Dialogue with the ISSB, globalization, the audit tender process, and a fraud case study

On 1-2 December 2022, the European Audit Committee Leadership Network (EACLN) met in London to discuss proposed sustainability standards with the International Sustainability Standards Board (ISSB); globalization trends and how companies are responding; and the audit tender process. Members also participated in a simulated audit committee meeting where they worked to uncover a potential fraud. Below is a summary of each discussion.[1] A forthcoming *ViewPoints* will provide additional detail on the audit tender process.

Dialogue with the ISSB

Members met with Sue Lloyd, ISSB Vice-Chair, and Roberta Ravelli, technical support, office of the ISSB Vice-Chair, to discuss the organization's priorities and its progress in its first year. The conversation focused on the ISSB's first two exposure drafts: IFRS-S1: General Requirements for Disclosure of Sustainability-related Financial Information[2] and IFRS-S2: Climate-related Disclosures,[3] which were issued in March 2022 and expected to be finalized in early 2023.

Ms. Lloyd described a *"pragmatic"* approach at the ISSB and noted that its goal is to build a global baseline for sustainability standards to meet the needs of investors and markets. *"We want to do for sustainability accounting what the International Accounting Standards Board (IASB) did for financial statements—create an international language that people can recognize and trust,"* she said.

While EACLN members were generally supportive of the proposed standards, they highlighted broader concerns around sustainability reporting:

- **Interoperability.** Members were particularly concerned about how the ISSB's standards will compare to those in development at the European Financial Reporting Advisory Group (EFRAG) and the US Securities Exchange Commission (SEC). Ms. Lloyd stressed that interoperability is a top priority for the ISSB: *"We are working bilaterally with the European Commission and EFRAG to identify where we have common ground … I'm confident that for a lot of the disclosures, we can get to a situation where companies would be able to provide the information in a way that meets both sets of requirements."* She described a goal of publishing a formalized interoperability map that will set out disclosures that meet both ISSB and European requirements, and for those that are only required by the ISSB or European sustainability reporting standards, enable companies to understand how to meet both sets of requirements.
- **Materiality.** Ms. Lloyd acknowledged that the ISSB and EFRAG take different approaches to materiality, a primary concern for audit chairs. The ISSB and SEC proposals focus on investors and thus on information that could impact financial performance, the cost of

capital, and the ability to access funding. But the proposed EFRAG standards use "double materiality", calling for companies to disclose not only how sustainability drives their performance and competitiveness, but also how they themselves impact the environment and society. Ms. Lloyd noted that the difference may be caused by EFRAG's objectives, which cover *"broader information needs, not just for investors, but for others including civil society and legislation."*

- **Short-termism**. Regulations could drive short-term decisions that lead to adverse environmental, social, and governance (ESG) outcomes, members said. *"The danger in setting standards is that it can lead you to make decisions that don't solve the problem, but just push it away,"* one said. For example, if companies feel that they will be penalized based on the ESG impact of certain businesses or vendor relationships, they may divest those activities instead of devoting time and resources to solve underlying problems.

- **Unintended consequences.** Members worry about the inherent complexities and trade-offs in prioritizing different aspects of ESG. *"From a climate perspective, you may be doing the right thing, but then your actions cause wider issues with other ESG factors,"* a member explained, describing it as a *"law of unintended consequences."* Members worried that compliance with regulations could be easier for large companies that have extensive resources, versus smaller companies; this could negatively impact local communities. *"My concern is about the long-term consequences—is climate more important than food, or is food more important than climate? I don't want to look back and say why did we make these choices,"* a member said.

- **Scope 3 emissions.** The requirement to report Scope 3 continues to be a major concern for audit chairs. As one said, *"It is almost like reporting on someone else's accounts. It is not in your own domain, so then the audit committee gets nervous."* The ISSB will require Scope 3 reporting when it is material, and they are working to provide support and guidance. Members stressed that *"perfect shouldn't be the enemy of good"* when it comes to Scope 3. One flagged the risk attached to certain ESG disclosures: *"Litigation is coming. We're trying to work out where we get value versus where the risk in these disclosures lies."* The ISSB is working to create a *"safe space for companies to feel comfortable and confident to start this journey. If there is an environment where companies are too scared to start, we're never going to make progress."* She highlighted three key steps to address these concerns:
  - The ISSB is talking to regulators about whether safe harbors should be provided so companies will not be punished for getting the number incorrect.
  - The ISSB is discussing not requiring Scope 3 disclosures for at least the first year a company reports thus allowing at least a one-year deferral to allow companies to prepare.
  - The ISSB will allow companies to use estimates for Scope 3 and is working to educate stakeholders. *"We just need good disclosure and explanation of the approach to measurement and estimation,"* Ms. Lloyd said.

Looking ahead

Members and guests discussed next steps for the ISSB as well as important considerations for audit committees in the coming years.

- **The ISSB is turning to its next priorities.** Ms. Lloyd described the ISSB's approach as *"climate first, but not climate only."* As the ISSB nears completion of its first two sustainability drafts, the board is considering its next projects. The proposed projects will be subject to consultation in 2023. Outlined in a December 2022 staff paper,[4] these include:
    - Biodiversity and nature-related issues;
    - Human capital, with a focus on diversity, equity, and inclusion;
    - Human rights, particularly related to the value chain;
    - Connectivity with the IASB to clarify how financial and sustainability reporting can together provide a cohesive picture to the markets.
- **Companies should continue to be vocal.** Members still worry about the challenges posed by multiple and potentially different ESG disclosure frameworks. The group discussed actions that audit committees can take to advocate for their companies' needs and to prepare for a complex reporting environment:
    - **Reinforce that interoperability matters.** Alignment on interoperability, relevance to investors, and materiality will only become more important as *"as we move further into areas around human rights"* and other ESG issues, a member said. Members agreed that it is crucial for companies to continue to increase awareness of ESG reporting complexities: *"The more we can have dialogues, the more regulators and investors become pragmatic. The message to us is to keep being vocal."*
    - **Explain how sustainability disclosure standards impact competitive advantage.** Several members worried that European companies will be disadvantaged against non-European competitors if they comply with rigorous ESG. Ms. Lloyd agreed that it is important that sustainability reporting be a tool for communication with investors: *"Our global baseline is designed to enable companies to communicate with their investors. It will enable them to attract capital."*
    - **Think holistically about reporting.** *"We need audit committees to think about the big picture,"* Ms. Lloyd said. She cited the example of measuring expected credit losses and how much change that involved in reporting. *"But what strikes me now is the number of positive conversations I have had about how that led to better connections between control and reporting functions and elevated discussions about credit risk management to the board. I'm hoping our standards will be a catalyst like that for sustainability risk management."* She also recommended moving sustainability departments closer to the audit committee, which several members previously shared that they have done.

Is globalization dead?

Recent events and political developments have directly impacted globalization. EACLN members discussed globalization trends and how their companies are responding to them with Richard Baldwin, professor of international economics at the Graduate Institute, Geneva, and editor-in-chief of VoxEU.org.

Mr. Baldwin argued that while many believe globalization peaked in 2008, this was a false peak. He offered data showing that trade in services continues to grow; in the EU, trade has not peaked, although it has stagnated. Mr. Baldwin says that technology and intermediate services will continue to push companies toward globalization. Intermediate services, such as bookkeeping, that contribute to a final, potentially regulated product, are less subject to strong regulation and therefore move across borders more easily. He also pointed out that *"the largest arbitrage left in the world is in wages,"* which could fuel companies to seek lower cost workforce solutions in other parts of the world.

Members acknowledged factors that are likely to continue to push companies toward globalization, including the need to maintain competitiveness and the overall difficulty in reversing course. A member asked: if companies are forced to move manufacturing back to Europe, *"How does the EU compete? The market isn't big enough to survive. You need a global market to be cost competitive. From a deglobalization standpoint, the pressure is there, but if the rest of the world doesn't follow, then you'll have markets pricing themselves out."*

Overall, however, members felt that many forces are working against globalization:

- **ESG disclosure.** Requirements for supply chain transparency may cause companies to relocate operations. As one member described, *"With Scope 3, you have to think all the way through your supply chain and have traceability."* Another added, *"There is more and more regulation for sustainability. From my perspective, it is almost an anti-globalization force. In my sector, certain regulations would require manufacturing to move away from China and back to Europe. There is no other way."*

- **Data regulation.** Members cited privacy regulations and protectionism around data as drivers of decreased globalization. *"There is a political push to have control of the data generated in your geography and the consequences for something going wrong can be quite dire to companies,"* one said. While Mr. Baldwin argued that intermediate services could still be prime candidates for globalization, members pointed out that transferring data about employees or customers across borders is *"difficult and sensitive,"* exposing companies to potentially enormous fines.

- **Geopolitical risk.** Members highlighted geopolitical tensions, particularly around China, as a major limit to globalization. *"We now face a situation that is very uncertain in how companies will adjust to a new world in terms of how China and the US are separating,"* one said. They were concerned that geopolitical risk associated with China may be underestimated and that some strategy conversations *"simplify the real underlying problems, like access to rare raw materials."*

- **Energy independence.** Disruptions in Europe's energy supply have increased pressure on countries to become more energy independent, contrary to past globalization strategies. Members believe this trend will continue: *"We were somewhat surprised to find dependence on gas, oil, and energy because it wasn't well tracked until we had an issue. It has caused us to think more about interconnectivity."*

The audit tender process

Audit tenders have become more frequent in Europe, partly due to the EU Audit Regulation and Directive. In a members-only discussion, audit chairs discussed the process and good practices with their peers and with EY leaders Marie-Laure Delarue and Julie Linn Teigland.

Overall, members pointed out both benefits and challenges associated with audit tenders:

- **Limited choice of qualified audit firms is a challenge.** Only the Big 4 audit firms have the global networks and expertise that EACLN members say they need. Choice can be further limited if firms are reluctant to tender—for example, if they want to preserve consulting relationships. Some audit chairs have insisted that consulting engagements will be ended if a firm fails to tender.

- **The tender process is resource intensive but can be valuable.** While some members had initial doubts about a tender's usefulness, the consensus was that the process can provide benefits, including fresh perspectives. One described: *"We made the decision to do a rotation even though it wasn't mandatory. I was coming from an American perspective where rotation means something is wrong. But the richness of the process was surprising. It was like a consulting job done by the firms with their perspectives and insights on the company that the audit committee benefitted from."*

- **Incumbent audit firms face inherent challenges.** There are 13 different mandatory audit firm rotation regimes across 30 European countries, including some where tendering is mandatory, but firm rotation is not.[5] Members discussed how incumbent firms that participate in tenders may face bias. *"The incumbent is in a difficult position to say how they will improve, because the company will ask why they haven't been doing so already,"* one said. *"It would require the incumbent to change the dynamic in a way that is unencumbered by the past."*

The tender process and selection criteria

Members also discussed the logistics of the audit tender process, how to run an effective and efficient tender, and selection criteria for an auditor. Good practices included:

- **Allow plenty of time.** Changing auditors is a significant undertaking. Members agreed that 18 to 24 months is needed to prepare for and execute an effective process. *"Then you need another year to see through the transition period,"* one added. Providing enough time to clear any independence issues is also key.

- **Identify the relevant stakeholders.** Several members reported that a key learning was to increase the engagement of the entire audit committee. *"It is essential that the whole audit committee is involved in all discussions, because it is a critical decision on who you will* *work with."* The audit chair, alongside management, is typically most involved; members emphasized that management's perspective is critical since they will work closely with the auditors. One audit chair considered it a good practice, in certain countries at least, to keep the CFO and other C-suite members out of the process. *"The C-level and C-minus-one level of management are excluded … The steps of the process are kept away from them, but there is a team supplied by management—spread between procurement, IT, controlling specialization, a strong matrix system across the organization—that supports a detailed process with a lot of pre-work."*

- **Employ creative interview techniques.** Members discussed helpful practices:
    - **Brief all candidate firms together.** One described holding an open meeting with all audit firms. This enabled the company to ensure consistency in the information shared and gain efficiency. *"We also wanted to see how the firms engage together and wanted them to see who they are competing with,"* the member said.
    - **Simulate a crisis or technical challenge.** This can be an effective means of assessing candidate firms in a dynamic, realistic way. One member inserted a simulated challenge just before the final presentation: *"Collaboration during a crisis is important and we wanted to see how they react and work with the team … It was very interesting to see their approach and who they engaged. They came back with very different responses."*
- **Ask how technology can bring value beyond the audit.** *"Technology and data analytics were the big distinguishing feature,"* many members said, although several noted that the Big 4 audit firms have invested heavily in audit technologies making it increasingly *"hard to distinguish"* between them. One differentiating factor that members look for: how technology can be used to improve overall business processes. *"How can it be applied not just to the audit and used as a control tool, but how can it be used for continuous improvement in the business? That was a key determinant."*
- **Prioritize a strong lead partner and a cohesive engagement team.** Members agreed that the audit team is one of the most important criteria. *"But how do you assess the quality of the team?"* one asked. *"Reputation, ability to work together, and character of the lead auditors"* were qualities that members highlighted, along with communication and integrity. *"The fact that people have worked together in the past"* is another positive indicator.
- **Think broadly about the audit firm's capabilities.** While engagement teams and technology were the highest priority factors for most audit chairs, taking a broad view of the firm's capabilities including industry expertise and geographic reach is also important for global companies. Members added that ESG capabilities are increasingly important, since assurance of sustainability data and non-financial reporting requirements continue to develop and many audit chairs expect a future with integrated reporting.
- **Determine if price is a factor.** Most members do not consider fees a major criterion. One said, *"As audit chair, I'm only focused on quality. I would rather have good quality with a higher price than low quality and a low price."* Another added, *"We were agnostic to it and chose who we thought was right. It wasn't a deciding factor; it was just additional data."*

Fraud case study

Members participated in a simulated audit committee meeting in which they were informed of allegations of financial fraud made by a short seller investor. While the company in the simulation was fictitious, the draft financial reports provided to the audit committee were taken from a company where a real financial fraud had occurred. Leaders from EY played the roles of CEO, CFO, HR Director, External Auditor, and Forensic Accountant.

The simulation demonstrated the importance of the audit committee's work on two fronts:

- **Process.** EY reviewed how the audit committee dealt with allegations, including how it pivoted from its planned agenda in light of the fraud allegations. Key considerations included launching an investigation, the investigative process, evaluating sources of information, and communicating with investors and other stakeholders. A member highlighted *"the benefit of having different perspectives and cognitive diversity around the audit committee table."* This became clear as each member reacted in a distinctive way and asked different questions to identify the issues.
- **Substance.** Clues were provided in pre-read documents that pointed to the fraud. EY reviewed information that the audit committee might have explored further, including:
    - Red flags in the financial reports: accounts receivable, inventory, and net sales that were consistent with a bill-and-hold fraud risk scheme.
    - Indicators in the business integrity survey suggesting a culture that may have significant pressure, rationalization, and reluctance to speak up.
    - The draft sustainability report which raised questions related to disclosures and vendor due diligence.

Appendix: Participants

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

- Julie Brown, Alumnus
- Aldo Cardoso, Imerys
- Liz Doherty, Novartis and Phillips
- Byron Grote, Tesco and Akzo Nobel
- Dagmar Kollman, Deutsche Telekom
- Pilar Lopez, Inditex
- Benoit Maes, Bouygues
- John Maltby, Nordea
- David Meline, ABB
- Karyn Ovelmen, ArcelorMittal
- Ana de Pro, STMicroelectronics
- Nathalie Rachou, Veolia
- Maria van der Hoeven, TotalEnergies

The following EACLN members participated virtually in part of the meeting:

- Jeremy Anderson, UBS
- Margarete Haase, ING
- Erhard Schipporeit, RWE
- Carla Smits-Nusteling, Nokia

The following Audit Committee Leadership Network (ACLN) members participated virtually in part of the meeting:

- Gretchen Haggerty, Johnson Controls
- David Herzog, MetLife
- Akhil Johri, Boeing and Cardinal Health

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

- Marie-Laure Delarue, EY Global Vice Chair, Assurance
- Julie Linn Teigland, EMEIA Managing Partner, EY

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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] The International Financial Reporting Standards Foundation, "IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information," exposure draft, March 2022.

[3] The International Financial Reporting Standards Foundation, "IFRS S2 Climate-related Disclosures," exposure draft, March 2022.

[4] The International Financial Reporting Standards Foundation, "ISSB Consultation on Agenda Priorities, Projects to be included in Request for Information," staff paper, December 2, 2022.

[5] Accountancy Europe, "Mandatory Rotation of Auditors – Streamlining European Countries' Audit Rules," May 2022.