Hywel Ball
Chair, Regional Managing Partner UK & Ireland
Ernst & Young LLP
1 More London Place
London SE1 2AF

29 November 2022

Dear Mr. Ball,

INVESTOR EXPECTATIONS: NET ZERO-ALIGNED AUDITS

We have been in a dialogue with EY since January 2019 as long-term investors seeking assurance that the firm is integrating climate risks into its audits wherever material[1]. Specifically, we have asked that EY alert shareholders where company accounts were not considering the financial implications of either the current decarbonisation pathway, the physical impacts from climate change, or the global transition onto a 1.5-degree Celsius pathway[2]. We have also sought reassurance over dividend resilience in the face of potential climate-related losses and liabilities, in keeping with the UK Companies Act 2006 capital maintenance regime[3].

While we have seen some welcome progress in the past twelve months, we are writing again because EY could do more to meet investor expectations. Specifically, we would like to ask that EY provides a commitment for all its audits of entities facing material headwinds linked to climate change that it will provide:

- Detailed and specific (not boilerplate) commentary on how it has addressed foreseeable climate risks in its determination that the accounts provide a true and fair view of the company's financial position; that dividends are payable in accordance with capital maintenance rules; and the going concern statement remains valid.
- Quantitative information of accounting adjustments made and the implications for the entity's financial position, or reasons why assumptions were not changed.
- An assessment of whether the entity has provided a reliable view of its exposure to a 1.5C-aligned pathway through robust sensitivity analysis.

To avoid any doubt, we view these disclosures to be material to our investment and stewardship decision-making[4].

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[1] The signatories to this letter are all long-term investors, both asset managers and asset owners.
[2] Investors wrote formally in January 2019 and then again in November 2021, and held several conversations individually or as a group of investors. The Institutional Investor Group on Climate Change published "*Investor expectations for Paris-aligned accounts*" (Nov 2020) setting out detailed expectations for auditors.
[3] In the UK, the capital maintenance regime requires that accounts are drawn up prudently to prevent illegal distributions (i.e. distributions out of capital) in line with Part 23 2006 Companies Act. Section 830 sets out that for distributions (e.g. dividends) to be legal, they can only be made out of "profits available for the purpose". This means accumulated realised profits not needed to cover foreseeable losses. In addition, companies must comply with the "net asset restriction" (s831), which prohibits distributions that result in net assets falling below the aggregate called up share capital and undistributable reserves. Similar legal requirements exist in the European Union.
[4] IASB guidance (2020) underlines that materiality depends on what impacts investor decision-making. Reflecting earlier investor statements setting out the importance of 1.5C visibility, in 2022 the investor-led Climate Action 100+ Initiative added accounting and audit criteria, including 1.5C alignment disclosures, into their assessment framework, which increasingly drives investment and stewardship decision-making. The FRC in 2022 also underlined the importance of 1.5C pathway sensitivities (see below)

Last year when we wrote, we highlighted analysis of carbon-intensive companies' financial statements published by Carbon Tracker, which demonstrated a failure of directors and auditors to act on our expectations. Carbon Tracker published an updated and extended analysis in October 2022 covering 134 companies' 2021 financial statements[5]. Their conclusions point to ongoing systemic failure to ensure financial statements are reflecting the economic realities of climate change. Critically, companies and their auditors are not providing disclosures on sensitivities to a 1.5-degree Celsius pathway.

EY is responsible for the audits of 34 of the entities examined by Carbon Tracker globally, and audits 2 UK-listed companies (Shell and SSE). While neither meet all the criteria set out by investors two years ago, we welcome leadership at Shell. It is worth stressing, however, that the Carbon Tracker analysis only covered a small group of climate-exposed entities, so the findings will be applicable to a wider group of companies that EY audits.

We set out in our previous correspondence the regulatory and legal backdrop to our call for EY to act[6]. Since then, climate-related matters have been reiterated as a priority in the latest European Securities Market Authority and the UK's Financial Reporting Council enforcement statements for 2022/2023[7]; the FRC published a review in July 2022 that underlined areas of weakness when it comes to complying with accounting requirements[8]; and the US Securities and Exchange Commission has consulted on climate-related disclosure requirements in financial statements[9].

In addition to regulator action, the investor-led Climate Action 100+ Initiative has now added accounting and audit criteria to its assessment framework, a tool which informs investment and stewardship decision-making, further underlining the materiality of this information to investors[10].

We believe that it is now well-accepted amongst companies and auditors in the UK that accounts must reflect the shifting economic realities of accelerating decarbonisation and climate change. Two areas that require urgent attention, however, are:

- Consistency: ensuring the company's climate-related promises are being properly reflected in the forward-looking assumptions used in the accounts – this becomes ever more important as companies produce more detailed TCFD-aligned reporting; and
- Consideration of a 1.5C pathway: sensitivity analysis for how a 1.5-degree Celsius scenario might impact companies' financial positions is material to investors as it provides insight on how resilient businesses are likely to be to this scenario.

In its recent review, the FRC highlights both. With respect to 1.5C alignment, it outlines requirements under IAS 1 and IAS 36:

- IAS 1: Companies should "*Disclose any related judgements and estimates which management considers to be significant as required by paragraphs 122 and 125 of IAS 1,*

[5] https://carbontracker.org/reports/still-flying-blind-the-absence-of-climate-risk-in-financial-reporting/

[6] See: IFRS - Educational material: the effects of climate-related matters on financial statements prepared applying IFRS Standards, IAASB Issues Staff Audit Practice Alert on Climate-Related Risks | IFAC, Summary-FINAL.pdf (frc.org.uk); European enforcers target COVID-19 and climate-related disclosures (europa.eu); https://www.frc.org.uk/getattachment/ecd6d6b2-7f4d-4a70-bf60-32b07143ece1/FRC-CRR-Year-End-Key-Matters_October-2021.pdf

[7] https://www.frc.org.uk/news/december-2021-(1)/frc-announces-areas-of-supervisory-focus; https://www.esma.europa.eu/sites/default/files/library/esma32-63-1320_esma_statement_on_european_common_enforcement_priorities_for_2022_annual_reports.pdf

[8] https://www.frc.org.uk/getattachment/65fa8b6f-2bed-4a67-8471-ab91c9cd2e85/FRC-TCFD-disclosures-and-climate-in-the-financial-statements_July-2022.pdf

[9] https://www.sec.gov/news/press-release/2022-46

[10] https://www.climateaction100.org/wp-content/uploads/2021/11/CA100-CTI_CAP-Accounting-and-Audit-Indicator-methodology-Nov-21.pdf

and consider whether additional explanations of how Paris-aligned outcomes have been taken into account when preparing the financial statements may be required by paragraph 112(c) of IAS 1 or useful to users of the annual reports and accounts, having regard to investor expectations in this area."

- IAS 36: *"If management has not used assumptions consistent with a Paris-aligned scenario in preparing its financial statements, but considers a 1.5C or 2C scenario to be reasonably possible, the company should consider whether these standards require disclosure of sensitivities to illustrate the financial effect of a Paris-aligned pathway."*

Auditors need to test company accounts against these requirements. We have appreciated Shell's market-leading efforts in this regard and would encourage you to build on this approach and ensure it is adopted across other audits.

The point of prudent accounting is to prevent excessive risk taking and to encourage earlier mitigation, thereby helping to secure capital into the future. We look to EY to reinforce this prudent mindset and prevent management teams from ignoring foreseeable but uncomfortable climate-driven risks to capital. This would also be in keeping with EY's commitment under the Net Zero Financial Service Providers Alliance (NZFSPA), to *"(a)lign all relevant services and products to achieve net zero greenhouse gas emissions by 2050 or sooner, scaling and mainstreaming Paris Agreement-alignment into the core of our business*".

We are copying this letter to the FRC, and would be grateful if you could ensure a copy is shared with the EY Audit Board as well as the Public Interest Board. We look forward to hearing back on the points raised in this letter.

Yours sincerely,

Natasha Landell-Mills, Partner and Head of Stewardship
Sarasin & Partners LLP

Erica Cadbury, Chair
Barrow Cadbury Trust

Dr Vic Sedlak, President
British Psychoanalytical Society incorporating the Institute of Psychoanalysis

Wim Van Hyfte, Global Head of ESG Investments and Research
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Darren Xiberras, Chief Finance Officer
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Mrs Mel Avis, CEO
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Carolyn Sawers, Chief Executive
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Dr Julian Elford, Treasurer & Chair of Finance and Investment Committee
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Dame Sarah Springman FREng, Principal
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Adam Matthews, Chief Responsible Investment Officer
The Church of England Pension Board

Dr Chris Hutchinson, Committee Chairman
The Norfolk Benevolent Medical Society

Alan Read, Chair of the Environmental Committee
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Andrew Lang, Chief Financial Officer
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Jane Madeley, Chief Financial Officer
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David Russell, Head of Responsible Investment
USS Investment Management

David Ireland, Chief Executive
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Cc: David Thorburn, Chair, Audit Board
Cc: Tonia Lovell, Chair, Public Interest Board
Cc: Sir John Thompson, CEO, FRC