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Managing fraud risks in an evolving ESG environment. Emerging fraud risks to consider

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PwC Forensics and Financial Crime

What do we do?

Forensic data analysis

Investigations

AML/KYC

Corporate Intelligence

Cybercrime

Compliance reviews

Expert reports

Anti-corruption

Computer forensics

Training

Anti-fraud

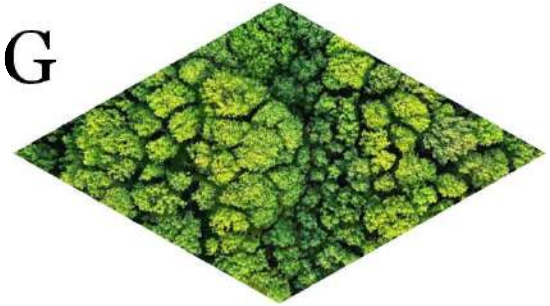
Agenda

1. Setting the scene
2. ESG fraud
3. Managing ESG fraud

1

Setting the scene: Is ESG reporting trusted? New reporting and transparency requirements. New risks

ESG



E- Environment

What is an organization doing to be a steward of the environment?
The environmental umbrella covers:
- How a company is combatting climate change
- What a company is doing to reduce carbon emissions
- How the company is preserving biodiversity, improving air and water quality, combatting deforestation, or responsibly managing its waste
- How the company is responsibly using resources and its supply chain
- What the company is doing to reduce its emissions?

S- Social

What is an organization doing to improve lives?
The social umbrella covers:
- How a company nurtures its people and workplace
- Gender, BIPOC, and LGBTQ+ inclusivity initiatives
- The company's employee engagement
- Data protection and privacy
- Community involvement
- Human rights and labor standards

G – Governance

What is an organization doing to stay ahead of corruption and ensure its investments remain sustainable in the future?
The governance umbrella covers:
- A company's internal controls
- Policies, principles and procedures governing leadership, board composition, executive compensation, audit committee structure, shareholder rights, bribery, lobbying, political contributions, and whistle-blower programs

Source: Wolters Kluwer

Is ESG reporting trusted?

Not really, according to PwC's Global Investor Survey

87%

of investors think corporate reporting contains unsupported sustainability claims (i.e., greenwashing)

89%

of investors use financial reporting sources to get information about how companies manage risks and opportunities

75%

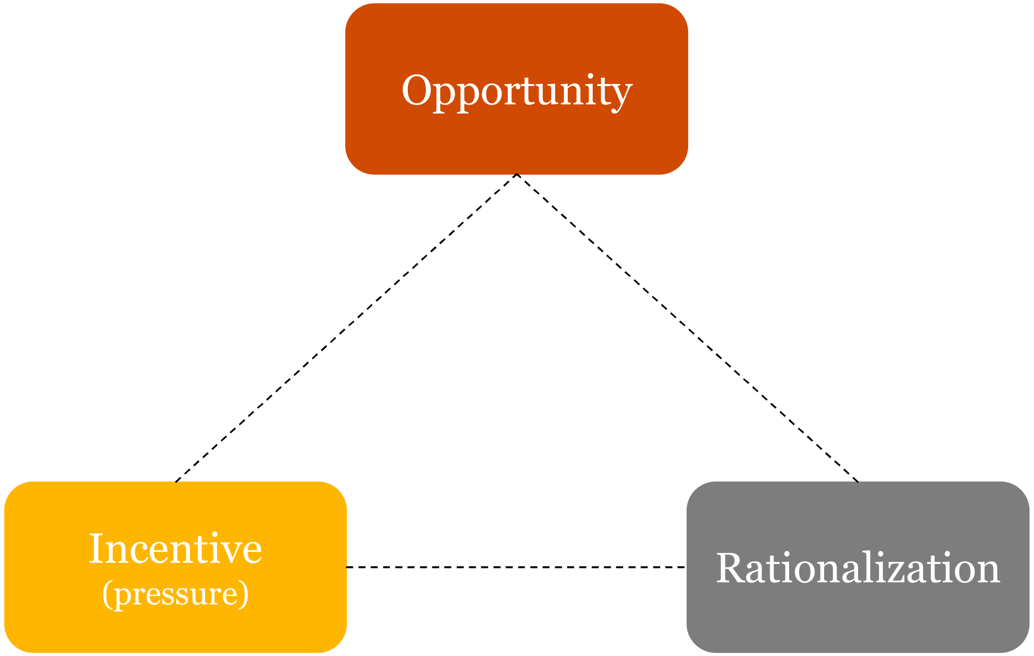
of investors said their trust in sustainability reporting would increase if it was done with the same rigor as financial reporting

Source: PwC's Global Investor Survey 2022 - The ESG execution gap

New requirements. New risks

Directive 2014/95/EU	Sustainable Finance Disclosure regulation	EU Taxonomy Regulation	Corporate Sustainability Reporting Directive	Corporate Sustainability Due Diligence Directive	Timeline for implementation of the new directives
Requires large companies to disclose non-financial information related to ESG.	Requires financial institutions to collect ESG data from clients	Aspires to provide companies, investors and policymakers with standard definitions for what's considered environmentally sustainable.	Requires a broader set of companies to report on sustainability, mandates an audit of sustainability information.	Requires companies to conduct due diligence to prevent adverse human rights and environmental impacts along their value chains.	Corporate Sustainability Reporting Directive: - Jan 2024 - Jan 2025 - Jan 2026 Corporate Sustainability Due Diligence Directive: - Jan 2025

ESG and fraud drivers



Source: ACFE x GT 2022 - Managing Fraud Risks in an Evolving ESG Environment

Opportunity

The environment that allows fraud to occur.

In the ESG context, such a control environment could include clear policies that establish ESG metrics, as well as oversight of internal and external actors to ensure compliance with these policies.

With respect to ESG reporting today, benchmarks are limited, and consistent guidance is lacking.

Many audiences—even sophisticated ones— lack a full understanding of company-reported metrics.

Incentive

The perceived burden potential fraud actors might experience that would incentivize them to commit fraud.

There is enormous pressure on the C-suite to make— and achieve—ESG promises. The pressure is particularly intense when it comes to raising capital.

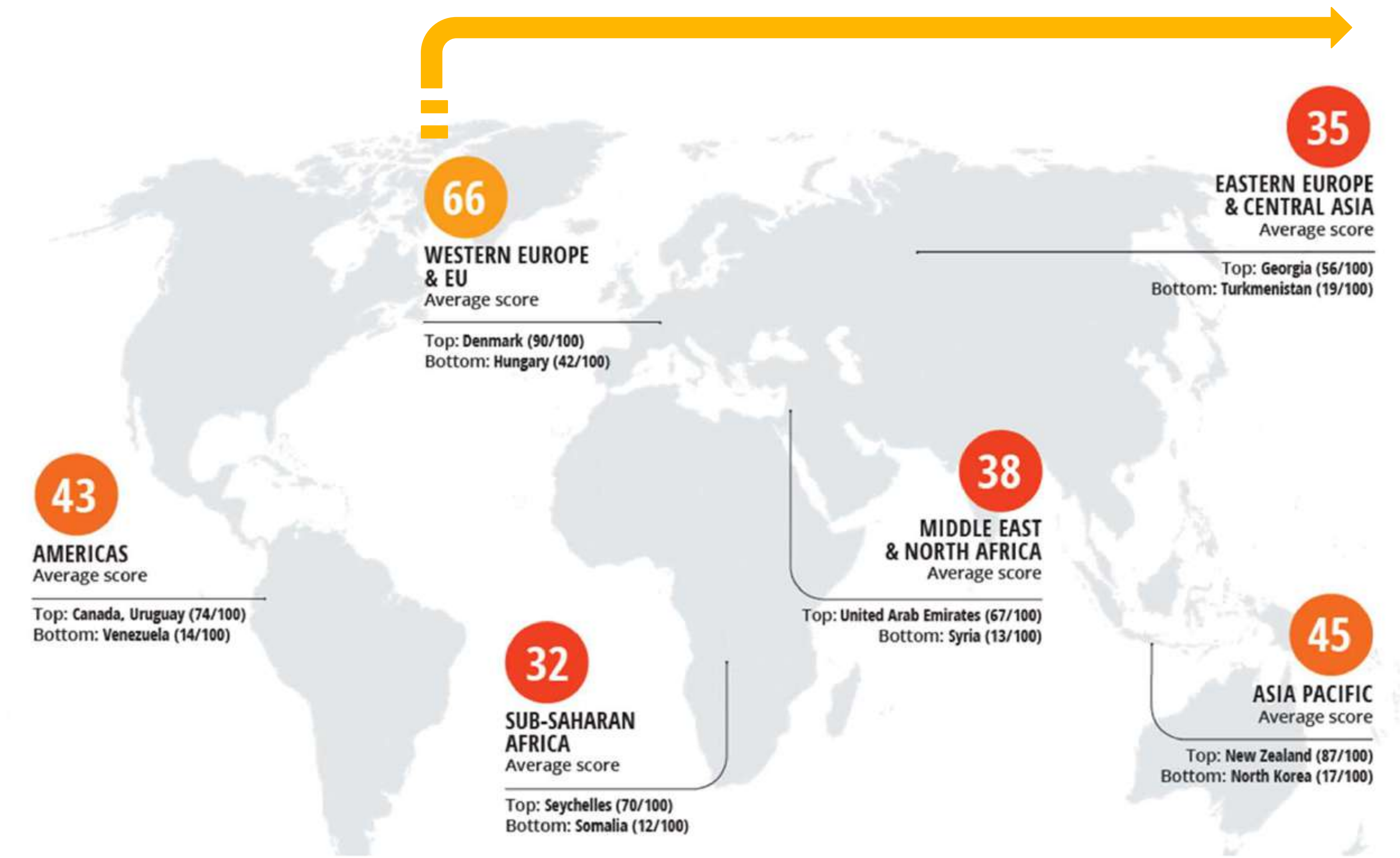
Increasing investment focus on ESG raises the stakes and increases the pressure to commit fraud. This pressure could also result in reduced scrutiny of suppliers or third parties, as uncovering ESG fraud in the value chain would negatively implicate the company.

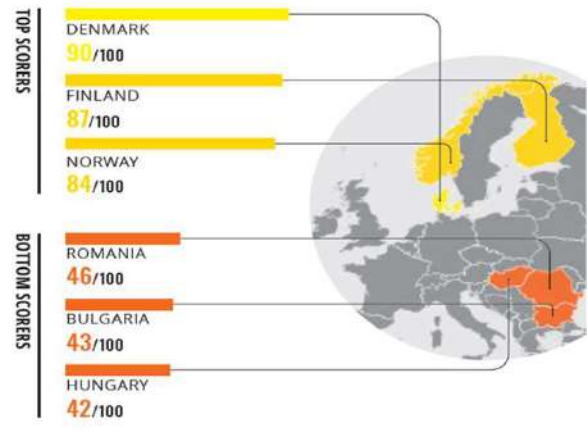
Rationalization

The ability of a fraudulent actor to convince themself that the circumstances justified their illicit act.

ESG represents many social virtues. Therefore, bad actors may rationalize that making progress on ESG promises is worthy of a reward, not punishment. For example, if an organization comes close—but still fails—to deliver on an ESG promise, the organization may rationalize a misstatement with the justification that "some progress is better than none." In other instances, individuals may justify their actions because the "ends justify the means." If the choice is between providing honest and transparent reporting of poor ESG performance resulting in market losses and layoffs, or cooking the ESG books to show a positive result, it becomes clear how some organizations might rationalize fraud.

Corruption Perceptions Index 2022





WESTERN EUROPE AND EUROPEAN UNION

With an average score of 66, Western Europe and the EU is once again the top-scoring region in the CPI. However, progress has stagnated in most countries for more than a decade, as undue influence and fragmented anti-corruption measures have taken their toll. The changing security landscape since Russia's invasion of Ukraine and a looming recession both demand robust responses from governments.

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ESG fraud

PwC's Global Economic Crime and Fraud Survey Highlights

Organizations without a programme to address bribery and corruption

6 in 10

Companies performing limited testing of operating effectiveness

3 in 10

Top 4 types of fraud

- Cybercrime
- Customer fraud
- Asset Misappropriation
- Bribery and Corruption

Anti-embargo fraud in the last 24 months

6%

ESG fraud reporting fraud in the last 24 months

8%

Incidents of supply chain fraud as a result of the disruptive caused by COVID - 19

1 in 8

Source: PwC's Global Economic Crime and Fraud Survey 2020 - 2022

Examples of ESG fraud scandals

- **Volkswagen** emissions scandal
- **Bosch** "Diesel gate" emissions cheating scandal
- **Theranos**, claimed to have developed a revolutionary blood-testing technology
- **Xinjiang** forced labor scandal

Examples of ESG fraud schemes

Internal

Intentional acts:

Reporting of false or misleading ESG information

Omitting material ESG facts

Improper disclosure of ESG initiatives (programs, metrics)

Internal ESG fraud may also involve corruption.

Examples:

- Failure to disclose the use of children
- Forced labor
- Harvesting resources from illegal sites
- Illicit trade
- Trafficking

External

External ESG fraud is fraud conducted by parties outside an organization, such as vendors in an organization’s supply chain, contractors, customers, or other third parties.

Examples:

- Sale of fraudulent “green” investments to supply desirable carbon emission credits to offset greenhouse gasses.

Source: ACFE x GT 2022 - Managing Fraud Risks in an Evolving ESG Environment

Examples of ESG fraud schemes

E

Harvest mixing: Mixing of valid and illicit goods while declaring all goods are valid to generate additional profit and nondisclosure gain.

Environmental standards manipulation: Falsifying or rigging environmental tests (e.g., emissions software) to falsely claim adherence to standards.

Inflated carbon credit value: Inflating the value of a carbon credit, contradicting a fair market value analysis.

Jurisdictional bribery: Bribing jurisdictional authorities for a license or clearance to harvest or transport protected wildlife and flora.

S

Labor condition concealment: An organization's officers collude with supply chain actors to conceal and misrepresent unsafe and noncompliant labor conditions.

Falsified Diversity, Equity &Inclusion metrics: An organization knowingly misrepresents data on DE&I initiatives.

Nonconforming social services: A vendor contracts to provide socially conscious services to support social-wellness programs but is not capable of performing such services.

Forced savings and deposit programs: A supplier withholds a portion of a worker's salary and deposits it into a savings account to which the worker does not have access until their term of work is complete, creating an element of servitude over fear of losing the withheld assets.

G

Misrepresentation of suspicious activity: A company wilfully disregards suspicious transactions passing through operations with clear indications of illicit activity.

Clearing and forwarding extortion: A clearing agent demands payment from an organization for additional bond on top of an existing contract to expedite the import of goods.

Violation of independence: Audit committee members violate conflict of interest standards when engaging in decision-making.

Capital expenditure misclassification: An organization misclassifies capital expenditures as ESG-related for the purposes of company reputation, or to meet executive compensation incentives.

Illegal tax shelters and underreporting: An investment management firm unlawfully hides assets and income in overseas tax shelters and sanctioned jurisdictions to generate a higher return and embezzle funds without disclosing to the investing organisation.

Source: ACFE x GT 2022 - Managing Fraud Risks in an Evolving ESG Environment

Types of ESG fraud – ESG Washing

"ESG washing" is a relatively new term that has been used to characterize some corporations' overselling of their ESG efforts and initiatives to gain a favourable impression from investors, consumers, employees and/or other stakeholders when the actual substance of those ESG initiatives falls short of any objective standard.

1 Greenwashing

Environmentalists have been using it since the 1980s to call out substandard corporate environmental policies and results. It refers to the practice of misleading/misinforming stakeholders and the public about the organization's environmental impact and/or initiatives.
(carbon washing)

2 Bluewashing

When coastal, oceanic, and marine development initiatives deliver little to no sustainable benefits and may instead cause harm to aquatic environments

When businesses registered as part of the UN Global Compact (UNGC), a non-binding pact to follow ten principles on corporate ethics and sustainability, advertise this commitment to stakeholders without actually adhering to the UNGC principles

3 Whitewashing

A company's attempt to cover up its scandals with investigations that are carried out with minimal effort and/or presenting biased data

Types of ESG fraud – ESG Washing – social washing

Pinkwashing (or rainbow washing)

This refers to the practice of advertising support and sponsorship of the 2SLGBTQIA+ community, while in practice little is truly done within the organization to ensure 2SLGBTQIA+ employees are being protected from discrimination, prejudice, or harassment
Pinkwashing has also been used to refer to companies that use the pink ribbons associated with breast cancer awareness to promote their products but provide little to no transparency on their involvement or production of products that are linked to causing breast cancer

4

Purplewashing

Organizations deliberately attempt to appeal to the diversity and inclusion of women to distract from internal practices that may be inconsistent with this messaging

5

Brownwashing

Corporations create a public image of support for Black, Indigenous and People of Colour (BIPOC) communities, while doing little to ensure their own BIPOC employees are being protected from discrimination, prejudice, or harassment

6

Redwashing

Organizations (whether corporations or governments) show public support for Indigenous initiatives to divert attention from activities such as environmental contamination or the forceful appropriation of land and water rights

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3

ESG fraud risk assessement

The impact of ESG fraud

Financial risks
Typical financial losses

Reputational risks
Investors lose confidence
Customers can boycott the brand.
Employees can abandon the company

Compliance risks
Violations can lead to financial penalties which can increase the reputational costs

Proposed solution?

Organizations that **proactively identify ESG fraud risk issues,** establish appropriate controls, and take swift remedial action when necessary will **fare much better than those that take a more reactive stance.**

Source: ACFE x GT 2022 - Managing Fraud Risks in an Evolving ESG Environment

> Organizations should periodically evaluate ESG fraud risks and corresponding internal controls that mitigate those risks by conducting ESG fraud risk assessments.
>
> *ACFE*

Defining ESG fraud risks: ESG fraud taxonomy

Corruption
➔Conflicts of interest
➔Bribery
➔Illegal gratuities
➔Economic Extortion

Financial statement fraud
➔Concealed ESG-related liabilities & expenses
➔Overstated ESG-related liabilities & expenses
➔Improper disclosures
➔Improper ESG-related asset valuations

Asset misappropriation
➔ESG-related inventory and other assets: larceny (ie. thefts of personal safety equipment), misuse (ie. personal use of donated goods)

Non financial reporting fraud:
➔False labelling or advertising
➔False disclosure or representation
➔False/ disingenuous certification or pledges
➔Failure to disclose or report

Source: ACFE x GT 2022 - Managing Fraud Risks in an Evolving ESG Environment

ESG fraud taxonomy – Non financial reporting fraud

False labelling or advertising	• Affirmative declarations or assertions: Made with 100% recycled materials
False labelling or advertising	• Negative declarations or assertions: Dolphin free tuna
False disclosure or representation	• Affirmative declarations or assertions: Greenhouse. Gas emissions declined by 10%
False disclosure or representation	• Negative declarations or assertions: None of our products contain inputs resulting from forced labour
False/disingenuous certification or pledge	• Affirmative declaration or assertion: We are the founding member of the ....ESG initiative
False/disingenuous certification or pledge	• Out of compliance with certification or pledge: Fully compliance with ....certification requirements
False/disingenuous certification or pledge	• Negative declaration or assertion: On track for net zero greenhouse gas emissions by 2023
Failure to disclose or report	• An event or action: No plant accidents required hospitalisation during the prior year
Failure to disclose or report	• A fact: Board does not include a diverse Director [not reported]

Source: ACFE x GT 2022 - Managing Fraud Risks in an Evolving ESG Environment

ESG fraud taxonomy – Financial statement fraud

Concealed ESG related liabilities and expense	• No real estate assets are in 100 year flood plain
Overstated ESG related liabilities and expenses	• Environmental reserve used as cookie jar
Improper ESG Asset valuation	• Inflated carbon credit value
Improper disclosures	• Omission of disclosures

ESG fraud taxonomy – Corruption

Corruption	• Purchasing/Sales schemes/ Carbon credit sales to undisclosed parties
Bribery	• Invoice kickbacks/Bid rigging/Collusion for disaster relief procurement
Illegal gratuities	• Grease payments to forgo safety inspection
Economic Extorsion	• Permit officer demand payment for lodging permit

Source: ACFE x GT 2022 - Managing Fraud Risks in an Evolving ESG Environment

Thank you!

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Mitigating ESG fraud risk (1/2)

Increase accountability

An ESG framework should address the traditional management assertions.

Accuracy

ESG reporting disclosures should have the same rigor as financial statement reporting.

Completeness

Organizations should disclose the full picture with thorough information regardless of the weight.

Rights and obligations

Organizations should only disclose information that legally belongs to the organization and is permitted for use.

Existence and occurrence

Organizations should only report ESG matters that have occurred during the period(s) or that relate to conditions that exist at the time of reporting.

Comparability

Organizations should seek a standardized reporting framework appropriate for their industry.

Source: ACFE x GT 2022 - Managing Fraud Risks in an Evolving ESG Environment

As stakeholders demand increased ESG accountability, they must develop tailored ESG frameworks with fraud risk management components that withstand scrutiny. Incorporating proper checks and balances to mitigate the risk of ESG fraud and misconduct is vital.

Fraud is not inevitable.

The key is:

- To install and maintain guardrails;
- To ask hard questions;
- To consistently enhance reporting, controls, and approaches to integrate ESG reporting into other reporting that undergoes scrutiny.

Rigorous ESG guidance should consider policies, procedures, data governance, and reporting controls. Additionally, an ESG framework should address the traditional management assertions of accuracy, completeness, rights and obligations, existence, and comparability, which are reflective of the principles that auditors rely upon for the assessment of financial audits.

Mitigating ESG fraud risk (2/2)

Materiality considerations

When setting up an ESG framework, consider the following types of questions in determining materiality:

- Are my company's ESG disclosures subject to the same rigor as our financial disclosures?
- What are our management assertions about ESG, and are controls in place to make faithful assertions?
- Have we considered the risks posed by our suppliers and vendors?
- Have we conducted adequate due diligence with our suppliers and vendors to confirm that their practices align with our ESG objectives?
- What is the plan to disclose and correct any ESG reporting problems?

Source: ACFE x GT 2022 - Managing Fraud Risks in an Evolving ESG Environment

Materiality is a key part of protecting organizations from ESG fraud risks.

When reporting, organizations could ask themselves:

Would this affect a stakeholder's decision-making?

ESG fraud risk management
Key components

FRAUD RISK GOVERNANCE: The organization establishes and communicates a Fraud Risk Management program.

FRAUD RISK ASSESSMENT: The organization performs comprehensive fraud risk assessments.

FRAUD CONTROL ACTIVITY: The organization selects, develops, and deploys preventive and detective fraud control activities.

FRAUD INVESTIGATION AND CORRECTIVE ACTION: The organization establishes a communication process to obtain information about potential fraud and deploys a coordinated approach to investigation and corrective action.

FRAUD RISK MANAGEMENT MONITORING ACTIVITIES: The organization selects, develops, and performs ongoing evaluations.

Source: ACFE x GT 2022 - Managing Fraud Risks in an Evolving ESG Environment

It can be difficult for companies to structure an ESG anti-fraud program when they are just starting out, especially with the ESG landscape evolving so rapidly.

While there may be challenges, traditional fraud risk management guidance can help.

This methodology provides a strong foundation upon which organizations can build a holistic fraud risk management program.

While ESG introduces new fraud risks and may require new controls and reporting mechanisms, a strong ESG fraud risk management program should still align to these core principles.