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01 November 2021

Dear Mr. Ball,

### **INVESTOR EXPECTATIONS: NET ZERO-ALIGNED AUDITS**

Many of us wrote in January 2019 seeking assurance that EY was integrating material climate risks into its audits wherever relevant. Specifically, we asked that EY 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<sup>1</sup>. 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<sup>2</sup>. We would like to understand what you plan to do to address these weaknesses in EY's audit process.

EY is responsible for the audits of thirty of the entities examined by Carbon Tracker globally, including Royal Dutch Shell and BHP listed in the UK<sup>3</sup>. While we have identified some welcome signs that EY was considering climate risks, notably at Royal Dutch Shell, based on our analysis overall these audits have not met our expectations. 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 EY. 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<sup>4</sup>. 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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<sup>1</sup> We also sought reassurance that any material physical impacts were being taken into account, wherever possible.

<sup>2</sup> [Flying blind: The glaring absence of climate risks in financial reporting - Carbon Tracker Initiative](#)

<sup>3</sup> We note that BHP has recently decided to proceed with delisting from London, to have just a single listing in Australia.

<sup>4</sup> 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<sup>5</sup>. 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<sup>6</sup>. 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<sup>7</sup>. 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 EY 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<sup>8</sup>:

*"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 \$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<sup>9</sup>. EY 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<sup>10</sup>. 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<sup>11</sup>. Auditors may provide this information through their disclosure of key or

<sup>5</sup> [Summary-FINAL.pdf \(frc.org.uk\)](#)

<sup>6</sup> [IAASB Issues Staff Audit Practice Alert on Climate-Related Risks | IFAC](#)

<sup>7</sup> [IFRS - Educational material: the effects of climate-related matters on financial statements prepared applying IFRS Standards](#)

<sup>8</sup> 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 \(ifrs.org\)](#)

<sup>9</sup> [Investor groups call on companies to reflect climate-related risks in financial reporting | PRI Web Page | PRI \(unpri.org\)](#)

<sup>10</sup> [Investor Expectations for Paris-aligned Accounts - IIGCC](#)

<sup>11</sup> 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. EY should have received copies at Engie, BHP, Deutsche Lufthansa, Equinor, Fiat Chrysler Automobiles (now Stellantis with PSA Peugeot), OMV, Royal Dutch Shell, Volkswagen, Airbus, Total (now Total Energies), PSA Peugeot (now Stellantis) and Air Liquide.

As highlighted above, we have seen some positive steps by your lead audit partner at Shell but these steps still appear to be the exception not the rule. Overall, EY is failing to ensure transparency on how climate risks are being factored in, with little detail provided on how critical assumptions and estimates are stress tested. Above all, we are concerned by the lack of an assessment of consistency with a 1.5C pathway.

This raises two important questions for investors. First, has EY 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 EY'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 EY become a signatory of the recently launched Net Zero Financial Service Providers Alliance (NZFSPA). We note EY 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 EY is not a voluntary exercise governed by a commitment that permits a potentially long phase-in period. EY 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 EY to act. From next voting season, you should increasingly expect to see investors vote against EY'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 EY Audit Board as well as the Public Interest Board.

We would welcome a dialogue with you on this matter. Please contact Natasha Landell-Mills ([natasha.landell-mills@sarasin.co.uk](mailto: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,

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

Heike Cosse, Engagement Manager  
Aegon Asset Management

Anders Schelde, CIO  
AkademikerPension

Sora Utzinger, Head of ESG Corporate Research  
Aviva Investors

Rachel Elwell, CEO  
Border to Coast Pensions Partnership

Faith Ward, Chief Responsible Investment Officer  
Brunel Pension Partnership

Wim Van Hyfte, Global Head of ESG Investments and Research  
Candriam

John W. Geissinger, CIO  
Christian Brothers Investment Services

Bess Joffe, Head of Responsible Investment  
Church Commissioners for England

Adam C.T. Matthews, Chief Responsible Investment Officer  
Church of England Pensions Board

Grégoire Haenni, Chief Investment Officer  
Caisse de prévoyance de l'État 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  
Local Authority Pension Fund Forum (LAPFF)

Gordon Ross, CIO  
LGPS Central

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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: David Thorburn, Chair, Audit Board  
Cc: Tonia Lovell, Chair, Public Interest Board  
Cc: Sir Jon Thompson, CEO, Financial Reporting Council

