

Investors' Perceptions of Potentially Fraudulent Environmental, Social, and Governance Disclosures

Introduction

Environmental, Social, and Governance (ESG) is a framework used by users and investors in understanding how an organization manages its ESG opportunities and risks. A company's willingness to disclose its ESG practices represents an organization's active interest in focusing on sustainable and ethical practices. How companies manage their ESG practices is a growing concern to everyone due to the increasing threat of global climate change, and many investors want to align their financial investments with policies and procedures that work towards aiding global injustices. Thus, corporations need to become aware of how their ordinary operations affect the world's climate. Organizations inform the public of their environmental performance in ESG disclosures that supplement the release of financial statements. Even though ESG disclosures concern environmental, social, and governance, investors are typically most interested in companies' environmental practices. These disclosures are intended to increase transparency from the reporting companies as they are supposed to be forthright in reporting how their operations positively or negatively affect the environment. While these disclosures are not required, they are needed to stay relevant, especially among younger investors. However, as ESG disclosures are becoming normal among corporations, so is fraud among the disclosures, a practice known as "greenwashing." Fraudulent ESG disclosures arise from organizations reporting misstatements and omissions on their practices regarding items such as moving towards carbon-zero emissions, composting their food waste, or their handling of hazardous substances in their manufacturing.

Background

In order to test investors' perceptions of potentially fraudulent ESG disclosures and thus their final investment decision, the subjects in this study were given one of four surveys that were randomly distributed. At the beginning of each survey the potential investor, undergraduate College of Business students, read details concerning a fictitious company, Trytex. Trytex is a publicly traded apparel manufacturing company. It developed a low-cost waterproofing process that they apply to outdoor fabrics, including clothing and camping gear. Trytex is described to be in good financial condition, with reports of a "rosy outlook" according to Morningstar, an investment research firm. The company also has celebrity endorsements, competes in markets with companies like North Face and Patagonia, and recently partnered with Lululemon to expand its market. However, Trytex uses per- and polyfluoroalkyl substances (PFAS) in order to make their materials waterproof. PFAS chemicals are notable ingredients with non-stick cookware, water-repellent clothing, cosmetics, and any items that resist grease or oil. Due to their chemical makeup, per- and polyfluoroalkyl substances do not breakdown, thus earning the nickname "forever chemicals." If utilized, these chemicals are found in the air, soil, and water of the surrounding plant. While research is still currently being conducted on whether exposure to the "forever chemicals" are harmful to humans, there has been studies that show linkage between PFAS chemicals and multiple health complications, but other studies have not found a correlation. In general, most scientists believe continued monitoring and research studies are needed to definitively determine the effects of PFAS, if any, on humans and the environment.

After potential investors read paragraphs about the background of Trytex, they were given the ESG disclosure published by Trytex in its annual report. The positive ESG disclosure stated "Our core values stem from maintaining our commitment to the protection of human

health and the environment. As a result of ensuring that our products are of the utmost quality, per- and polyfluoroalkyl substances (PFAS) are utilized. Presently, Trytex use of PFAS is at the lowest possible capacity. We have integrated systems, processes, and protocols to guarantee that PFAS is used safely, controlled to the highest standards, and minimized. Further, where PFAS is used, we are actively and continuously working with our customers and academia to pursue alternatives where feasible.” Following the background information needed for potential investors to become educated on Trytex to make an informed decision, they were given a whistleblower statement that contradicted the disclosure published by Trytex; the whistleblower alleges that Trytex was illegally dumping PFAS materials near their manufacturing facilities.

An initial survey was conducted and completed by graduate East Carolina University College of Business students to determine whether internal and external sources were viewed to have equivalent credibility. Subsequently, a 2x2 between subjects' design was conducted to test the two independent manipulations that were included in the whistleblower statement. In the study, the alleged location of the illegal dumping and the source of the whistleblower were manipulated. The alleged dumping either occurred in-state, Raleigh, North Carolina, or out of the country, Lima, Peru; the source of the whistleblower was internal to the company, plant manager, or external to the company, EPA supervisor.

Research Questions

This purpose of this study was to answer the following questions:

- (1) Is there a greater likelihood of investment when the alleged dumping occurs out of the country rather than in-state?

- (2) Is there a greater likelihood of investment when the source of the whistleblower is external to the company rather than internal to the company?

I hypothesized that there will be a greater likelihood of investment when alleged dumping out of the country rather than in-state, and when the source is internal to the company rather than external.

Data and Analysis

After collecting results, my sample size equaled 113 subjects. In order to test the research questions and hypotheses, an ANOVA test was completed.

ANOVA Results:

Source of Variation	SS	df	MS	F	P-value	F-crit
Location	7.81	1	7.81	3.33	0.07	3.93
Source	0.02	1	0.02	0.01	0.92	3.93
Interaction	2.02	1	2.02	0.86	0.36	3.93
Within	234.35	104	2.34			

It was found that the location of the alleged dumping had a p-value of 0.07, thus making it statistically significant. The source of the whistleblower had a p-value of 0.92, thus making it not statistically significant. Additionally, simple t-tests were conducted to compare the investment decisions of the independent variables. For source, the p-value equaled 0.98, for location, the p-value equaled 0.06. The t-tests supported the results found from the ANOVA test.

My first hypothesis that there would be a greater likelihood of investment when alleged dumping was out of the country rather than in-state, is supported. My second hypothesis that there would be a greater likelihood of investment when the source of the alleged dumping is internal to the company rather than external, is not supported.

Conclusion

The adage “not on my backyard” seems to apply to the allegations of illegal dumping of per- and polyfluoroalkyl substances. Investors were more like to invest in the company if the dumping was distant of their home, Peru, than if it was nearby their home, Raleigh. Additionally, other factors were examined that could influence investor decisions. These included the current financial condition of Trytex, independent investment ratings, transparency of the company’s environmental position, competition with name brands, partnership with Lululemon and celebrity endorsement, use of PFAS, and potential fines. The company’s compliance with ESG and the transparency of ESG disclosures were found to be minor factors. Four other factors, partnerships and celebrity endorsements, competition with name brands, independent investment ratings, and current financial condition, had no relevance in the investment decisions. Overall, it can be concluded that investment decisions are driven by financial performance rather than ESG disclosures and transparency.