






The rising challenge of sustainability fraud

**Understanding fraud risks and
fraud prevention for investors
and companies**



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Introduction

Until recently, sustainability information and management has been a secondary activity for many companies. Often, a separate sustainability department was created and given the responsibility for the development of sustainability projects and programs. As companies started to report on their efforts, this was conveyed via separate reports. Of course, over time things have progressed. In an increasing number of companies, sustainability is becoming a mainstream topic and reporting has become integrated in annual reports, giving it higher prominence.

It is only recently that sustainability is seen as a critical business topic that is correlated with an organisation's financial performance and that could impose a financial risk and/or opportunity. Investors are starting to notice the risks from sustainability developments, particularly climate change, and are slowly but steadily also starting to act on it. This is demonstrated by Blackrock and investor alliances such as the Climate Action 100+. Also, regulators are following with a rising sustainability agenda. Only in 2020, the EU, Canada, the United Kingdom and Japan have stepped up their efforts and close to 60 central banks as well as the International Organization of Securities Commissions (IOSCO) have strengthened their focus on sustainability issues.

All this comes not only with a rising attention for the future of the planet, but also with increasing financial interests, and an understanding that the two are growing ever more intertwined. A company that is not achieving expected sustainability objectives may face investor (and legal) actions, while the board may see lower remuneration. More importantly, with the introduction of the EU Taxonomy, access to capital will be impacted by whether projects are green or brown.

This paper is meant for companies and investors, to develop a further understanding of what inevitably is going to happen: as we know from our longstanding experience, financial interests not only come with positive drives towards better performance, they also bring risks of misrepresentation of relevant sustainable information - 'fraud'. We also know from our work with clients for over 25 years that systems, processes and internal controls of sustainability information are generally not at the level of those for financial reporting.

It is time, therefore, to address the topic of sustainability fraud and provide you with the potential risks you should be aware of and the actions you can take to prevent and act on it.



Current developments, for example to EU Taxonomy, place increasing pressure on companies to meet investor criteria and thus present data more favorable than they actually are.

On fraud



Risks of fraud and misconduct are a constant threat to the public trust and confidence in (corporate) organisations. Yet whilst many have an opinion on these topics, there is no clear, widely-accepted definition of fraud. Fraud and misconduct are broad concepts that generally refer to misappropriation of assets, fraudulent financial reporting, and violations of law, regulation, internal policy and expectations for ethical business conduct.

Fraud is often defined as an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an intended unjust or illegal advantage. As part of increased efforts regarding fraud risk management we observe that many companies come up with own definitions of fraud, in which the underlined items are prevalent.

On sustainability fraud

In this paper, we define sustainability fraud as fraud and misconduct (see above) committed with sustainability data, either by sustainability or other professionals within a (corporate) organisation. The responsibility for sustainability data is usually dispersed across various roles (e.g sustainability manager, HR manager, another professional or a board member), who can all commit a fraudulent act with sustainability information. For example, an intended unjust or illegal advantage that involves the data for Lost Time Injuries (that generally are registered by HR and/or quality professionals) would have to be considered sustainability fraud (as part of fraudulent (financial) reporting).

Sustainability fraud can take many forms, ranging from undue variable compensation to incorrect reporting in order to receive higher ratings/rankings that result in higher reputation and thus higher share price. Incorrect or incomplete performance data can also result in (more favorable) access to capital and therefore be fraudulent. The reputation of the company or its leadership is another area that can be influenced by over- or underreporting, or failing to provide the right context.

Sustainability fraud has not been widely researched thus far, yet based on available third-party and our own research, manipulation of sustainability information does happen already and may harm companies and its (financial) stakeholders in various ways. We provide a few examples throughout this paper. An important notion here is that sustainability fraud can not only harm companies in a quantitative (i.e. financial way) but also, in a qualitative way. As with many risks, companies normally use quantitative information to evaluate risk exposure. Where possible they complement it with qualitative descriptions. Yet, as with all fraud risks, qualitative information is becoming more important. An example is reputation, an intangible asset that companies often cite as an important driver for them or their sustainability efforts. Other qualitative information may include (internal) compliance and business ethics, operating factors such as adherence to laws and regulations, or societal factors such as social licenses to operate.

Exploring the Fraud Triangle for sustainability



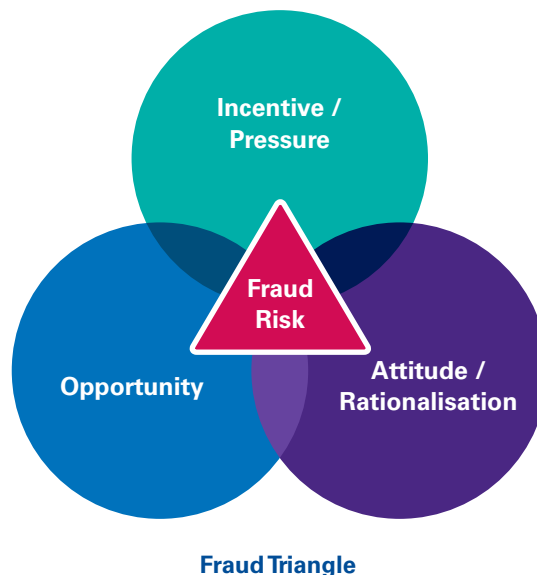
Within this paper we will assess the topic of 'sustainability fraud' by applying the Fraud Triangle. The Fraud Triangle is a framework used to explain the motivation behind a decision to commit fraud and/or to make a structured assessment of the fraud risk. Generally, the Fraud Triangle entails:

incentives and pressures to act fraudulently

perceived opportunity to commit fraud

rationalisation of fraudulent acts

As sustainability becomes a mainstream issue and is further integrated into annual reports, this leads to an increase in incentives, opportunities and rationalisation for companies and individuals to step into fraudulent behaviour in order to exploit sustainability efforts for their own advantage.



Incentives and pressures to act fraudulently



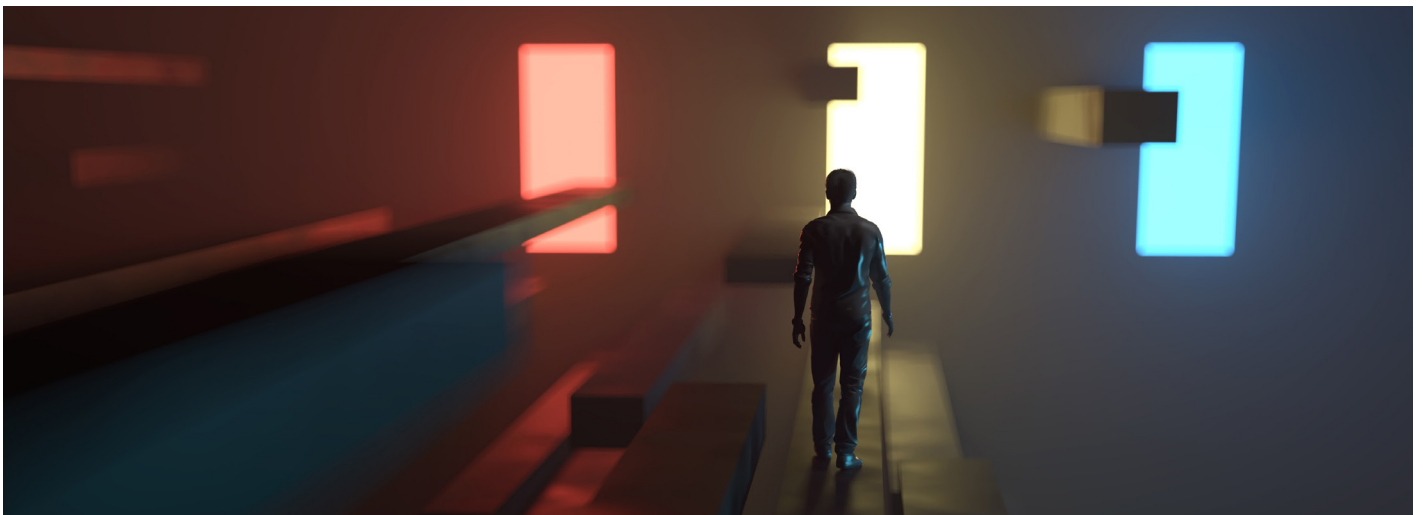
‘Incentive and pressure’ refers to the (perceived) potential positive or negative consequences when certain actions are taken or omitted, or when certain information is disclosed or kept confidential. Whereas there are also very personal pressures (such as an addiction to gambling), we focus here on the organisational incentives and pressure in relation to sustainability. Below, we describe the key pressures and incentives and pressures that can be distinguished and to whom in the organisation they would be most relevant.

Financing requirements

With the increasing attention of banks on green investments and financing, and the introduction of the EU Taxonomy in the coming years, pressure can emerge to deliver against these rising requirements. Providing inaccurate or incomplete information can result in stronger access to capital or favorable financing conditions. In this context, adjusting data reported to meet certain targets and incorrectly categorising projects/investments as green is a way to meet requirements set by financial institutions.

Company value

Either from a wider societal perspective or from a financial risk perspective, investors are integrating sustainability (or: ESG [Environment Social Governance] scores as the investor community tends to call it) into their investment decisions and valuation of companies. Also linked to remuneration (see below) this creates rising pressure for companies to meet the criteria that investors set. Not only will this provide access to capital, it may also result in a higher share price if criteria are met.





Many investors rely on rating agencies to select and evaluate investments. Manipulating the information provided to these agencies would therefore be a way to fraudulently gain the investors' appreciation. Also, providing inaccurate, incomplete or unbalanced information in sustainability reporting could be practiced for the same reason. For the latter, there may be a thin line between greenwashing and fraud.

Revenues and benefits from sustainability issues

The Dutch government includes sustainability criteria in its procurement contracts and many companies have implemented them. Relatedly, specific requirements for companies to be able to bring their products to market – such as emission levels for cars – create a direct financial incentive to reportedly meet these criteria. More regulations are expected as part of the EU Green Deal. This means that a motive exists to provide wrong data in case this results in additional sales or continuing a contractual relationship.

Costs related to sustainability issues

Some sustainability issues come with investments or costs such as taxes. Carbon emissions are the most well-known example of this. As emission certificates increase in price, and thus become financially more material, there is a growing incentive to report incomplete data in order to save costs related to emissions.

Compliance

Regulatory requirements put pressure on companies to meet them, as non-compliance could result in fines or even loss of business. These could include licenses and permits to operate. If these requirements get more and more tightened, and therefore become difficult to meet, this can result in companies crossing the line of providing incorrect information, as we have seen with Volkswagen.

Remuneration

A limited number of leading companies have integrated sustainability factors, such as safety and energy, for a long time into their executive remuneration schemes. This trend has grown over the past years with the rising attention by many societal actors. Remuneration can be a pressure factor from two perspectives. Firstly, the incentive to meet targets set in variable compensation schemes and the financial advantage therefore to favorably report data against these targets. Secondly, as many board compensation schemes include stock options, there is an incentive to manage the sustainability reputation of the company as a whole and thus ensure that the sustainability performance of the company appears positive. The latter point is related to the comments made under 'Company value' above.

Soft benefits

It is common to see the incentives for committing fraud as financial benefits. However, there may also be more soft pressures to consider fraud from the perpetrator's perspective. Amongst the most prominent ones that we see are career opportunities and personal or company reputation. With respect to the first type, in some companies, sustainability roles are part of a career development path for employees. Therefore, showing strong sustainability performance and progress can be a driver to progress someone's career. This incentive could result in fraudulent reporting.

Also, the increasing pressure from media and NGOs on companies to deliver wider societal benefits (for example related to the Sustainable Development Goals) can add pressure to 'protect the reputation' by intentional erroneous reporting.

On personal and company reputation, there is an increasing interest amongst world leaders in sustainability. Several fora exist that bring the great and the good together (such as the World Economic Forum in Davos). Being part of such fora can be perceived as a personal motive to demonstrate continuous strong performance in sustainability, therefore adding pressure and increasing the risk of fraud.



H&M

marketing of a 'sustainable' collection

In April 2019, H&M launched its Conscious collection, claiming that every piece in the collection is made from a sustainably-sourced material, such as 100 percent organic cotton, Tencel or recycled polyester. The Norwegian Consumer Authority however, criticised H&M for its misleading marketing and claims about the collection while there are significant differences between the various garments within the collection (for example with regards to the percentage of sustainable fibers used). The consumer watchdog stated that the clothing retailer provides insufficient information about the sustainable nature of its sustainable style collection that may cause consumers to make a purchase that they would otherwise not have made, and thus benefitting the company financially.¹



Volkswagen

from green to shamed

In September 2015, the US Environmental Protection Agency found that many of the Volkswagen diesel cars contained software that could detect when they were being tested. The car manufacturer had intentionally programmed these turbocharged direct injection diesel engines to activate their emissions controls only during regulatory testing in order to meet NO-output standards. However, the cars emit up to 40 times more in reality. This practice not only caused damage to the air quality and environment, but also had a significant financial impact on Volkswagen itself. Initially, a successful marketing campaign praising these cars for their low emissions resulted in a financial benefit with nearly 600,000 cars (that included cheat software) being bought in the US alone. However, after Volkswagen admitted having misled the authorities, it lost about a quarter of its market value and until now, paid over EUR 30 billion in fines and settlements. Cash outflows are expected to continue until 2021.²

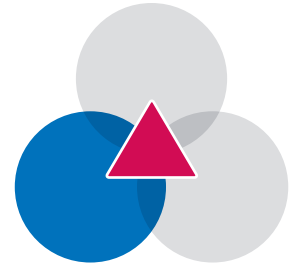
¹ <https://www.dezeen.com/2019/08/02/hm-norway-greenwashing-conscious-fashion-collection-news/>

² <https://www.bbc.com/news/business-44005844>

<https://www.reuters.com/article/us-volkswagen-results-diesel/volkswagen-says-diesel-scandal-has-cost-it-31-3-billion-euros-idUSKBN2141JB>

<https://www.columnfivemedia.com/volkswagen-stock-price-plunges-after-emissions-scandal>

Perceived opportunities to commit fraud



'Opportunity' refers to circumstances that allow fraud to occur. Of the three elements in the fraud triangle, opportunity is the one easiest controlled by the company as it is closely linked to the internal control environment, for example through segregation of duties, strengthening processes, policies and procedures. Opportunities for sustainability fraud are many and vary between company and type of information. However, they can be roughly divided in three categories: general ethical climate, control environment and internal control, and reporting policies.



General ethical climate

The general ethical climate, also referred to as 'Tone at the top', describes the culture within the organisation and corporate values relating to ethical behaviour, as propagated by senior management. The Tone at the top regarding sustainability is demonstrated by management's general attitude towards the topic and how sustainability is positioned within the company. Does management value sustainability as a vital part of the organisation, connected to strategy and risk, or is it merely seen as a compliance or marketing and communications function?

The way sustainability is regarded might influence the opportunity to commit fraud: little focus and treating sustainability as a minor topic might increase the opportunity for fraud, as management is less likely to invest in solid reporting systems and subject matter experts. Many organisations do not explicitly address potential (sustainability) fraud risks as part of their fraud risk management and do not have a clear penalty structure in place for when sustainability fraud does occur.



Control environment

The control environment refers to processes and procedures that ensure the accuracy of data. Sustainability is a broad topic for which data provision is often not centralised in one department. As a result of this diffusion, processes are generally not harmonised and the internal control environment on sustainability topics is often considered to be immature. Examples of immature control environments include insufficient or unclear segregation of duties and responsibilities, lack of clear governance structures and weak processes as to what and how to document.

Internal controls

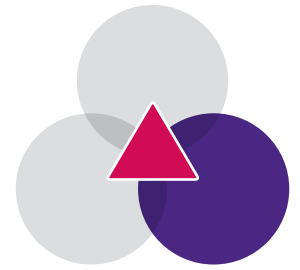
Unlike financial information/transactions, there are no (automatic) checks and balances in the information reported (i.e. no double-entry bookkeeping). Also, there is no principle of opposite independent information based upon which sustainability reporting can be evaluated. A lack of external assurance on sustainability reports keeps the detection risk at a relatively low level. Furthermore, as the topic and systems are not yet harmonised or structurally incentivised, clients or other stakeholders may also lack the knowledge, systems or incentive to thoroughly test claims.

Reporting policies

Reporting policies describe what data is reported, in what way, and by and to whom. Inadequate policies leave room for misrepresentation and intentional under- or over reporting. Reporting on sustainability is relatively nascent and therefore not yet harmonised within and across sectors. This leaves ample opportunities to manipulate target setting and reporting processes. For example, the discretion in defining scope and methodology, interpreting relatively vague definitions, standards and subjective narrative disclosure open opportunities for fraud and misconduct. As the internal processes are relatively weak (e.g. weak controls/immature control environment) this would not necessarily be detected (low detection risk) or be challenged (general ethical climate).



Rationalisation and attitude



Research shows that individuals who deliberately act unethically, usually experience guilt and discomfort before committing the act, trying to reduce the guilt and discomfort through rationalisation. By understanding the rationalisation of individuals, organisations can design internal control measures and ensure proper soft controls (such as culture and ‘tone at the top’) that limit the risk exposure to fraud. However, it should be noted that many, if not all, individuals carry the ability to rationalise any behaviour under specific circumstances.

Little research has been done on the personal characteristics of people working in the sustainability field and on how potential sustainability fraud can or is currently rationalised. An unanswered question thus far is whether sustainability managers are more driven by ethical values than other managers. Despite the little amount of research on rationalisation of sustainability fraud, a lot can be learned from long-term research and practical experience on rationalisations of improper behaviour in general. Based on our own and third party observations, and practical experience, several forms of rationalisation can be identified:

Denial of responsibility

Individuals state that they were forced to act because of personal or economic circumstances. This can also include (unrealistic) goal setting.

Denial of injuries

Individuals state that no harm exists as a result of their fraudulent actions.

Denial of victims

Especially within corporate fraud victims may ‘deserve’ harm or ‘will likely not feel the negative consequences’.

Blaming others (such as regulators or competitors)

Individuals state that others, such as regulators, competitors or colleagues, forced them into certain actions.

Appeal to ideals

Individuals state that their irrespective actions are justified due to the positive effects these may have (e.g. fraudulent actions to protect employees or actions to protect a company going out of business).

These categories can also be applied to sustainability, which as many other departments includes moralists, idealists, pioneers and individuals striving to make a career.

Due to the way that many companies are structured, the distance from the sustainability function to the board is often short and individuals are quickly involved in strategic decision making. In addition, the notion of sustainability is still broad and interchangeably used (e.g. with corporate responsibility). As such, definitions within companies may be vague, as can be methodologies and standards with regard to this topic. This makes it relatively easy for individuals to rationalise as they can more easily find positive arguments for their decisions.



Individual decisions may be judged as being 'for the company's benefit' or as a result of undue incentives and pressures. Fraudulent actions that carry an (intended) positive effect for the company are often easier to rationalise for individuals than those that focus on individual effects only. The position of sustainability departments is changing from a compliance role, reporting role or marketing role to increasingly strategic positions with corresponding (bonus) targets that individuals need to meet. Targets or definitions that may still be considered vague and inappropriate behaviour may not yet be clearly defined. Individuals may feel forced to achieve the goals that have been set and rationalise fraudulent action as such.

Also, typical when speaking of sustainability fraud, the consequences of misconduct are hard to observe. Sustainability fraud is most prevalent in the form of fraudulent (financial) reporting and rarely carries a direct financial impact, hence having no visible victim. Fraudsters may feel that their act will not lead to any harm and therefore also not lead to any victims. Most prevalent to the outside world, however, when speaking of sustainability, may be the appeal to ideals, where the notion of doing good would justify misconduct:

"If I don't do it, who will?"



EU Carbon Credit Fraud

5 billion lost in taxes

The EU emissions Trading System (EU ETS) was a simple cap-and-trade system, the second phase of which was designed to help limit climate change by reducing greenhouse gases. EU member states set a cap on the amount of carbon companies were allowed to produce. These 'emission allowances' could then be traded on the European market: surplus could be sold, additional 'allowances' could be bought and it was also possible to purchase international credits from emissions-saving projects abroad. Allowances purchased outside of Europe did not fall under the EU's 19.6 percent value-added tax (VAT). It did not take long before allowances were resold in Europe, taxes included. But instead of paying the VAT, the cash was used for future trades. But instead of handing the VAT over to the authorities, they pocketed the cash to use in future trades. This trading-scheme cost the EU approximately EUR 5 billion in taxes.³



Manure fraud

Dutch fraud case causes tension on European level

A Dutch company was convicted in 2019 for large-scale manure fraud. This company was involved in the transport and storage of manure. Due to manipulation of equipment, forgery of samples and faked transport documents, much more manure could be handled than was allowed. The company was fined EUR 50,000 but the effects spread much wider than the company itself. It also reached European politics. The Netherlands receives an exception from Europe regulation regarding maximum nitrogen emissions, which are systematically exceeded due to intense farming. In order to be granted this 'derogation' the Netherlands must demonstrate that sufficient efforts are being made to tackle manure fraud. This fraud case did not only result in damage to the environment and financial damage to the company, it also caused a risk for the entire sector and the reputation of the Netherlands in the European context.⁴

³ <https://www.factorco2.com/es/multi-billion-euro-carbon-trading-fraud-trial-opens-in-paris/noticia/60>

<https://www.thebureauinvestigates.com/stories/2019-05-07/how-major-banks-turned-a-blind-eye-to-the-theft-of-billions-of-pounds-of-public-money>

⁴ <https://www.trouw.nl/duurzaamheid-natuur/treedt-nederland-wel-streng-genoeg-op-tegen-fraude-met-mest~bed5a3a3/>

How to guard against sustainability fraud



Based on the presence of all three aspects of the fraud triangle (incentive/pressure, opportunity and rationalisation), it may be clear that sustainability fraud is likely to occur and that this calls for preventative actions. As we know from our work on fraud prevention and fraud investigations to date, many companies will assess the fraud risk as low and therefore postpone implementing internal controls and mechanisms, and changes in culture.

We recommend companies conduct at least a focused assessment of the potential risks, by evaluating several factors:

- What are the inherent opportunities within our company to commit fraud with sustainability-related information, considering the pressures? This results in an overview of the types of fraud that could occur in principle, without further organisational measures and control environment/control procedures.
- What does the governance of sustainability look like?: does it have sufficient attention at all levels in the organisation, including the non-executive board?
- Based on this assessment, do we have sufficient internal controls in place to detect fraud cases at an early stage? Where should these be potentially strengthened?
- In addition to the hard internal controls, what is our culture and attitude (the soft controls) towards sustainability? Are we pushing the envelope, are we inclined to highlight or emphasize the positives and less open to share negative performance/information?
- Would there be reasons for specific functions or individuals to rationalise a committed fraud due to their (personal or professional) circumstances?

For investors we see strong arguments to pay attention to the governance, internal controls, and reporting on sustainability. Not only in direct interactions (including for example the Annual General Meeting) with the company but also by remote analysis of potential fraud risk factors which can be flagged at an early stage. Such factors could include:

- Unbalanced reporting with a focus on positive stories and a lack of challenge related to sustainability data
- Vague reporting, for example when it comes to explaining developments in performance
- Performance that is (consistently) just meeting targets
- Strong links of the profile of the company or company's management to external rewards (such as awards or inclusion in (the top of) indices)
- A need to get access to financing that is based on sustainability performance/metrics
- A weak company structure or governance around sustainability, including internal controls.

When acquiring a company, investors could consider a thorough ESG Due Diligence assessment that could bring (fraud) risks and opportunities in environmental, social and governance areas to light.

When the risk assessments show a high likelihood of fraud, we advise companies to set up a robust sustainability fraud risk management programme, including fraud prevention and deterrence, how to detect fraud and how to respond to fraud cases.

Conclusion



In this paper we have outlined that there are plenty of incentives, opportunities and rationalisations to commit fraud or misconduct with sustainability information. These have existed for a long time, but now there is also increasing pressure to deliver on higher expectations with respect to sustainability performance; and the financial interests are rising alongside. This will increasingly drive the vulnerability of companies and management to fraud.

We have highlighted a few cases of fraud committed with sustainability information as a demonstration of the reality of sustainability-related fraud. These cases also underline the potential direct and indirect financial impact, as well as the environmental and social impact of claiming a positive result that is not met.

Many companies are making strides to improve their efforts and performance on sustainability. There is also increasing recognition that sustainability can or will have financial benefits to companies and thus investors. These good efforts should not be undermined by a lack of trust, skepticism or a perception of greenwashing.

We hope that the paper includes some eye-opening information for consideration, both by investors and companies. We also hope we will help prevent fraud by getting the right level of attention for the topic from all who have an interest in it.

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