Audit Committee Leadership Summit

August 2023

ACLS

SUMMARY of THEMES

ESG reporting, oversight, and reputational risk, relations with China, the future of work, and cyber simulation

On 12-13 July 2023, members of the North American and European Audit Committee Leadership Networks (ACLN and EACLN) convened in London to discuss:

- **ESG: Communicating performance and assessing reputational risk** with Olivier Lebleu, Head of ESG, Edelman Smithfield and Guy Turner, Founder and CEO, Trove Research
- **Audit committee oversight of ESG reporting requirements** (members-only discussion)
- **Global governance in an environment of shifting EU-China-US relations** with Theresa Fallon, Founder and Director, Centre for Russia Europe Asia Studies
- **The future of work in the age of sustainability, AI, and deglobalization** with Denis Pennel, Managing Director, World Employment Confederation
- **Cyber simulation** with EY and Microsoft

Below is a summary of each discussion.[1] Two forthcoming *ViewPoints* will provide additional details on the ESG reporting, oversight, and reputational risk and shifting EU-China-US relations discussions.

ESG: Communicating performance and assessing reputational risk

ESG communications are complex: deciding when and how much to report is challenging, and companies must navigate a wide range of different, often conflicting, stakeholder views creating significant reputational risk. With ESG disclosure regulations still in their early stages, many members advocated for a *"less is more"* approach, acknowledging that external stakeholders—nongovernmental organizations (NGOs), in particular—may push for additional disclosures.

Olivier Lebleu, head of ESG at global financial communications firm Edelman Smithfield, advised that companies create a comprehensive ESG communications framework and offered guidance for doing so:

- **Focus on a few material issues that align with business strategy—not the entire ESG universe.** *"The number one error we see when it comes to putting together a company's*

ESG message, is that it's a grab bag of anecdotes," Mr. Lebleu said. *"If you want to avoid the grab bag, you need to stop treating sustainability reporting as a marketing exercise."* Be selective about which elements of ESG are material and choose those tightly linked to strategy, he advised. This will *"greatly enhance the credibility of your communications."* When ESG is connected to strategy and meaningful key performance indicators, it provides a foundation of facts for the communications team to work from when crafting a company's ESG narrative. Julie Linn Teigland, EY EMEIA area managing partner, agreed: *"ESG efforts need to be aligned to business priorities and a fundamental pillar that the CEO is driving from a strategic perspective."*

- **Anchor the framework in feedback from stakeholders, knowing that not all will be satisfied.** Members described the challenge of reporting on ESG in a way that meets regulatory requirements and diverse stakeholder expectations while remaining grounded in achievable outcomes. Companies must consider employee views as well. *"You cannot satisfy everyone,"* one audit chair said. Despite this challenge, stakeholder engagement is vital. Mr. Lebleu explained, *"It's up to you as a company to say, 'We've listened to all of our stakeholders and have decided to address the following issues.'"* This allows the company to control the narrative. *"Don't just wave it away and say, 'We cannot please everyone so why bother? That will get you in more trouble than you realize."*
- **Engage a range of internal leaders to mitigate risk.** While the approach will vary by company, getting input from legal, finance, sustainability, and other leaders can provide protection. One member described building the ESG communications framework within the general counsel and sustainability functions. *"The communications team did not have a role initially. It was technically knowledgeable people, and they determined the terminology that would be allowed to be used."*
- **Understand that change will happen as ESG reporting evolves.** While a global baseline for ESG reporting has not yet come to fruition, Mr. Lebleu believed that innovations and refinements will occur over time. A member added, *"The world is always changing. We will be trying to adjust our strategy and communications to a different world in a few years. It is important to recognize that our targets and the ways we measure progress are likely to change."*

Should companies use carbon credits as part of their ESG strategy?

Members questioned the value of purchasing carbon offsets as part of a company's carbon neutrality goals. Many felt that the risks of doing so are growing, without much upside. Many expressed skepticism about the legitimacy of projects in the carbon market and concerns about greenwashing allegations. *"I'm a skeptic of carbon offsets,"* one said, *"I'm very afraid that we will get into a mess where we bought offsets and 10 other companies bought the same ones. I also feel like it is a bit of a distraction away from the hard work that needs to be done to reduce emissions."*

Guy Turner, CEO of Trove Research—a data and advisory firm focused on climate policy, carbon markets, and energy transition—shared his perspectives and highlighted considerations for directors:

- **Companies need to think carefully about carbon neutral claims.** There is a difference between a company claiming that it contributes to decarbonization efforts and a company claiming that it offsets its emissions, Mr. Turner cautioned. The word "offset" can be problematic, especially with increased scrutiny around corporate climate claims. *"If you're funding a good project to protect forests, then say that. But don't extend that to say, 'We are neutralizing our own emissions.' If you cannot prove the project removes the same amount of carbon that you claim it offsets, you are in trouble."*
- **The integrity of the projects behind the carbon credits matters.** Mr. Turner noted that Trove Research analysis shows a surplus in the carbon credit market for the next 10 years, before tightening happens in 2035: *"But not all carbon credits that you can buy today are worth buying."* Companies should assess the integrity of projects and invest in high-quality ones. Demand for these high-quality carbon credits is likely to increase, so Mr. Turner advised that *"companies in this for the long game should start planning now"*—some big companies are starting to invest in assets directly, such as owning protected forested areas.
- **Companies that put a price on carbon reduce it faster.** A recent analysis conducted by Trove Research found that "companies that use material quantities of carbon credits are decarbonizing at twice the rate of companies that do not."[2] The report argues that the credits create cash outlays in corporate budgets, which companies then strive to reduce. So, while carbon credits are not *"a substitute for a company reducing its own emissions,"* they can provide momentum toward environmental goals, Mr. Turner advised.

Audit committee oversight of ESG reporting requirements

As the effective dates for ESG disclosures approach, this members-only discussion focused on preparing for forthcoming mandatory reporting requirements.

While all member companies are working on ESG disclosures, progress varies. There are many challenges companies face in preparing for mandatory ESG disclosures. Members highlighted the advantages of serving on several different boards, which helped them learn from experiences at other companies.

Members discussed their concerns and insights:

- **Convergence of reporting standards remains a top concern.** Members expressed concerns about the lack of convergence and the complexities that arise from different reporting frameworks, some of which are not yet finalized or have only been recently released. Of particular concern is how upcoming SEC rules for climate-related disclosures will converge with already-published standards. *"Different answers under different sets of standards is the worst-case scenario and I am not totally sure this won't happen. Agreements to address this situation will be difficult."* EY's Marie-Laure Delarue, global vice chair of Assurance, reminded members that the International Standards Sustainability Board (ISSB) has *"started to work to provide interoperability with the European standards, i.e., how to reconcile any differences."*
- **Consistency in how the standards are applied is crucial for comparability.** Members expressed concern about how different reporting standards could impede comparability between industry peers and over time. Dissimilar outcomes could also arise from different interpretations or using alternative options within the standards themselves. *"We will be compared to our peers, and if we choose different methods or different interpretations of the same standard, this could result in information that is not comparable."* Members discussed how differences between the reporting standards will need to be reconciled wherever possible. Members recommended that forums be set up to discuss how consistent disclosures could be achieved, most likely organized by industry sector. It was noted that some sectors are already making progress on this.
- **Public commitments are important, but targets must be realistic and strategic.** Members broadly agreed that it would be best not to commit to targets that are unlikely to be achieved. Nonetheless, they said, companies had to have some targets, even if they change as the company progresses in its ESG efforts. *"For non-financial information, the more you're committing to doing something by a certain year the more the concept is flawed. We're not clear about the future—it's easy to commit within your own tenure, but you should be consistent and realistic. It's not that they're not trying to do the right thing, it's just so complicated."* The conversation cited budget considerations in setting targets,

with members agreeing that targets that are truly integrated with strategy will have appropriate budgets allocated to achieve them.

- **Setting targets will continue to evolve.** One member called for flexibility in strategies for achieving targets in an environment that continues to evolve. *"We need to have flexibility on how to achieve the targets and get there. It gives opportunities to businesses. It's not easy to communicate the journey. For example, NGOs criticize the targets, and they criticize you on the steps to be taken to achieve the targets and they want to see results."* Members discussed how targets can motivate boards and others to employ good ESG practices.
- **More progress needs to be made in relation to disclosures on social performance.** Disclosures of companies' social data are generally not as advanced. Audit chairs explained that they had started thinking about these disclosures, but that further progress is still needed. Members pointed out the limits of controlling social aspects across a large, complex supply chain, as well as obtaining reliable information for reporting purposes. They agreed that information could be certified, but the quality of third-party certifications could vary. A company can audit its primary suppliers; but, as a member said, *"You can have them certified, but at the end of the day, you can't go down the chain to check if people are providing you with true information. When you encounter incidents, there's a breakdown, and you take the appropriate steps to correct it."*
- **Reporting structures within companies will need to take into account audit committee oversight of ESG reporting.** Members whose companies have already set up a reporting structure explained that the finance function often took the lead on reporting, with the broader aspects of ESG often being positioned with an ESG committee. Some regulations will require audit committee oversight of mandatory sustainability disclosures, although some members noted they were still considering the oversight role of the audit committee. One member highlighted that for his company: *"I think the board is ahead of management in thinking about ESG reporting."*
- **Members worry about assurance of ESG disclosures.** Members had questions about whether financial statement auditors or other assurance providers will be able to express an assurance opinion. *"Based on what we know now, where are we, where are the gaps, how will we be able to get assurance?"* There were also concerns about how far along companies are in putting internal control systems in place to provide the necessary information to the assurance providers, and most agreed that this was still a work in progress. *"Longer term, the journey is always to get the non-financials at the same state as financials. Short term, no."* Members questioned which standards their auditors would use; Ms. Delarue explained, *"We're working with auditing standard setters to make it much more specific to what we are expressing an opinion on. They're working on the assurance standards, but we will apply the standards before they are officially effective."*

Global governance in an environment of shifting EU-China-US relations

China's relationship with the West remains increasingly complex and directors continue to cite China as a top concern. Heightened tensions with Taiwan, dependence on China for critical goods, the challenge of formulating an effective derisking strategy, and China's strategic goals are particularly worrying. In this session, members met with Theresa Fallon, founder and director at Centre for Russia Europe Asia Studies, to discuss the challenges companies face operating in an environment of evolving EU-China-US relations. Key themes from the conversation included:

- **China's misleading communications make doing business riskier.** The Chinese deliberately make their policies difficult to decipher. As Ms. Fallon put it, *"To paraphrase strategist Sun Tzu: China's overall intent is always deception."* She added, *"Xi has to do a very diplomatic dance: tell the Europeans that China is neutral but that they lean towards Russia—whatever that means."* This ambiguity makes it challenging for the West to improve relations with China and creates a risky environment for Western companies doing business with China.

- **Boards must continue to monitor China-Taiwan tensions and formulate scenario plans.** Members noted differences in views on a possible Chinese invasion, even within their boards, but all agreed that it is crucial that directors continue to monitor Chinese actions that are increasing in frequency and intensity. One member said, *"China is so important to most companies that trying to figure out a contingency plan is almost impossible."* Another member highlighted the possible impact of an invasion of Taiwan for companies and entire industries, *"As audit committee chair, I asked for a risk analysis on what would happen to us if China invaded Taiwan…it was eye opening because we don't have the power to change much. The dependencies are so massive."*

- **Reducing corporate reliance on China is crucial but effective derisking strategies are elusive.** Members are eager to diversify their supply chains but noted that there are numerous challenges to first consider, including:
    - **Provoking China could have severe consequences.** An overly aggressive derisking strategy can lead to further problems, given China's tight hold on critical resources and its willingness to use legal and extra-legal measures to coerce Western companies. Ms. Fallon said, *"China still offers economic opportunities. The top thing is for companies to mitigate risks without upsetting China. There is a fear of retaliation."* She added, *"China is always searching for leverage."*
    - **Derisking is complicated and takes a long time.** While it is possible to relocate supply chains from China, it is a slow process. Ms. Fallon said, *"It can't be done overnight. It will take years."* Members emphasized that in addition to being slow, it is also a painful

process, but working collectively can ease some discomfort. One audit committee chair noted how their industry moved suppliers for many items from China to India and are making a point to *"focus on what we can do."* Another member described how, owing to a US sanction on one item, an entire industry reduced dependency on China, and called for government intervention to help drive these changes: *"When a big agent like the US government is putting sanctions on a small part of the supply chain, things start to change. This can't be left to the business world. With the right level of intervention, things could move fast."*

- **Companies must learn from their dependency on China and be forward-thinking in their strategy.** As companies aim to diversify their supply chains and global footprints, many are looking to, or have started to, move suppliers to emerging markets such as India and Africa. But it is essential that companies learn from their dependency on China and build this into their strategy. One member warned, *"We replaced Huawei with other actors, but we kill one of the heads, and seven others grow. We're creating a replica of China in India and of India in Malaysia. We're not bringing it back to Europe. We've changed dependency to a country who has openly declared dictatorship, if you look at the dynamics, it's not much better."*

- **China's economy could be boosted by innovation, but labor market issues will prove a challenge.** China is no longer showing double digit growth. *"Gravity has hit the Chinese economy,"* said Ms. Fallon. This is putting pressure on China to find domestic solutions. Labor market issues are coming to the fore, in particular a mismatch between the skills young workers have and their expectations. Graduating students are openly pessimistic about future opportunities, and Xi Jinping faces a substantial risk of a "lost generation", with attendant social and political problems. The Chinese leaders see innovation as a solution, but China has yet to achieve increased productivity. Annual growth targets have fallen from 10% to 5%, with real growth estimated at about 2.4%.

  Members noted that China is innovating, not merely by *"copy-pasting"* Western research but with genuine innovations in areas ranging from biotechnology to semi-autonomous battlefield systems. One member said, *"Their technologies are good … There's no way we can produce environmental things like solar or wind power without China. That production isn't just copy and pasted. They've been doing copy-pasting for many years, but they've leapfrogged now and they're doing a lot of innovation."* But Ms. Fallon noted that the development of advanced semiconductor chips has faced hurdles, despite being heavily subsidized by the Chinese government. Advanced chips, such as the ones used for generative AI, are now the key area of US-China competition, with implications for Taiwan.

The future of work in the age of sustainability, AI, and deglobalization

Companies face multiple compounding challenges that are significantly affecting their work forces: changing attitudes towards work, the impact of technology, population changes across the world, and managing the effects of a world in a *"poly-crisis environment (wars, famines, and trade competitions)."* Members met with Denis Pennel, managing director at the World Employment Confederation, to discuss how these issues are changing the world of work and how companies should prepare and respond. Key themes discussed include:

- **Adapt to changing expectations and priorities to attract and retain talent.** Companies must recognize that what employees value in a job is evolving and, for many workers, these priorities are nonnegotiable. Mr. Pennel said, *"Previous generations had to adapt their lives to work. Now they want work to adapt to their personal lives. Work has become a lifestyle, adapted to your personality, constraints, and choices."* Being flexible and working out how to accommodate these preferences can help companies retain and attract workers. Mr. Pennel and members discussed potential strategies including:
    - **Flexible working arrangements.** COVID-19 forced workers to adapt and manage their own work conditions, causing a change in their priorities, attitudes, and expectations around work. Flexible working arrangements, such as hybrid working, remote working, or allowing pets in the office, can be attractive to potential and existing employees. Mr. Pennel said, *"If you don't offer flexible working conditions, it'll make life more complicated to recruit talent."*
    - **Better working conditions and salary increases above inflation.** Many who were not able to work during the pandemic acquired skills to find jobs in new industries. Often, these jobs offered a higher salary and better working conditions. Mr. Pennel recommended offering attractive benefits, especially higher pay, to encourage workers back into hard-to-fill jobs. He said, *"For two years they couldn't work because their sectors were closed, so they looked for job opportunities and moved from one sector to another. They realized that they can be better paid, work more sociable hours, and have less tough working conditions. Those sectors have difficulty recruiting now because wages there haven't increased, maybe it's part of the solution."*
    - **Experiences and lessons that cannot be found online.** Members noted that workers have become more interested in distinctive experiences and opportunities to learn than in climbing corporate ladders. One member said, *"It's not about the career anymore. They want interesting positions, experiences, the opportunity to grow."* Ms. Delarue agreed and added, *"If you provide learning on something they can find instantly on the internet, they don't value it—it's useless to them. But if you give them the opportunity to experience something they can't find online, it'll be valued."*

- **Learning what is important to staff can help bring them back to the office.** Since the easing of social restrictions, many organizations have been attempting to bring workers back into the office with either little success or many complaints. One member noted that learning *"what is important to your staff"* is one of the most important ways to encourage workers to return to the office. Other considerations included:
    - **An appealing or convenient office location.** Companies should consider whether the office is located near where workers live and if the area is attractive in other ways, such as being close to restaurants and stores. Mr. Pennel said, *"Location is essential, especially commuting time … Many workers can't afford to live in cities because of the cost of real estate and renting so they need to move away and commute a long time."* One member noted that their company moved their offices to outside of city centers and this increased office use: *"We opened offices in the suburbs. There was no reason to have offices in the most expensive capitals in the world. We found that everywhere, except for San Francisco and New York City, people came back to the office happily."*
    - **Office space that is better than the home.** Companies can make offices more desirable working spaces by offering perks, such as healthy meals and good coffee, or by creating spaces that allow for team working. Ms. Teigland described how EY has redesigned offices from open plan to *"making huge investments to redesign for collaborative spaces."* She added, *"People want to come into the office for a purpose. They think much more of using the office to collaborate with others, instead of just a place to do their work or spend time on the phone."*
    - **Management teams committed to a positive in-person working environment.** Mr. Pennel said, *"Make sure there's a good management team. Make sure the workplace isn't a toxic place where staff doesn't want to meet their colleagues—this is not helping them to do their work."* Having gained more autonomy working from home, it can be important for some teams to have this carry over into their office space. This can take the form of having the management team come in less often to the office. One member said, *"When leaders weren't in the office every day, the office was used more often."*
- **With the right training, AI will enhance work quality, increase productivity, and create new roles.** Owing to its accessibility and applicability in every sector, AI will significantly impact how jobs are performed. Automation, in particular, will substantially increase productivity and efficiency. Mr. Pennel said, *"AI won't destroy jobs, but it will destroy some tasks you're performing. It'll make jobs more efficient, more productive, and according to the latest OECD report, make many jobs more pleasant. Things that are boring and routine will be replaced by automation."*

    Boards and companies must invest time to learn the benefits and risks of using AI and prepare to upskill and reskill employees. One member noted, *"We haven't addressed that* *we need a lot of upskilling in the organization. We can't assume someone doing tasks today can do them in a different way tomorrow. This is something we all need to have a clear understanding of: how do we steer people to use and enable new technology?"* Mr. Pennel added, *"A big fear for workers is that they think AI will steal their job. For me, I'm less worried about AI stealing jobs, but other workers who are using AI to do their jobs stealing them."* Ms. Delarue advised explaining the benefits to workers to encourage them to use AI. She said, *"We need to explain to them that we're going to equip you with "co-pilots;" technology for you to work at your best."*

Cyber simulation

Members were divided into two groups to participate in a simulated board meeting in which they were informed of an ongoing cyber-attack at a fictitious company. Leaders from EY and Microsoft played the roles of chief executive officer (CEO), chief information security officer (CISO), external auditor, and general counsel.

The simulation demonstrated the important role board members have during a cyber breach and highlighted the importance of asking the management team the right questions. Key considerations included collecting the necessary information regarding the attack; communicating with authorities, regulators, other external stakeholders, and the media; whether to pay a ransom; and establishing a recovery plan.

Appendix 1: Meeting participants

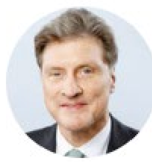
The following members participated in all or part of the meeting:

Jeremy Anderson
Audit Committee Chair, UBS

Werner Brandt
Audit Committee Chair, Siemens

Liz Doherty
Audit Committee Chair, Novartis and Philips

Ana de Pro Gonzalo
Audit Committee Chair, STMicroelectronics



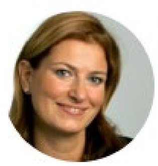
Renato Fassbind
Audit Committee Chair, Nestlé

Byron Grote
Audit Committee Chair, Akzo Nobel and Tesco

Margarete Haase
Audit Committee Chair, ING

Liz Hewitt
Audit Committee Chair, Glencore

Suzanne Nora Johnson
Audit Committee Chair, Pfizer

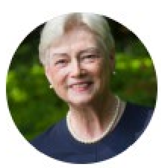


Dagmar Kollmann
Audit Committee Chair, Deutsche Telekom

Pilar López
Audit Committee Chair, Inditex

Benoît Maes
Audit Committee Chair, Bouygues

Leslie Seidman
Audit Committee Member, Moody's, Audit Committee Chair, Janus Henderson



Maria van der Hoeven
Audit Committee Chair, TotalEnergies

EY was represented in all or part of the meeting by the following:

Marie-Laure Delarue
Global Vice Chair, Assurance, EY

John King
Americas Vice Chair - Assurance, EY

Jonathan Milligan
Chief of Staff to the Global Vice Chair, Assurance, EY

Pat Niemann
Partner, Americas Center for Board Matters, EY

Julie Linn Teigland
EMEIA Area Managing Partner, EY

Endnotes

[1] *Summary of Themes* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Quotations in italics are drawn directly from members and guests in connection with the meeting but may be edited for clarity.

[2] Trove Research, "Corporate emission performance and the use of carbon credits," June 1, 2023.