

## Top concerns for audit committees, corporate fraud, the energy supply crisis, and E-liabilities

On 15-16 September 2022, the European Audit Committee Leadership Network (EACLN) met in Berlin to explore current challenges for audit committees; corporate fraud; the European energy supply crisis and its impact on companies' climate transition plans; and a proposed methodology for accounting for greenhouse gas emissions. Below is a summary of each discussion.<sup>1</sup> Forthcoming *ViewPoints* will provide additional detail on the sessions discussing fraud and top challenges for audit committees.

### Top concerns for audit committees

As boards face unprecedented levels of uncertainty and a complex risk landscape, audit committees are faced with an ever-growing set of risks and responsibilities. In our members-only session, we examined the issues that are keeping committee chairs up at night. As one put it, *“Expectations of audit committees are getting more and more complicated. And at the same time, the way we are being looked at by external stakeholders is also increasing. How do we manage it all?”*

We heard three groups of concerns for audit chairs: 1) planning in the face of unprecedented—and sometimes unknown risks—including a volatile macroeconomic environment; 2) non-financial reporting requirements; 3) cybersecurity. We discuss each below.

- **Planning during times of unprecedented risk and economic volatility.** Most members cited the risks associated with high levels of geopolitical uncertainty coupled with volatility in the global economy as their top concern. This has led boards to reassess their processes around risk assessment, oversight, and planning. As one member put it, *“We have processes that aren't totally appropriate anymore, because they look at risks one by one and how we would mitigate them individually. But we now need to think differently and look at risk in its entirety.”* Another asked, *“How do you plan for the future now? Forget the historic way of doing it. It doesn't work anymore.”*
- **Non-financial reporting.** As implementation deadlines for various ESG reporting requirements approach, audit chairs worry about their readiness to manage data and provide reliable disclosures. *“Non-financial reporting is going to be as important as financial reporting and we don't have the same controls, reporting infrastructure, etc. around the information,”* one member worried. He continued, *“Add to that a variety of stakeholders who don't agree on what they want and are asking for completely different data sets. It doesn't end well.”*

Many audit chairs highlighted the tensions between disclosures for *“marketing purposes”* and those that will be part of the financial statements and therefore subject to rigorous

processes and controls. Several speculated that ESG litigation is inevitable as *“companies are publishing way too much information coming out of non-controlled environments.”*

- **Cybersecurity.** Cybersecurity has long been high on audit committee and board agendas, but current geopolitical turmoil raises the stakes. A member wondered whether her audit committee and board know how to evaluate the company’s cybersecurity team and its work. She asked, *“Do you bring in external expertise or do you just rely on management?”* Another audit chair lamented, *“This is what keeps me awake every night. We’ve separated the first and second lines of cyber defense—taken security out of IT. And we have recruited from government with specialized expertise to fill key roles.”*

One board decided to test their security—both physical and cyber—and hired hackers without management’s knowledge. The hackers managed to breach the physical security and had begun to access a server when an employee raised an alarm. The audit chair noted that even though the board had performed this exercise without management’s prior knowledge, executives took it as an *“opportunity to make progress and improve.”*

## Corporate fraud—Wirecard as a case study

Members discussed corporate fraud and the Wirecard case with Dr. Katja Langenbacher, professor of Law, Goethe University and member of the supervisory board of BaFin; Marie-Laure Delarue, global vice chair of assurance, EY; and Jean-Yves Jégourel, EY’s country managing partner, Germany. Guests shared perspectives on Wirecard, noting several themes:

- **Collusive fraud involving top levels of management is difficult to uncover.** Major fraud incidents involving collusion among executives, as occurred in Wirecard, are very challenging to prevent and detect. *“The level of sophistication of the fraud and the ability of key individuals to deceive can be incredible,”* Ms. Delarue reflected.
- **Traditional lines of defense can be hindered by cognitive biases.** Boards, management, auditors, and regulators all play a vital role in the fight against fraud, but none of them uncovered the issues at Wirecard. Cognitive biases, such as groupthink and confirmation bias, likely played a role said Dr. Langenbacher: *“The German securities market culture believed that Wirecard was the star of its fintech scene. That influences how people process information and you end up with biased thinking in groups like the board, compliance, legal, auditors, and regulators.”* She reminded stakeholders in the corporate governance ecosystem to remain vigilant for biases and to use professional skepticism to help detect fraud situations.
- **Evidence from external sources—such as short sellers and social media—can be key.** Dr. Langenbacher highlighted that it is not uncommon for insiders to *“look the other way”* when bad behavior occurs due to the perceived or real costs associated with whistleblowing. Internal whistleblowers may fear job loss or other reprisal, but external whistleblowers—in this case short sellers and *Financial Times* reporters—typically face lower risk when they bring this type of information forward. Members and guests emphasized heightened monitoring of external sources in fraud detection. For example:

- EY established a new center to assess whistleblower complaints, short seller reports, social media, and other external data, and share results with audit, risk management, and forensic teams.
- Dr. Langenbacher noted that BaFin now monitors external information, including monitoring short selling.
- **Increased training and tools for external auditors.** Ms. Delarue and Mr. Jégourel described changes made by EY since Wirecard occurred, both globally and within EY Germany. The firm implemented mandatory fraud training for audit professionals including an increased emphasis on interviewing skills, required the use of data analytics for fraud testing for all listed companies, expanded the use of electronic cash and bank confirmations, and developed a proprietary Fraud Risk Radar tool. They also noted that EY is more selective about audit client acceptance and continuance.

### Audit committee oversight of fraud risk

Audit chairs continue to seek methods to improve fraud risk oversight, a persistent challenge due to the inherent “*unknown*” nature of fraud and actions of bad actors to deter detection. Members and guests discussed important factors for audit committees to consider:

- **Whistleblower systems are essential and audit committees should ensure effective oversight is in place.** “*The governance structure of the whistleblowing reporting and follow-up is key,*” one member said. Ms. Delarue advised members to review benchmarks: “*Information is available that allows companies to quickly assess if their process and governance around whistleblowing is appropriate.*”
- **Corporate culture and tone at the top are key indicators of fraud risk but challenging to effectively assess.** Members recounted several experiences where, in hindsight, certain executive personalities could have been identified as early signals of fraud risk. But getting an accurate read on culture and tone at the top can be difficult for boards. Members described internal audit as a crucial resource; culture audits are another possible tool.
- **Audit committees may find it useful to expand their relationships with external auditors.** “*I interact with lead audit partners, not so much the rest of the audit team. I might start asking to meet with a wider group to encourage speak up culture,*” one member said. Another shared a suggestion: “*Once a year we had all worldwide partners involved in the audit get together for lunch, which was very useful and allowed me to engage with local partners.*” Another member added that having a relationship with the local office partner has proved valuable.

### How energy supply issues are impacting companies’ climate commitments

The European energy crisis, caused by Russia’s constraints of its gas exports, have imposed new pressures on large companies’ climate commitments. Members met with Tera Allas, director of research and economics at McKinsey, and Andy Agg, chief financial officer at

National Grid, who offered views on the energy situation and its impact on companies. Several themes emerged:

- **Uncertainty will continue, and short-term adjustments will likely lead to long-term systemic changes.** The Russian invasion of Ukraine, pandemic, supply chain bottlenecks, rising inflation, and labor challenges have created unprecedented levels of uncertainty for businesses. Ms. Allas also called attention to the fact that energy supply has now been explicitly “*weaponized*” by a nation state. “*We’ve moved to a new geopolitical context,*” she cautioned, “*and we may not know who will be a friend or foe in 10 years’ time.*” These unprecedented levels and types of uncertainty have created difficulty in forecasting and planning around energy pricing and supply. “*It is not an easy time to plan or budget,*” Ms. Allas said, adding that even if current challenges are temporary, they will likely lead to long term structural changes both from consumers and companies.
- **The energy sector’s previously competing goals of decarbonization, affordability, and supply security are now more aligned.** While there will be a short-term refocus on fossil fuels, Mr. Agg explained that the energy sector’s “*trilemma*”—a choice between three competing objectives—is no longer as difficult as it was, because decarbonization is likely to be the best path toward energy affordability and supply security. Much work is needed on both energy transmission and storage but decarbonization is far more viable than even two years ago. This is true for other companies and sectors as well. As Ms. Allas pointed out, fossil fuel prices are now at a historic high whereas many zero carbon investments are “*deep in the money.*” She advised members that “*while there are challenges, now is the time to keep investing for a sustainable future.*”
- **Most companies remain committed to climate commitments.** Members’ companies are committed to their long-term climate plans, despite current uncertainties. Some energy companies are pushing back near-term commitments, but they remain locked on their overall net zero goals. One audit chair in the utility sector reported: “*It was a bit of a shock when gas prices surged, and we had to mediate political aspects of our strategy. The board decided to keep the net zero commitment but postpone implementation of the policy.*” Even so, the company continues to invest in research and development. Another audit chair, also in the utility sector, similarly noted that her company is “*investing massively in R&D*” and committed to its ESG goals.
- **Communicating transparently with stakeholders is key.** While most members’ companies are not slowing or stepping back from previously announced climate commitments, several members raised the importance of being transparent about any changes in their plans. Mr. Agg emphasized this point: “*The critical thing is that we need to be honest with our stakeholders on what we can control, what we’re doing, and provide clarity in communication and transparency around the drivers of our decision making.*”
- **Leaders are weighing potential unintended consequences of government intervention with the need for supply security and stability.** Members and guests debated the roles of governments and large companies when it comes to energy supply and security. “*Governments have their politics, then regulators have policies, then communities and*

*consumers have a third view. So how do businesses square the circle of these competing objectives and purposes?” one member asked. Ms. Allas made the argument that businesses are best equipped to solve the energy supply and security problem: “The kind of agility, R&D, technical talent, moving things around, connecting with customers, and long-term thinking are things only the private sector can do. Government may try, but they also need to look to the next election and act based on their political mandate.”*

But members believed that some government support is needed. One noted that she did not like market intervention from politicians: *“But we also need stability and security in energy supply.”* Another pointed out the need to share the often-costly responsibility for *“final risks,”* those beyond a company’s normal control, in order to make decarbonization investments bankable and tradable. Governments are providing near-term support, for example, in the United Kingdom through price caps, and elsewhere through investment and nationalization moves. The group also discussed the role of nuclear power, especially after German policy recently shifted to postpone a nuclear phaseout. Several members believe that, even despite the challenges of dealing with waste, nuclear is an important part of the energy solution.

## Measuring and accounting for greenhouse gas emissions through E-liabilities

Investors and regulators are pushing companies to provide trustworthy disclosures of their greenhouse gas (GHG) emissions, not only from sources that they own and control (“Scope 1”, as defined by the Greenhouse Gas Protocol<sup>2</sup>), but also for indirect emissions throughout a company’s supply chain—upstream and downstream. The Protocol describes these as “Scope 3” emissions, and they have proven difficult for companies and boards to measure and report in a consistent and reliable way.

To discuss this problem and a potential solution to it, members met with Karthik Ramanna, professor of business and public policy at the University of Oxford’s Blavatnik School of Government, and Rachel Maher, EY’s product owner for OpsChain ESG and a member of the firm’s 1500-strong blockchain group. Prof. Ramanna, working with Robert Kaplan of the Harvard Business School, has proposed an approach called “E-liability”, for enabling reliable, accurate Scope 3 reporting. The E-liabilities method aims to address several aspects of Scope 3 reporting that we hear are problematic for many audit chairs. They include:

- **Reasonably calculating Scope 3 and avoiding multiple counting of emissions.** Prof. Ramanna explained that Scope 3 reporting often violates fundamental principles of accounting by failing to count every material unit of GHG emission or counting the same unit more than once. In many cases, companies are estimating emissions based on industry averages, rather than on measured outcomes. The E-liability approach transforms Scope 1 emissions—which can be accurately and consistently measured—into cradle-to-gate product carbon measures. This is done by using well-established principles of inventory and cost accounting, treating Scope 1 emissions like a currency, and using blockchain technology to maintain a publicly accessible record of emissions as they are transmitted down a supply chain. For instance, Ms. Maher described EY’s OpsChain ESG



tracking application. While not directly based on the Ramanna/Kaplan model, it tracks emissions (among other ESG metrics) on a blockchain and can be used throughout a large company's supply chain.

- **Consistent and comparable reporting.** Members wondered how far the initial E-liability numbers could be trusted. Prof. Ramanna noted that rigorous standards for measuring Scope 1 emissions are emerging, with third-party assurance—though he noted that audits of Scope 1 emissions will be “*more like goodwill accounting than inventory accounting.*” If these Scope 1 standards can be made trustworthy, he said, cradle-to-gate numbers can become reliable and auditable. Ms. Maher noted that “*smart contracts*” built into blockchain systems could help ensure that Scope 1 numbers are transformed into Scope 3 disclosures in a rigorous way.
- **Tracking emissions at a product rather than entity level.** Scope 3 reporting does not break out the components of a product. For instance, a commercial jet flight would assign Scope 3 emissions both to the maker of the jet's engine and to any company whose employees are traveling for business on the flight, among a host of others. E-liabilities, on the other hand, are tracked at a product or component level, but can be aggregated for a product or an entity as a whole. For example, an upstream producer (say, a mining company) creates E-liabilities based on its Scope 1 emissions. These are tracked and atomized on a blockchain, and transferred to the mining company's customers, the next stage in the chain, somewhat resembling a value-added tax liability. Furthest downstream, the product or service sold to the end user can have a reliable GHG emissions number attached to it; this could be used for purposes including consumer awareness and carbon taxation. Carbon removal offsets such as sequestration (but not avoidance offsets) can be tracked as contra-liabilities, extinguishing E-liabilities in a reliable manner.
- **Standardized reporting.** A frequent concern from audit chairs is the absence of a standardized reporting framework for climate metrics. Members wondered how the E-liability model fits into the alphabet soup of current ESG reporting standards. Prof. Ramanna noted that the E-liability creators are speaking with regulators in North America and Europe, including the US Securities and Exchange Commission, the International Sustainability Standards Board, and the European Financial Reporting Advisory Group. He emphasized that regulators must “*jointly embrace*” the model and agree to phase out non-rigorous approaches to measuring Scope 3 emissions—industry averages, for example—for the E-liability approach to gain traction. He also noted that large companies, in a range of industries, are running pilots of the E-liability approach and believes that having this real world data could help encourage regulators to adopt the E-liabilities methodology as part of their reporting frameworks.

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## Appendix: Participants

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

- Jeremy Anderson, UBS
- Werner Brandt, Siemens
- Carolyn Dittmeier, Assicurazioni Generali
- Eric Elzvik, Ericsson and Volvo
- Margarete Haase, ING
- Marion Helmes, Heineken
- Liz Hewitt, National Grid
- Benoît Maes, Bouygues
- John Maltby, Nordea
- David Meline, ABB
- Marie-José Nadeau, ENGIE
- Karyn Ovelmen, Arcelor Mittal
- Stephen Pearce, BAE Systems
- Nathalie Rachou, Veolia
- Bernard Ramanantsoa, Orange
- Guylaine Saucier, Wendel
- Erhard Schipporeit, RWE
- Maria van der Hoeven, TotalEnergies

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

- Pam Daley, BlackRock
- Bob Herz, Fannie Mae and Morgan Stanley
- Kimberly Ross, Cigna
- Jim Turley, Citigroup

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

- Marie-Laure Delarue, EY Global Vice Chair, Assurance
- Jean-Yves Jégourel, EY Country Managing Partner, Germany
- Julie Linn Teigland, EMEA Managing Partner, EY



## Endnotes

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<sup>1</sup> *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.

<sup>2</sup> WRI/WBCSD GHG Protocol, "Corporate Value Chain (Scope 3) Accounting and Reporting Standard" September 2011, 27.