

Michelle Hinchliffe
UK Chair of Audit
KPMG LLP
15 Canada Square
London E14 5GL

29 November 2022

Dear Ms. Hinchliffe,

INVESTOR EXPECTATIONS: NET ZERO-ALIGNED AUDITS

We have been in a dialogue with KPMG since January 2019 as long-term investors seeking assurance that the firm is integrating climate risks into its audits wherever material¹. Specifically, we have asked that KPMG 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 pathway². 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 regime³.

While we have seen some welcome progress in the past twelve months, we are writing again because KPMG could do more to meet investor expectations. Specifically, we would like to ask that KPMG 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-making⁴.

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 statements⁵. 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.

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

We set out in our previous correspondence the regulatory and legal backdrop to our call for KPMG to act⁶. 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 2022/2023⁷; the FRC published a review in July 2022 that underlined areas of weakness when it comes to complying with accounting requirements⁸; and the US Securities and Exchange Commission has consulted on climate-related disclosure requirements in financial statements⁹.

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 investors¹⁰.

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/ec6d6b2-7f4d-4a70-bf60-32b07143e1/FRC-CRR-Year-End-KKPMG-Matters_0ctober-2021.pdf](#)

⁷ [https://www.frc.org.uk/news/december-2021-\(1\)/frc-announces-areas-of-supervisory-focus;](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.

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 KPMG 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 KPMG’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 KPMG Audit Board and the Public Interest Committee. 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
Candriam

Darren Xiberras, Chief Finance Officer
Cardiff University

Sarah Davidson, Chief Executive
Carnegie UK

Rev Dr Andrew Harper
CFB & Epworth Investment Management Ltd

Rachel Hewitt, Chief Finance Office
ClientEarth

Mrs Mel Avis, CEO
Congregation of Jesus Charitable Trust

Carolyn Sawers, Chief Executive
Corra Foundation

Stephen Willis, Chief Finance Office
Durham University

Stewart Adkins, Trustee & Chair of Investment
Committee
Elijah’s Pot CIO

Craig Martin, Chief Pensions Officer
Environment Agency Pension Fund

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

Vincent Kaufmann, CEO
Ethos Foundation



Peter Redhead, Chair of Trustees
Francis C Scott Charitable Trust

Eoin Fahy, Head of Responsible Investing
KBI Global Investors

Cllr Doug McMurdo, Chair
Local Authority Pension Fund Forum

Dewi Dylander, Underdirektør
PKA

Matt Crossman, Stewardship Director
Rathbones Group PLC

Rachel Harris, Director of Finance
Royal College of Music

Dr Julian Elford, Treasurer & Chair of Finance
and Investment Committee
Royal College of Radiologists

Dame Sarah Springman FREng, Principal
St Hilda's College, Oxford

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
The Salvation Army

Claire Berthier, CEO
Trusteam Finance

Andrew Lang, Chief Financial Officer
University of Bradford

Jane Madeley, Chief Financial Officer
University of Leeds

David Russell, Head of Responsible Investment
USS Investment Management

David Ireland, Chief Executive
World Habitat

Cc: Claire Ighodaro, Chair, Audit Board, KPMG

Cc: Lord Evans of Weardale, Chair, Public Interest Committee, KPMG

Cc: Sir John Thompson, CEO, FRC

