programs.[105] There is potential ambiguity in the interpretation of the meaning "available processes and programs" in determining recyclability raising the question of whether only the latest available technology is sufficient to consider or whether a piece-meal approach needs to be used to assess the recycling programs in each of the jurisdictions in which the organization sells its products.

According to the Corporate Responsibility Report issued by the organization, recyclability was measured internally to determine whether the packaging would be correctly sorted by the latest recycling technology. The Competition Bureau, in contrast, looked at whether the packaging materials were accepted by municipal recycling programs. This would appear to be a difference between theoretical recyclability as measured by the organization and actual recyclability as measured by the Competition Bureau when considering current industry practices in the relevant jurisdictions.

The working papers of the assurance provider are not available therefore an analysis with respect to potential gaps in the limited assurance engagement cannot be performed. Given the complexity and the far-reaching impacts of ESG practices and the increasing importance therein placed by stakeholders, it raises a question of how materiality is assessed in ESG assurance engagements, whether limited assurance in respect of ESG reports and disclosures is meaningful, and the effectiveness of the procedures performed in obtaining assurance over ESG information disclosed in such reports.

Rationalization

Information with respect to rationalizations employed in this case is not publicly available however, a potential rationalization that may have applied is a lack of awareness. The individuals

[105] Non-Alcoholic Beverages Standard

responsible for reporting on the recyclability of the product may have believed that they had complied with the relevant standards based on their interpretation of the terms and definitions provided therein and may not have realized that there were other methods of measuring recyclability that a fact finder would deem as a more accurate approach. Alternatively, there may have been a willful lack of awareness whereby the individuals responsible for reporting on the recyclability of the product rationalized that the "100% recyclable" claim was acceptable as it technically complied with the standards given that the method of testing recyclability was not specifically prescribed.

Another rationalization that may have been applied was denial of injury whereby the negative impacts of the claim that the packaging was 100% recyclable were minimized by comparing the incremental waste produced by the product packaging to the total waste production globally.

10 Concluding Remarks

The demand for ESG practices and reporting is growing and rife with pressures and opportunities to engage in ESG washing. As regulations surrounding ESG reporting and disclosures mature and organizations and stakeholders adapt to this new reality, IFAs will play a key role in building trust in ESG practices and reporting.

This paper has provided foundational information about ESG and the different types of ESG washing identified to date and has demonstrated the application of the fraud triangle in the context of ESG washing. Finally, this paper has explored how IFAs can leverage their unique skill set to proactively prevent and detect ESG washing and to assist when allegations of ESG washing are brought forth.

11 Areas for Further Research

This research paper offers an overview of the current ESG disclosure landscape and the pressures, opportunities, and potential rationalizations that may lead to ESG washing. Areas for further research have been identified in the course of the review of available literature and are discussed.

During this review, only one study was found that considered psychological characteristics of individuals working in the sustainability field. The sample size of this study was very small (12 participants), and the format of the study was an interview therefore it is difficult to accept the findings of the study as widely applicable. There is an opportunity for further research in this area to develop an understanding of how people working in sustainability departments may engage in rationalization and whether this differs from the current body of knowledge with respect to rationalization.

The global interest in ESG has created related markets such as the sustainability bond market, ESG investment funds, and voluntary carbon offset markets to name a few. In the course of this review, a study or assessment of fraud risks in these markets was not found. Further research into the fraud risk areas with respect to these related markets may be of interest to IFAs.

There is a growing body of research with respect to greenwashing and less so for the other types of ESG washing. It may be the case that research into greenwashing is occurring as a result of the looming consequences of climate change making the environmental pillar of ESG higher priority or it could be that greenwashing is more prevalent than the other types of ESG washing. Though it is possible that the findings with respect to the drivers of greenwashing are applicable to other types of ESG washing given their fundamental similarities in terms of intentionally misrepresenting alignment with the ESG metrics, it presents an area of interest to explore further.

Another area of interest for further research is what level of assurance is meaningful for stakeholders in the context of ESG reports. A review found no literature considering the effectiveness of assurance engagements with respect to ESG reports. Due to the growing interest in ESG and the increasing reliance of stakeholders on the disclosures made by organizations regarding their ESG performance, it is necessary to assess the level of assurance that would be meaningful to stakeholders and therefore would contribute to building trust in ESG reports.

12 Restrictions

This research paper was prepared for the purposes of the Master of Forensic Accounting program at the University of Toronto Mississauga. This paper should be viewed as providing general guidance and should not be distributed, reproduced, or copied without the prior approval of the author. The author will not accept responsibility for any losses, damages, or other expenses incurred as a result of distribution or reliance on this paper.

13 Appendix

13.1 Appendix 1: Comparison of GRI Standards and SASB Standards

	GRI Standards	**SASB Standards**
Basis For Reporting	Rules-Based	Rules-Based
Materiality	"Material Topics" Based on relevant stakeholders and significance of impact on economy, environment, and people	"Financial Materiality" Based on information that would impact a user's investment or lending decision based on financial performance and enterprise value
Standard Structure	32 Topic Specific Standards 2 Industry Specific Standards	77 Industry Specific Standards Average 6 topics per industry
Scope of Reporting	Scope includes organization's activities and business relationships	Scope only considered organizations that would be consolidated for financial reporting purposes

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