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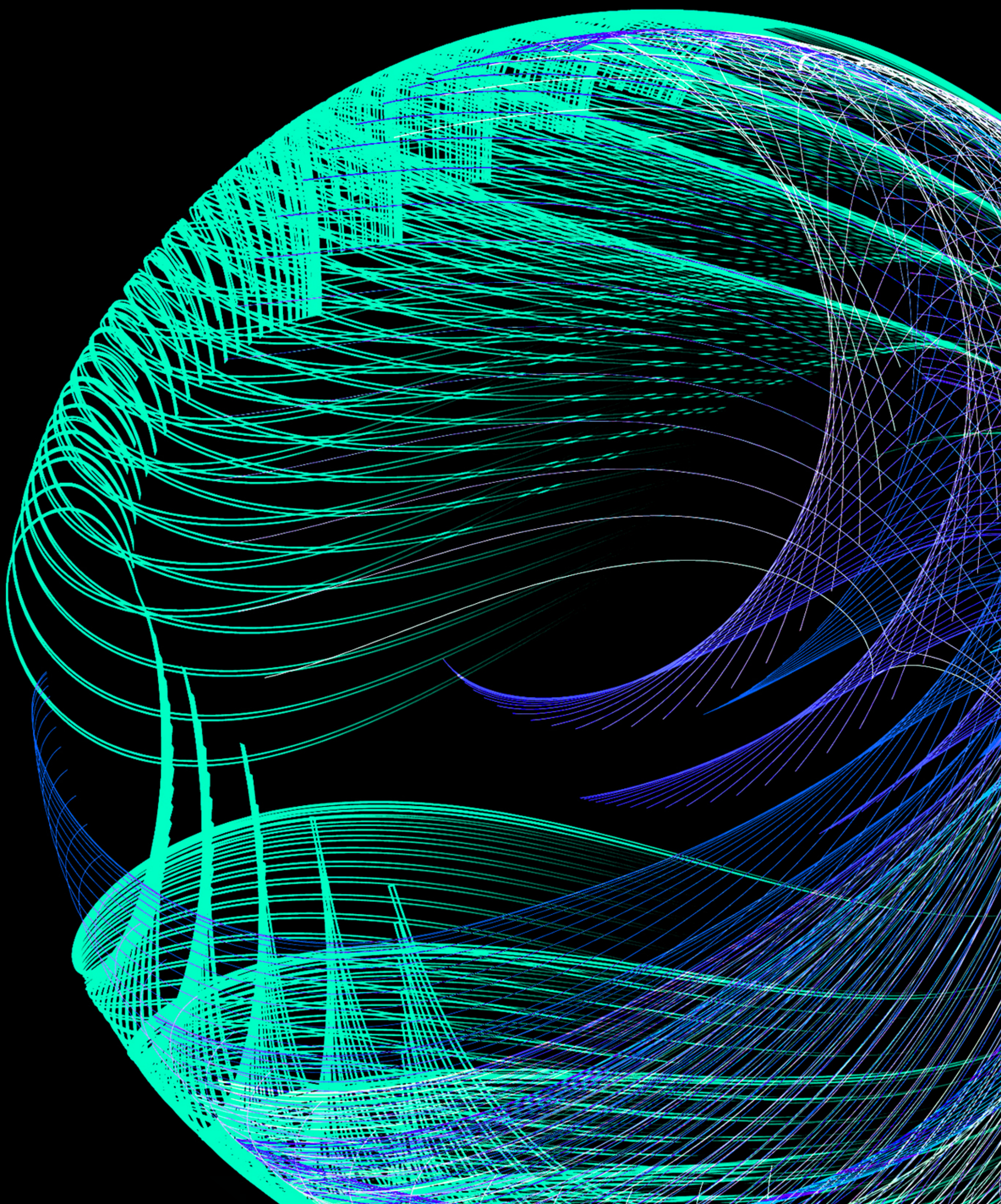
Keeping it clean

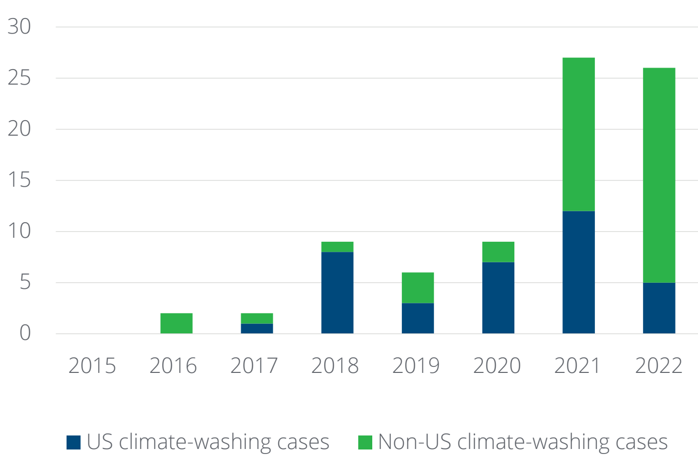
Internal audit’s role in mitigating the risk of greenwashing and other misleading communications



As extreme weather events become more frequent and intense, so does the pressure for companies to demonstrate how they are responding to climate change. Stakeholders and regulators are demanding an increase in transparency and accountability, adding to the pressure. As a result, companies across a variety of industries are communicating more on a broad range of topics. But how much of this communication and reporting can withstand scrutiny from stakeholders? And if communication is inconsistent, inaccurate, unsubstantiated, or misleading, how much risk does this pose to the organization?

With greenwashing lawsuits on the on the rise,[1] strategic, regulatory, legal, reputational, and fraud risks associated with greenwashing are likely to increase. Consequently, companies across sectors need to be vigilant about whether they have sufficient governance and internal controls to proactively mitigate the risk. Internal audit is well-positioned to play a key role—objective in nature, with a questioning mindset, and an overarching view of the organization. However, to understand the vital role internal audit can play, one first must understand the many nuances of greenwashing and why it can be so insidious.

Climate-washing cases against corporate actors in the US and outside the US, 2015–2022



Source: Authors using Sabin Center databases

Greenwashing is "the act or practice of making a product, policy, activity, etc. appear to be more environmentally friendly or less environmentally damaging than it really is."[2] As such, it ranges from intentional acts of deception to inadvertent acts of misrepresentation. For the purposes of this discussion, greenwashing encompasses the following:

- **False or misleading statements, labeling, or advertising**
  Consumers may be led to believe that a product is more sustainable than it is if they encounter exaggerated or vague claims, or "greenlabelling "[3] a tactic used by marketers to portray products as green or sustainable when, upon closer inspection, they are not.

- **Inaccurate or misleading disclosures or material omissions**
  This includes unsubstantiated disclosures, selective disclosure, and omission of material climate risks.[4] Such reporting could lead stakeholders to believe a company is making more progress toward sustainability goals or causing less damaging environmental impact than is really the case.

- **Inconsistent communications and actions** – Saying one thing and doing another. Communicating sustainability goals and transition plans, and then not demonstrating commitment through action. For example, investments, capital expenditures, and lobbying[5] do not reflect communicated goals and plans; resource and budget allocations are insufficient; and clear transition plans[6] are not created, tracked, and reported on for progress.

IA's role: Review pledges, policies, spending, and transition plan for credibility and accountability. Leverage the United Nations High-level Expert Group (HLEG) report *Integrity Matters and Implementation Checklist* for guidance.

- **Misleading commitments, goals, and targets** – Companies may fail outright to make progress on their environmental pledges, such as reducing emissions, waste, and water consumption. "Greenrinsing "[7] occurs when a corporation frequently modifies its environmental, social, and governance (ESG) goals before achieving them and fails to communicate transparently.

IA's role: Understand and assess the company's process for approving, tracking, reporting, and modifying commitments, goals, and targets. Have Science Based Targets been set? Have roles and responsibilities been defined? Has greenwashing been appropriately considered as part of an overall entity-wide risk assessment? Are policies and procedures in place? Does the organization adhere to its own policy? If sufficient progress is not made, does the organization communicate transparently when setting new goals and targets?

"Greenhushing"[8] and "social washing" have also entered the lexicon. Greenhushing describes management who hide or under-report their sustainability efforts to avoid investor scrutiny. "Social washing takes place when companies paint themselves in a positive light by obscuring an underlying social issue in an attempt to safeguard reputation and financial performance."[9] From washing to rinsing to hushing, such communication practices represent a growing panoply of risks.

For information on incentives, pressures, opportunities, and rationalizations for committing fraud, as well as an ESG Fraud Taxonomy, refer to Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) "Achieving Effective Internal Control Over Sustainability Reporting (ICSR), principle 8, Assesses fraud risk."[10]

How greenwashing impacts risk management

Leading companies are identifying, assessing, and managing sustainability risks by integrating them into their overall risk management processes. Contemplating the traditional risk domains to decipher where sustainability risks reside is not a straightforward exercise, as risks will likely cut across several domains. The same is true for greenwashing, as it can span across multiple risk domains including, but not limited to, the following:

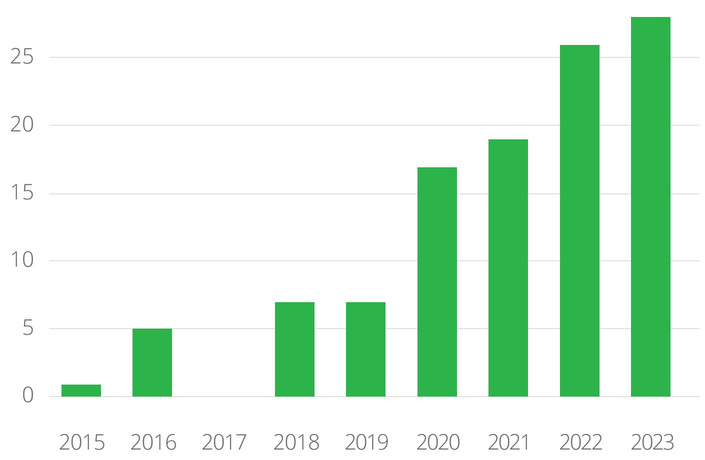
- **Strategic risk** – Lack of leadership buy-in can affect a company's ability to execute on its sustainability strategy successfully and make progress on commitments and goals. To avoid the risk of greenwashing, prioritize alignment—or better yet, integration—between business strategy and sustainability strategy within the organization.

IA's role: Review the organization's business strategy and sustainability strategy. Are the two aligned? Are they integrated? Inquire with leadership regarding past and/or current challenges around buy-in.

- **Regulatory and legal risk** – Failure to comply with regulatory requirements may have financial implications, such as fines or penalties. A host of regulations focused on sustainability reporting and marketing have been proposed or finalized, many of which aim to reduce greenwashing. Companies may also contend with increased private litigation around greenwashing or other misleading communication practices, which has further financial implications.

In the US, more than 100 class-action lawsuits accusing marketers of making misleading environmental claims have been tracked since 2015. Lawsuits have been filed in 15 states with nearly half of the complaints (49) filed in California.[11] The number of greenwashing class-action lawsuits has steadily increased over the years and more than doubled between 2019 and 2020.

Greenwashing class-action lawsuits by filing year



- **Reputational risk** – Greenwashing can tarnish a company's reputation, negatively affect brand loyalty and repeat purchases, and erode stakeholder trust, which takes a lot of time and effort to rebuild. University research shows that companies perceived to be greenwashing often suffer a drop in customer satisfaction,[12] which can have an impact on brand loyalty and trust.

- **Fraud risk** – The pressures and underlying lucrative financial incentives for executives to achieve ESG targets is an increasing fraud risk that should be considered by an entity as part of its overall enterprise-wide fraud risk assessment. As ESG key performance indicators (KPIs) are included more frequently as a component of incentive based compensation, consider fraud as a risk factor, for which fraud schemes should be identified to determine if sufficient controls are in place to mitigate such risk.

Regulators exert green pressure

Governing bodies have made it clear that greenwashing is a material risk, and action will be taken against companies found to be misleading customers, investors, and other stakeholders. Accordingly, the following agencies have proposed or finalized regulations to curb greenwashing and related deceptive practices.

- **European Union Green Claims Directive**[13] – Proposed in March 2023 by the European Commission to address greenwashing concerns, the European Parliament recently adopted its first reading position on March 12, 2024.[14] "Under the proposed rules, companies will need to substantiate environmental claims using life cycle assessment, communicate them accurately and holistically, and have them externally verified. Common phrases such as 'net zero,' 'carbon neutral' and 'eco-friendly' would be prohibited in advertisements, in social media posts or on packaging unless they were sufficiently substantiated and verified."[15] Deloitte estimates that the requirements will apply as of 2026, but this timeline is subject to change. Penalties for noncompliance may include legal investigations and fines up to 4% of annual turnover.[16]
- **Greenwashing Directive** – "On January 17, 2024, the European Parliament formally endorsed its provisional agreement with the European Council on the Directive Empowering Consumers for the Green Transition through Better Protection against Unfair Practices and Better Information ('Greenwashing Directive')."[17] Once the Council endorses the agreement, the Greenwashing Directive will be published in the EU Official Journal and come into effect. The Greenwashing Directive is intended to work in conjunction with the European Union Green Claims Directive.
- **California's Voluntary Carbon Market Disclosures** – On October 7, 2023, California Governor Gavin Newsom signed into law AB-1305 Voluntary Carbon Market Disclosures,[18] which is intended to combat greenwashing of climate-related emissions claims. It's applicable to both public and private companies that (1) sell and market VCOs in California; (2) purchase or use VCOs sold in California, make climate-related emission claims, and operate in California; or (3) make climate-related emission claims in California and operate in California. There is no revenue threshold associated with its applicability. Effective as of January 1, 2024, reporting requirements occur on an annual basis. Failure to comply will result in a fine of $2,500 per day for each violation, not to exceed $500,000.[19]
- **US Securities and Exchange Commission (SEC) Climate and ESG Task Force** – On March 4, 2021, the SEC announced the creation of the Climate and ESG Task Force in its Division of Enforcement, which is charged with identifying wrongdoing related to sustainability claims.[20] A primary objective of the Task Force is to "identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules."[21]
- **UK Competition and Markets Authority (CMA)** – In 2021, the CMA produced the Green Claims Code—a guide to help businesses understand how to communicate their green credentials, while avoiding the risk of misleading shoppers.[22] The CMA has the power to impose direct civil penalties on companies that engage in greenwashing, and it has recently launched an effort to examine the accuracy of green claims made about household essentials—such as food, beverages, and toiletries—to make sure shoppers are not being misled.[23]
- **US Federal Trade Commission (FTC)** – The FTC can sue companies accused of greenwashing that violate consumer protection laws, and it has issued nonbinding guidelines on green marketing, called ***The Green Guides***, which courts often use when deciding greenwashing cases.[24] These cases can result in significant financial and reputational risk. For instance, the FTC recently prosecuted two top retailers for making misleading environmental claims about bamboo products, when they were actually made of synthetic rayon, which requires intense chemical processing.[25]

Internal audit's role in preventing greenwashing

Modern internal audit functions have elevated their role, acting as trusted business advisers, delivering across the four A's—Assure, Advise, Anticipate, and Accelerate. While internal audit functions have varying degrees of maturity in the sustainability space, they are well-equipped to support the organization in mitigating the risk of greenwashing and playing a key role in transparent and reliable reporting.

- **Assure** the reliability of reporting by performing testing of metrics and disclosures, assessing the completeness, accuracy, and consistency. Ideally involvement occurs up-front and throughout the reporting journey, rather than at the end, before report(s) are published. For more mature organizations, perform testing over ESG controls established by the organization.

  Also consider designing a specialized audit to verify the accuracy of sustainability claims, such as "100% certified and sustainably sourced," or whether commitments are on track, such as "made with 100% sustainable cotton by 2025." Whether or not there are external assurance requirements, reliable reporting is essential to protect brand value.

- **Advise** on processes, risks, and controls. Assess the current state of the organization's overarching sustainability program. Identify gaps and improvement opportunities by assessing governance (including tone at the top), goal setting, regulatory monitoring, the integration of sustainability strategy and risks into existing processes, and sustainability reporting, to name a few.

  Furthermore, establish an ESG internal control framework. While the business is responsible for designing controls, internal audit can play an advisory role, providing feedback based on review. Reliable ESG reporting starts by understanding the reporting requirements and establishing effective internal controls across data gathering, transformation (aggregation, standardization, calculation), and reporting processes, creating the building blocks for a SOX-like framework.

- **Anticipate** risks and integrate them into existing risk management processes. For example, carbon offsets are often purchased voluntarily by organizations that strive to achieve carbon-neutral goals. Understand whether the organization uses carbon offsets as part of its carbon-neutral strategy and current reporting. Do certain regulations apply, such as California's AB-1305? Does the organization make climate-related emissions claims? Is there an internal policy that defines acceptable carbon offset registries to purchase from, whether independent verification is considered, and acceptable project type such as avoidance or removal. Understand whether sufficient documentation is maintained to support the validity of the project and retirement of the offsets. Finally, did the organization purchase and retire sufficient offsets to satisfy its claim of "carbon neutral". Are there financial incentives for executives to meet ESG targets? Identify the components of executive compensation (for example, reading of the Compensation Committee report in a proxy statement or Remuneration Report) to determine if there is an increased risk of fraud through manipulation of ESG targets for personal gain.

- **Accelerate** change through training and education. Advocate for responsible marketing, and advise business leaders on red flags to consider when approving communications, labeling, and marketing campaigns. These signs include, but are not limited to, the following:

  - Hidden trade-offs – Claims like "recyclable" or "compostable" can make a product sound more eco-friendly than it is. Such terms are sometimes used to cover up the environmental impact of making the product, whereby hidden trade-offs like high emissions, toxic waste production, or high resource consumption are swept under the rug.[26]

  - Natural imagery – A company may use pictures of flowers, trees, beaches, etc. in its advertising to project an environmentally conscious image when in fact its products or services have no environmental benefits, or even worse, the company engages in environmentally damaging practices such as deforestation or unsustainable development.[27]

  - Empty claims – Some companies say they are environmentally friendly even though they have no proof to substantiate such claims. For example, a company may claim that a product contains a certain percentage of recycled materials or that a specific amount of emissions has been offset during the manufacturing process, but they have no factual evidence or third-party certifications to back up their claims.[28]

A collective approach to preventing greenwashing

Some companies have established ESG panels of experts to validate their sustainability claims in an effort to avoid greenwashing accusations. Panels comprise leaders from corporate affairs, sustainability, legal, marketing, and communications. These subject-matter experts work to make sure that all marketing claims and disclosures follow ESG regulatory requirements and are backed by evidence before they are published.[29] Companies may also consider embedding such responsibilities within their existing disclosure committee, which includes representatives from finance and reporting, as well as risk and compliance.

It's a collective effort when it comes to preventing greenwashing within the organization. Tone at the top, culture, and education can go a long way. As scrutiny over sustainability communications and reporting increases, internal audit should stay abreast of evolving roles and responsibilities within the organization that are tasked with reducing the risk of greenwashing and strengthening the overall control environment.

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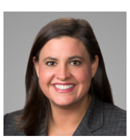

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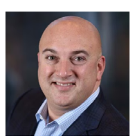

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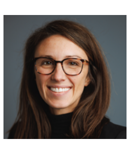

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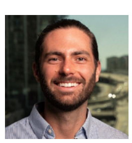

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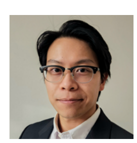

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