



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

11 January 2019

Dear Mr. Varley,

Investor expectations: auditor assurance that companies are accounting for material climate risks

We are writing as a group of long-term investors to ask Ernst & Young to explicitly incorporate climate considerations into the audit of companies that are materially exposed to transitions risks through decarbonisation¹. Specifically, we expect our auditors to test critical accounting judgments against credible economic scenarios that are consistent with the Paris Climate Agreement, which entered into force in November 2016. We expect the auditor to highlight where company assumptions may be too aggressive. Likewise, we expect Ernst & Young to ensure that climate change-related factors identified in the audit are consistently reflected in the risk and viability sections of the company's strategic report, or flag where they are not.

While we believe climate-related risks will impact a wide range of industries, we are focusing in the first instance on fossil fuel-based energy companies that are most obviously exposed to decarbonisation.

In the event you are unable to give assurance that such issues will be incorporated within the audit, could you write to us and explain why.

Context

Under the Paris Accord, Article 2.1(c) signatories have committed to: *"Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development"*.

Accounting numbers are critical in directing finance flows. This point is also emphasised by the Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD) and the Climate Action 100+ initiative, which now has over \$30 trillion in assets behind it, emphasises the critical importance of incorporating climate risks in companies' annual report to shareholders.

¹ The focus of this letter is on decarbonisation, but we are also concerned that auditors consider the materiality of the physical impacts from climate change wherever possible.

In the Spring, IIGCC published a briefing paper (attached) setting out the responsibilities for Audit Committees and auditors to consider material climate risks as part of their existing obligations to ensure that a company's financial statements deliver a true and fair view of the underlying economics of the business. As part of this, we expect the auditors to check whether the critical accounting judgements are prudent, and are consistent with a sustainable planet. If they are not, then there is every likelihood that performance and capital will be overstated.

As you will know, in the UK the capital maintenance regime requires that accounts are drawn up prudently to prevent illegal distributions (i.e. distributions out of capital)². Foreseeable losses or liabilities need to be accounted for, while unrealised gains should not be treated as distributable. These requirements underpin trust in financial markets as they reassure providers of both debt and equity capital that their capital is protected.

Finally, it is important that key judgments, assumptions, sensitivities and uncertainties are disclosed to shareholders, and auditors must check that the narrative disclosures in the Annual Report and Accounts (such as the Strategic Report, including the Viability Statement) are consistent with the numbers presented in the accounts. These disclosures are also part of meeting requirements for company Report and Accounts to be "fair, balanced and understandable".

We have concerns that, at present, accounting and audit practice assumes 'business as usual', and that climate considerations are being ignored. Such an approach risks of over-statement – and thus potential over-distribution – in the fossil fuel-based energy sector, which faces a future of declining demand under any climate stabilisation scenario. The Paris Climate Accord has set out a clear global commitment to transition away from fossil fuels. To meet the well below 2°C target, the world must reach zero net carbon emissions before 2075. To reach 1.5°C target, net zero emissions must be achieved by 2050.

To achieve these goals, governments are implementing policies to drive down the use of fossil fuels. At the same time technological advances in low carbon power, transport and a range of other sectors is reducing demand for fossil fuels. In short, decarbonisation is not just a political goal but an economic reality that companies in all sectors need to recognise and adapt to.

Uncertainty around the decarbonisation trajectory is not a reason to delay accounting and reporting adjustments. Indeed, it is precisely because of the high level of uncertainty around the transition pathway that the audit industry has an enhanced responsibility to

² Part 23 2006 Companies Act s830 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.

provide assurance that companies are taking a prudent approach. Capital protection depends on avoiding the overstatement, and providing transparency around critical judgments and sensitivities to different decarbonisation scenarios.

Are oil and gas companies overstating their position?

While a wide range of industries will be impacted by decarbonisation, it is clear that fossil fuel extractive (coal, oil and gas) companies face particular headwinds, and accounting assumptions will need to be carefully scrutinised.

Take the decision by a European utility to depreciate a coal-fired power station over 25 years. This sits uncomfortably with the Paris-aligned phase out of coal power under the IEA's B2DS scenario, which eliminates all coal-fired power generation in Europe by 2030.

Likewise, critical accounting assumptions by oil and gas companies around their long-term (structural) energy prices used for impairment purposes need to be queried. Are these price assumptions taking account of structural declines in fossil fuel demand as required by the Paris Accord? A recent review by Sarasin & Partners of eight listed European oil and gas companies (RD Shell, BP, Total, Eni, Repsol, Equinor, Soco International and Cairn Energy) suggests the commodity price assumptions may be aggressive³. Worryingly, none of the companies' Audit Committees or auditors (including Deloitte, EY, KPMG and PWC) indicated that they had considered the Paris Accord or decarbonisation in their assessment of the accounting judgments. None identifies decarbonisation as a key audit risk. Only RD Shell references the energy transition to a low carbon future in its Viability Statement. This appears inconsistent with disclosures in the same companies' Strategic Reports that acknowledge decarbonisation as a material threat, as well as third party assessments that long-term demand and prices for fossil fuels will fall as the Paris Accord is implemented.

Meeting request

In the context of market concerns over audit quality, we welcome statements from the audit industry that they wish to restore trust. A key aspect of building trust in audit is ensuring professional scepticism and challenge. As outlined in this letter, we believe that companies facing material threats from decarbonisation are a worrying example of where companies are using 'business as usual' assumptions in their accounting judgments without clear evidence of challenge from external auditors.

We would welcome a dialogue with you on what you are already doing, or planning, to ensure you incorporate structural shifts away from fossil fuels in your audit process. In the first instance, we would be keen to focus on the fossil fuel extractive companies, but over time we would hope to extend the discussion to a broader range of sectors, e.g. power utilities, industrial gas companies, car manufacturers, and marine transport companies to name a few. We will also be raising our concerns with the Financial Reporting Council.

³ See <http://www.sarasinandpartners.com/docs/default-source/esg/are-oil-and-gas-companies-overstating-their-position.pdf?sfvrsn=2>

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We would be grateful if you could contact Natasha Landell-Mills (natasha.landell-mills@sarasin.co.uk) to arrange a meeting.

Yours sincerely,

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

Cllr Paul Doughty, Acting Chair
Local Authority Pension Fund Forum

Michael Marshall, Director of Responsible Investment & Engagement
LGPS Central Ltd.

Erica Cadbury, Chair
The Barrow Cadbury Trust

Phil Harding, Director of Finance and Business Affairs
University College London

Frank Gargent, Bursar
St Hilda's College, Oxford

Jane Madeley, Chief Financial Officer
University of Leeds

Dr. Ian Winterton, Treasurer
Dr. Simon Lockett, Deputy Treasurer
The Cameron Fund

David Tennant, Chair
Frank Jackson Foundation

Edward Mason, Head of Responsible Investment
Church Commissioners for England

Adam C.T. Matthews, Director of Ethics & Engagement
Church of England Pensions Board

Sister Catherine Collins, Congregational Treasurer
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Sr Frances Orchard C.J., Chair
Congregation of Jesus Charitable Trust

Paschal Somers, Passionist Development Worker
Congregation of the Passion of Jesus Christ

Craig Martin, Chief Pensions Officer
Environment Agency Pension Fund

James Bevan, Chief Investment Officer
CCLA Investment Management

Faith Ward, Chief Responsible Investment Officer
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Dr. Jan Amrit Poser, Chief Strategist & Head Sustainability
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Nick Spooner, Engagement
Hermes EOS & Hermes Investment Management

Heike Cosse, Engagement Manager
Aegon Asset Management

Freddie Woolfe, Head of responsible investment and stewardship
Merian Global Investors

Ashley Hamilton Claxton, Head of Responsible Investment
Royal London Asset Management

Rob Stewart, Head of Responsible Investment
Newton Investment Management

Faryda Lindeman, Senior Responsible Investment Specialist
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Charlotte Sølling, ESG Manager
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Danish Labour Market Pension Fund (PKA Ltd.)

Kirstine Lund Christiansen, Head of ESG
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Eoin Fahy, Head of Responsible Investing
KBI Global Investors

Cc: David Thornburn, Chair, INE Oversight Committee