



How good governance can keep corporates clean from greenwashing

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Amid increasing scrutiny, the future success of a business is now more than ever based on embracing and reporting sustainability practices.

Companies keen to publicize their ESG ambitions face increasing scrutiny. Better governance measures can help avoid the pitfalls.

On climate change there is no room for failure, as the latest Intergovernmental Panel on Climate Change report warned¹. But determining which businesses will successfully reduce their carbon emissions to net-zero is difficult. There are many examples of companies making commitments which are questioned by media and other stakeholders. Claims of greenwashing may ensue.

Corporations face similar challenges across a host of other ESG (environmental, social and governance) topics including supply chains, data privacy, packaging, pay, diversity and inclusion, workplace safety and social justice. The lack of global agreement on standards in all areas of ESG leaves corporate leaders and in-house counsel in a challenging position – forced to set targets and make decisions without reliable data and without priorities and guidance from regulators or lawmakers. In the absence of clear metrics and global standards, companies are often left to construct their own reporting mechanisms, which may open them up to censure.

General counsel and in-house litigation leaders are anxious to see loopholes closed: 28% reported their so-called ESG dispute exposure increasing last year, and 24% expect it to deepen over the next 12 months, according to the ESG 2023 annual litigation trends survey by law firm Norton Rose Fulbright.²

The weak regulatory environment, combined with stakeholder demands around ethical and environmental performance, leaves organizations under huge pressure, resulting in the rise of so-called “greenhushing.” Corporates fearful of being accused of greenwashing instead opt for silence on their environmental and societal (diversity, equity and inclusion) ambitions.

Rob Locke, EY Oceania Forensic & Integrity Services Managing Partner, suggests there is a “governance bubble,” in which “expectations about ‘greenness’ are accelerating and the governance layer within businesses is struggling to keep up.”

How can companies leverage good governance to put sustainability at the heart of their strategy and report on progress in a transparent and authentic way?

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Rob Locke

EY Oceania Forensic & Integrity Services Managing Partner

Chapter 1

The pressure cooker

The first component of the fraud triangle is leading to confusion and chaos for organizations looking for a solution.

In the case of sustainability, pressure in the fraud triangle is intensifying as investors, activists, customers, consumers, employees, suppliers and regulators all have heightened expectations of a company's strategy and reporting in this area. Companies are compelled to respond. But how?

Traditionally they'd look to either regulation or the competition, but neither currently offers clear guardrails when it comes to ESG outcomes. Promises are therefore quickly made, and internal practices along with current structures of systems, processes and controls that allow an organization to govern itself often don't seem to be fit for the challenge.

Take net-zero targets. The plans of the so-called pioneers - now being picked over by activists, investor groups and non-governmental organizations (NGOs), among others - may well have been set in good faith but not backed by the necessary due diligence, data and processes.



The result? Greenwashing. The Cambridge Dictionary defines greenwashing as “behavior or activities that make people believe that a company is doing more to protect the environment than it really is.” Planet Tracker³, an NGO, has identified six main types of greenwashing that are “increasingly sophisticated” and are spreading far and fast as ESG becomes a defining characteristic of successful, sustainable and socially aware companies.⁴

Scrutiny of the numbers will only intensify as we move towards reasonable assurance, and missing carbon targets can have financial consequences too. Recent research across large global food and beverage companies showed gaps in shareholder return and EBITDA growth between top and bottom performers on ESG goals, and just 4% are confident of delivering the required reductions in their Scope 3 emissions.⁵

Much like climate and social impacts, greenwashing doesn’t stop within an organization’s four walls. Delivering against ESG targets means lifting the lid on supply chains and digging through the detail. However, accurate data on climate risk, greenhouse gas emissions, biodiversity impacts, employee treatment, human rights, tax transparency, anti-corruption and anti-bribery, board diversity and many more aspects of ESG isn’t often readily available and requires companies to collaborate and if necessary, investigate across the entire supply chain to source it.

Chapter 2

Opportunity knocks

Opportunities to commit fraud in the ESG space are plentiful and profitable.

“In financial accounting you state your position and make representations, but these can be substantiated by accounting rules,” explains EY Canada Forensics & Integrity Services Leader Zain Raheel. Debits must correspond to credits, for example. But when it comes to environmental accounting, there are few such assurances and there could be opportunities for fraud. “You’re currently expected to rely on data that may have some significant limitations when placed under testing scrutiny,” he adds.

Assets in global sustainable funds hit a high of US\$2.97 trillion in 2021, according to Morningstar⁶ for example, and yet unsubstantiated or misleading claims continue to exist with green finance.

ESG data may be manipulated, with employees relying on the inherent weaknesses and ambiguity of sustainability reporting. Within a financial reporting system, typically a strong controls framework with management signoffs is in place. However, as ESG programs are cross-functional and less mature, that same controls framework may not be in place. People also matter: how the signoff is enabled illustrates the importance of governance in the avoidance of such greenwashing.

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EY Canada Forensics & Integrity Services Leader

76%

of investors are worried about businesses “cherry picking” on sustainability activity

42%

of green claims made online by companies are exaggerated, false or deceptive

It's no surprise, then, that 76% of investors accuse businesses of “cherry picking” on sustainability activity.⁷ The EY global survey of senior finance leaders and institutional investors, published in November 2022, found ESG metrics lacking.⁸ A resounding majority (88%) of investors said “unless there is a regulatory requirement to do so, most companies provide us with only limited decision-useful ESG disclosures.”⁹

Experts at MIT and the University of Zurich, who recently reported divergence of ESG ratings between major ratings agencies, have joined others in calling for “greater transparency” and harmonization of ESG disclosures.

The regulatory net is also tightening around green claims, including ones made in relation to ESG topics like net-zero, and those made in marketing materials. International authorities coordinated by the UK Competition and Markets Authority found 42% of green claims made online by companies were exaggerated, false or deceptive - and could by turn break consumer law¹⁰. Mandatory reporting structures are on their way, and these are in the interests of both inadvertent misreporting and fraudulent claims.



Chapter 3

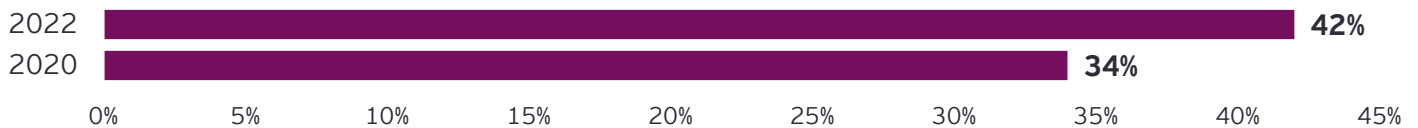
The rationalization of rule-breaking

Not all employees are environmental evangelists.

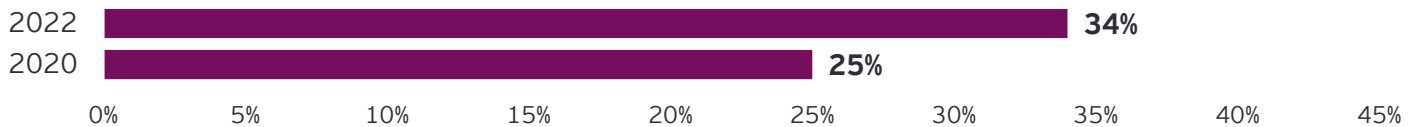
From top to bottom, The EY Global Integrity Report 2022 found ethical standards to be slipping in the aftermath of the pandemic.¹¹

The responses from those who categorized themselves as Board members were particularly insightful:

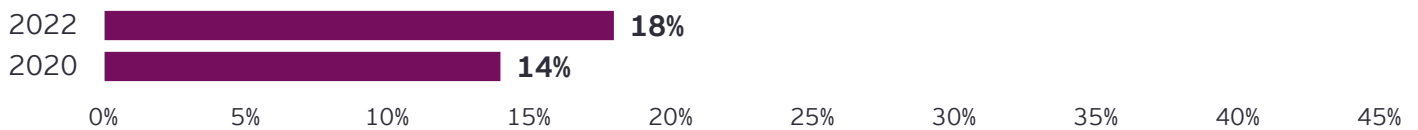
Board members who agree that unethical behavior in senior or high performers is tolerated in their organizations



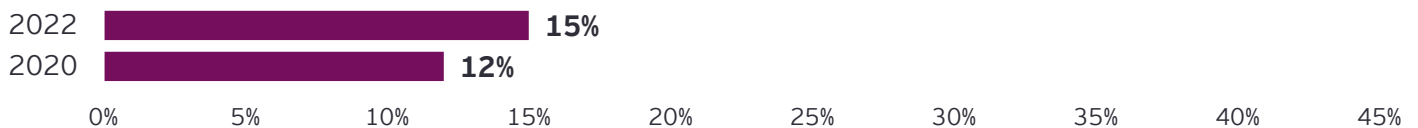
Agree that it is easy to bypass the business rules in their organization



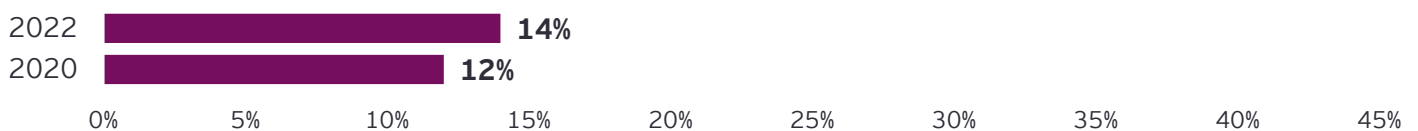
Board members who would mislead external parties such as auditors and regulators



Would falsify financial records



Would offer or accept a bribe



Base: Global Integrity Report 2022 Board members (442), and Global Integrity Report 2020 Board members (333)

Among a list of fraudulent activities, including falsifying financial records, taking or offering bribes, and misleading regulators or auditors, 43% of board members and 35% of senior managers would do at least one of these for personal gain. Thirty-nine percent of employees would be willing to perform an illegal or unethical activity for their own benefit or at the request of a manager.

Employees will justify their actions in committing ESG fraud the same way they do when committing financial fraud. “No one gets hurt;” “it’s not a big deal;” and “it’s for the greater good of the company” are common rationales. And with remuneration increasingly linked to ESG performance, personal hardship is a potential fraud risk factor at every level of an organization.

The tone and action from the top are crucial. And yet boards are too often failing to recognize where ESG risks and issues exist, particularly in challenging an organization’s ESG communications and reporting. Is lack of experience at the very top an issue for the evolving challenges and standards companies are facing? Research from New York University’s Stern Center for Sustainable Business demonstrates some of the gaps: The team dug into the ESG credentials of 1,188 Fortune 100 board directors.¹² Just 6% had relevant experience relating to each of the “E” or “G” in ESG; only three people (0.2%) had specific climate expertise. Is your board equipped to recognize where tough questions need to be targeted in their management teams?

Legal counsel is taking on more responsibility. Corporate social responsibility (CSR) and ESG teams are shifting their reporting to the General Counsel, for example: The 2022 Chief Legal Officers (CLO) survey by the Association of Corporate Counsel found that 24% of organizations’ CSR and ESG teams have such reporting lines, compared to only 15% in 2020.¹³ The 2023 report showed this had fallen slightly to 23%, but 69% of CLOs believe the focus on ESG will accelerate (versus 66% in 2022).¹⁴

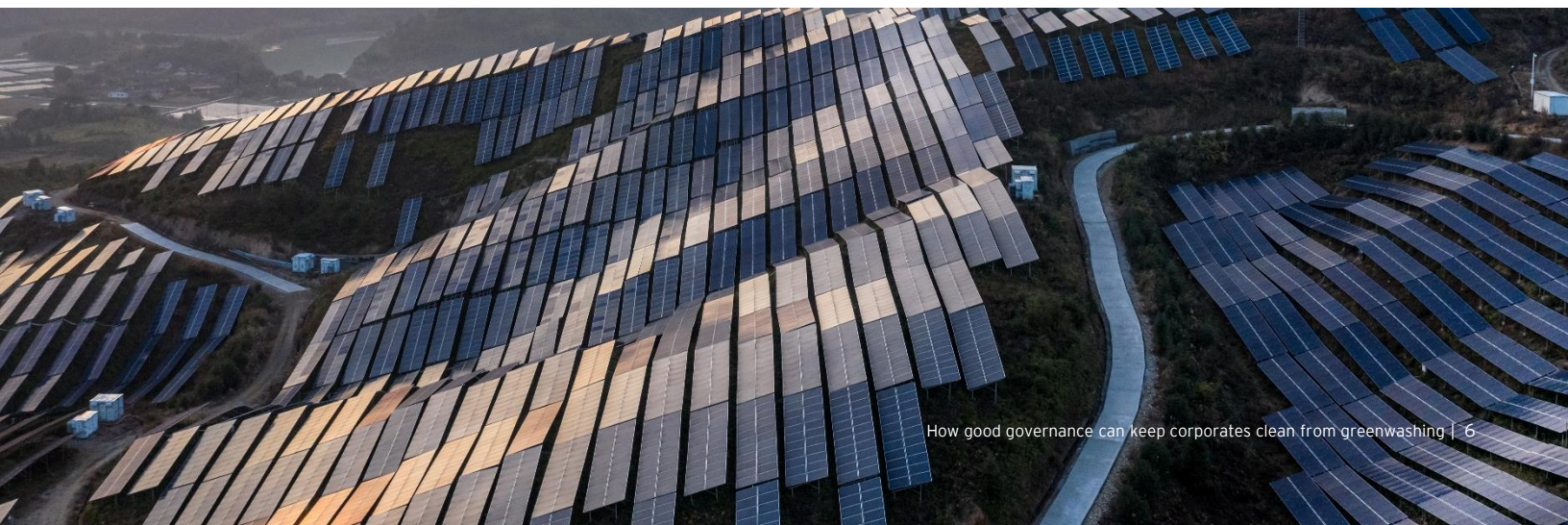
The role of law departments in ESG is evolving rapidly, but the lack of a controlled regulatory environment makes policy-making problematic.

90%

of law departments report challenges in creating policies where there are no specific regulations connected to environmental issues

92%

of law departments have difficulty creating policies on social issues when there are no specific regulations to follow





Chapter 4

4 The strong arm of the law

The fraud triangle outlines three components that contribute to the increasing risk of fraud.

Pressure, opportunity and rationalization, the conditions of the fraud triangle, are all present in the current ESG climate. And the regulatory landscape serves as fertile ground to feed all three, at least currently.

Appropriate regulation establishes a level playing field and ensures that ambition is always matched by action. Indeed, the International Sustainability Standards Board, established by the IFRS in 2021, is also working on standards that should form a global baseline of sustainability disclosures to meet both investor and public policy needs.

The UK now requires large companies to report on their climate-related risks in line with the recommendations of the global Taskforce on Climate-related Financial Disclosures (TCFD). The EU Corporate Sustainability Reporting Directive (CSRD) means that companies will be required to publish detailed information on sustainability performance. And in the US, the Securities and Exchange Commission has proposed rule changes that would require climate-related disclosures.

Global consumers, as demonstrated in the longitudinal data of the EY Future Consumer Index, are increasingly “green.” The percentage of those who say purchasing or behaving sustainably is a guiding principle of their everyday lives has increased from 47% in May 2021 to 53% in October 2022. This provides temptation for companies to exaggerate their green credentials. Regulators are gearing up:

- ▶ The digital markets, competition and consumer bill, set to be introduced in the UK in spring 2023, will give the Competition and Markets Authority (CMA) powers to impose penalties on companies for misleading green claims.
- ▶ The European Commission meanwhile has just published the draft of its green claims directive, which is designed to offer “common criteria” for businesses looking to make environmental claims.¹⁵

The EY 2022 General Counsel Sustainability Study, involving interviews with 1,000 General Counsel and Chief Legal Officers from businesses representing 12 industries across 20 countries, showed the challenges presented by lawsuits and increased enforcement were among the risks faced due to sustainability issues or practices.¹⁶

“Consumer litigation over misleading advertising tied to ESG-related claims is increasing,” explains Chandan Sarkar, Principal, Forensic & Integrity Services, Ernst & Young LLP. “Everything from sustainable packaging to carbon-cutting claims are under the microscope, and courts are allowing the claims to progress to ‘fact discovery’ stage, which is a noteworthy shift.”

Greenwashing negatively impacts a customer’s experience with a company’s product or service, according to academics writing for Harvard Business Review on the topic: “[...] when customers believe a company is greenwashing, it directly affects how they experience its products or services.”¹⁷ In their published study, the researchers estimated that companies perceived to be greenwashing suffered, on average, a 1.34% drop in their American Customer Satisfaction Index (ACSI) score.¹⁸ Such a small change in a organizations customer satisfaction score, however, can have significant implications for corporate performance.

Damage to the brand, loss of customers, reputation-damaging headlines and a struggle to recruit and retain staff from an increasingly climate-conscious workforce are among the myriad risks emerging from greenwash, so what do companies do about it?



Chapter 5

Integrating integrity

Integrity is important; however, a gap exists between what companies say they have in the way of an ESG policy and their accountability.

A record 97% of respondents to the EY Global Integrity Report 2022 agree that integrity is important.¹⁹ However, senior management is often overconfident in the effectiveness of corporate integrity programs, with a growing “say-do” gap emerging between rhetoric and reality. This has implications for an organization’s ESG aspirations and increases the opportunities to greenwash.

Greenwashing in this context can be seen as a disconnect between words (what an organization says) and actions (what it is actually doing).

Senior management and board members should make sure they can back up what they are saying and consider the potential commercial, reputational, legal and financial risk of making statements they cannot support. Otherwise, they can be held accountable for violating a basic principle of stewardship and corporate citizenship, namely corporate integrity.

Consider what has happened with the financial services sector, where there is a swath of regulations sweeping across the globe to ensure organizations are held accountable both for their investments and the products they sell.

“If you’re investing in a ‘green’ fund you now need substantial documentation that those funds are living up to their name,” says Sarkar. “You need to look at the metrics you are using, how up to date the information is and whether it is disseminated appropriately and compliantly.”

Climate reporting and crises

Corporate reputations and the careers of CEOs are quickly destroyed by public disclosures of a say-do gap, and those reputations will be even more closely scrutinized as rigorous disclosure obligations on a company’s ESG performance come into force. Any companies facing scrutiny on disclosures, deeper analysis between peers and more cross-border enforcement should understand how they can validate (through strategy, data, and reporting) public-facing statements. Without that grounding, the reputational risks may be tantamount to greenwashing, regardless of a statement’s intent. “With ESG, it’s much harder to see where the threat is going to come from and how to respond,” says David Higginson, Partner, Forensic & Integrity Services, Ernst & Young LLP. “The ability to manage a greenwashing issue quickly and effectively needs to be moved further up the Board agenda.” He cites EY research showing that 58% of board directors/members and 37% of other employees would be “fairly” or “very concerned” if their decisions came under public scrutiny.²⁰

Integrity can be a difficult concept to define, not least because organizations face different ethical dilemmas. It’s about making the intangible tangible, about committing to the interdependence of business and society by embedding integrity into the culture and behaviors of the organization. But fewer than half those EY surveyed for the 2022 Global Integrity Report are using the basics of integrity enhancing measures such as providing regular training on regulatory issues (43%) or ethics (38%), applying sanctions to address behaviors (32%) and conducting due diligence on suppliers (30%) or customers (28%).

Suppliers, it should be noted, are exposed to the same pressures, and can be enticed by equally favorable opportunities and will rationalize these decisions in similar ways to their clients and customers. In other words: The very same fraud triangle exists, so the very same risks of greenwashing are present and the impacts can be felt up the supply chain.

Organizations should take a “tell me, now show me” approach to ESG with facts to the fore. Board members need to be on top of this strategy, because regulators increasingly are. Some are already employing data science to ensure, for example, that the claims made in glossy CSR reports match official ESG accounts.

Harmonized and mandatory reporting will help reduce ambiguity and provide more confidence in reporting. And make no mistake: Organizations will increasingly need to communicate externally – often with external assurance – on key sustainability matters and metrics applicable to their activities, like greenhouse gas emissions, as pressure from all stakeholders increases. This communication is the foundation of an organization’s social contract with all stakeholders. Moreover, putting sustainability at the heart of company strategy pays financial dividends. In a recent survey of more than 500 companies committed to improving their environmental performance, 69% report that they capture higher financial value than expected from their climate initiatives.²¹



Recommendations and actions

Governance and oversight

- ▶ Evaluate if General Counsels alone are the most effective function to drive ESG and evolve the organization towards sustainability while having a more integrated approach towards integrity more broadly.
- ▶ Challenge and re-imagine board structures and functions along with their mandates as part of the sustainability journey, e.g. imagine how Ethics Officers or CFO roles can evolve to drive the sustainability transformation while managing risk and provide assurance on non-financial performance.
- ▶ Increase board diversity: bring expertise into the board, and while that is underway, use specialist committees to ensure strong sustainability expertise informs the board's work.
- ▶ Break down siloes, find new ways of working, and establish rigorous systems and processes (including incentive structures) to facilitate effective management and reporting across relevant functions, e.g., operations, ethics officer, HR, internal audit and compliance, etc.
- ▶ Ensure there is a comprehensive understanding of the ESG reporting framework in place, define what-could-go-wrong scenarios with mitigating actions, and identify potential red flags.

Data Quality

- ▶ Ensure ESG objectives and progress are supported by reliable and measurable data points to protect companies from potential allegations of greenwashing.
- ▶ Proactively take a forensic approach to the identification, collection, processing and reporting of data to identify possible weaknesses or potential for data manipulation early and remediate red flags across the organization.
- ▶ Use a rigorous data strategy and reporting to support a vision of the company's progression towards ambitions such as net-zero and carbon reduction initiatives, which will build confidence and trust internally as well as externally.

Culture

- ▶ Ensure a transparent and realistic approach to ESG is nurtured across the organization, led from the top.
- ▶ Embed leading practice governance features to continuously support the ESG journey, such as integration of ESG and integrity into the HR life cycle, no-blame speak-up, pro-sustainability leadership, seriously driving diversity, equity and inclusion, etc.
- ▶ Develop an organizational approach to ESG that isn't only focused on risk or corporate defense but also seeks and celebrates the opportunities and innovations a strong sustainability agenda can offer forward-looking enterprises.

Summary

ESG should be led from the top and integrated into the business culture and strategy. Organizations' ESG objectives and credentials need to be visible and measurable so they can be held up to scrutiny and avoid any allegations of greenwashing.

About this article



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