SARASIN & PARTNERS

Paul Stephenson
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01 November 2021

Dear Mr. Stephenson,

INVESTOR EXPECTATIONS: NET ZERO-ALIGNED AUDITS

Many of us wrote in January 2019 seeking assurance that Deloitte was integrating material climate risks into its audits wherever relevant. Specifically, we asked that Deloitte alert shareholders where company accounts were not considering the financial implications of either the current decarbonisation pathway, or the global transition onto a 1.5C pathway[1]. We are writing again now as an even larger group of investors following analysis of carbon-intensive companies' financial statements published by Carbon Tracker, which details the broad failure of both directors and auditors to act on our expectations[2]. We would like to understand what you plan to do to address these weaknesses in Deloitte's audit process.

Deloitte is responsible for the audits of nineteen of the entities examined by Carbon Tracker globally, and audits three UK-listed companies: BP, CRH and Glencore. While we have identified some welcome signs of leadership, notably at BP, based on our analysis overall these audits have not met our expectations. Outside the UK, the picture is worse. Of the remaining sixteen audits undertaken by Deloitte, only three mention climate risk. None provides the visibility we seek on the potential financial implications of a 1.5C pathway, which global leaders have committed to delivering.

We set out in our 2019 letter the regulatory and legal backdrop to our call for immediate action by Deloitte. Since writing, the situation has become more pressing. We would draw your attention to three developments, in particular.

First, structural changes linked to both climate change itself and associated policy action are accelerating. These changes cannot reasonably be ignored in company accounts or their audits. The evidence that without drastic action we are on track for an increasingly inhospitable future is now irrefutable. The IPCC's Sixth Assessment Report published earlier this year makes this clear. This is driving a more robust policy response globally. The economic impacts of both will vary by sector and company but are inevitable, as so clearly outlined in a range of government and academic analyses[3]. Companies that base accounting assumptions on 'business as usual' risk misrepresenting their economic position. Likewise, auditors that fail to test accounting assumptions taking these structural shifts into account are, in our view, failing in their duty to shareholders.

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[1] We also sought reassurance that any material physical impacts were being taken into account, wherever possible.
[2] Flying blind: The glaring absence of climate risks in financial reporting - Carbon Tracker Initiative
[3] See for instance the recent Central Bank modelling, such as the recent Network of Central Bankers and Supervisors for Greening the Financial System (NGFS) scenario analysis.

Second, audit standard setters and regulators have underlined auditors' responsibility to take material climate risks into account under existing standards and regulations. The Financial Reporting Council published the results of its review of climate reporting in November 2020, which concluded that auditors need to improve consideration of climate-related risks[4]. In October 2020, the International Audit and Assurance Standard Board (IAASB) issued a Staff Audit Practice Alert reiterating that climate risks should be treated like any other material economic factor in the audit process[5]. In November 2020, the International Accounting Standards Board published further guidance to highlight how existing requirements in IFRS Standards require companies to consider material climate-related matters[6]. The failure of the large audit firms to follow this guidance suggested by the Carbon Tracker analysis should be a matter for regulatory enforcement.

A third reason Deloitte must not delay strengthening its audit processes is that investors are expressly asking for accounting disclosures that align with a 1.5C pathway. This makes these considerations material, and thus under the existing rules, a matter for directors to disclose, and auditors to audit. As helpfully reiterated in the latest IASB guidance, materiality is not something to be determined by management without reference to investor expectations[7]:

"Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that primary users of financial statements (hereafter, investors) make on the basis of those financial statements, which provide financial information about a specific company. For example, information about how management has considered climate-related matters in preparing a company's financial statements may be material with respect to the most significant judgements and estimates that management has made."

Beyond the investors writing to you today representing just over $4.5 trillion in assets, in September 2020, investor groups representing over $100 trillion in assets publicly called for company accounts to be aligned with a 1.5C future[8]. Deloitte must respond to this expectation.

To provide more clarity on what precisely investors wish to see, IIGCC published a detailed paper in November 2020 "*Investor expectations for Paris-aligned accounts*" which articulated five expectations for directors, and four for audit firms[9]. Specifically, investors are asking auditors to provide reassurance that company accounts incorporate material climate risks and that they provide visibility as to whether the accounts can be considered aligned with a 1.5C pathway. Additionally, the investors expect any inconsistencies between narrative disclosures around climate risks and the financial statements to be called out, and that dividend payments are affordable in line with local solvency or capital maintenance rules, having taken these climate impacts into account[10]. Auditors may provide this information through their disclosure of key or

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[4] Summary-FINAL.pdf (frc.org.uk)
[5] IAASB Issues Staff Audit Practice Alert on Climate-Related Risks | IFAC
[6] IFRS - Educational material: the effects of climate-related matters on financial statements prepared applying IFRS Standards
[7] This point was clearly also set out by IASB Board member Nick Anderson in his November 2019 article on the topic in-brief-climate-change-nick-anderson.pdf (ifrs.org)
[8] Investor groups call on companies to reflect climate-related risks in financial reporting | PRI Web Page | PRI (unpri.org)
[9] Investor Expectations for Paris-aligned Accounts – IIGCC
[10] 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

critical audit matters, and consider whether this would necessitate a qualification to their opinion on the financial statements.

These expectations were sent to thirty-six listed companies in Europe, copied to the lead audit partner for that company. Deloitte received copies at BP, Shell, CRH, Arcelor Mittal, Lafarge-Holcim, Engie and EDF.

As highlighted above, we have seen some positive steps by your lead audit partners at BP (we also note welcome disclosures by the same lead audit partner at National Grid) and Glencore but these steps still appear to be the exception not the rule. Moreover, even in these cases the audit work seems to be partial – for instance only focusing on upstream assets at BP, without any indication of impairment assessments extending to refining facilities. The CRH audit fell short in all aspects. Above all, we are concerned that an assessment of consistency with a 1.5C pathway are lacking in rigour and professional scepticism.

This raises two important questions for investors. First, has Deloitte ensured sufficient disclosure to investors on material climate-related risks to enable us to properly interpret each entity's accounts, and thus deploy capital efficiently? Second, if material climate risks have not been properly examined, how reliable are Deloitte's opinions that these companies' accounts meet the true and fair view standard as required under the UK 2006 Companies' Act? Both of the above, of course, also underpin company boards' decisions on dividend payments to shareholders, which is of utmost importance to many long-term shareholders.

Given the concerns outlined above, we were pleased to see Deloitte become a signatory of the recently launched Net Zero Financial Service Providers Alliance (NZFSPA). We note Deloitte is now committed to "Align 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". However, we would stress again that action by Deloitte is not a voluntary exercise governed by a commitment that permits a potentially long phase-in period. Deloitte needs to act immediately to ensure investor expectations are met in compliance with existing regulations and standards.

We began our engagement with you almost three years ago. We cannot afford to wait another three years for Deloitte to act. From next voting season, you should increasingly expect to see investors vote against Deloitte's reappointment as auditor where you fail to meet the expectations we have clearly set out in our previous correspondence, the November 2020 IIGCC paper and underlined again here.

We are copying this letter to the Financial Reporting Council so they are aware of investor engagement with you on this important topic. We would also ask that you share this with the Deloitte Audit Governance Board.

We would welcome a dialogue with you on this matter. Please contact Natasha Landell-Mills (natasha.landell-mills@sarasin.co.uk) to arrange a meeting.

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that result in net assets falling below the aggregate called up share capital and undistributable reserves. Similar legal requirements exist in the European Union.

Yours sincerely,

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Sarasin & Partners LLP

Heike Cosse, Engagement Manager
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Anders Schelde, CIO
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Bess Joffe, Head of Responsible Investment
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Adam C.T. Matthews, Chief Responsible Investment Officer
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Grégoire Haenni, Chief Investment Officer
Caisse de prévoyance de l'Etat de Genève (CPEG)

Richard Burrett, Chief Sustainability Officer
Earth Capital

Laurent Galzy, CEO
Établissement de Retraite additionnelle de la Fonction publique (ERAFP)

Eric Tracey, Non-Executive Director
GO Investment Partners LLP

Bruce Duguid, Head of Stewardship
EOS at Federated Hermes (on behalf of its stewardship clients)

Cllr Doug McMurdo, Chair
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Andrew Harper, Head of Ethics
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Chandra Gopinathan, Senior Investment Manager – Sustainable Ownership
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David Russell, Head of Responsible Investment
USS Investment Management

Cc: Margaret, Baroness Ford of Cunninghame OBE, Chair, Audit Governance Board