Office of the Secretary
PCAOB
1666 K Street, NW, Washington, DC 20006-2803

June 10, 2022

Re: **Request for Comment, Post-Implementation Review, Interim Analysis of Estimates and Specialists Audit Requirements**

Dear Chair Williams,

On behalf of Public Citizen, a national advocacy group with thousands of retail investors among its membership, and Americans for Financial Reform, we appreciate the opportunity to comment on this Interim Analysis of Estimates and Specialists Audit Requirements. Our response addresses Questions 1 and 2 for investors under "Auditing Accounting Estimates, Including Fair Value Measurements" and "Auditor's Use of the Work of Specialists."

The updates have not achieved needed improvements to audit quality with respect to climate-impacted accounting estimates or the use of specialists. The underlying deficiencies in development of financial statements, as well as the lack of acknowledgment of any issues in PCAOB-governed audit reports, threatens to undermine investor confidence in financial statements. The recent proposed rule on climate-related disclosures by the Securities and Exchange Commission (SEC) reflects that investors do not have the information they need to trust the financial statements of companies facing significant effects from climate-related risk. The PCAOB must rapidly clarify that auditors must assess the effects of climate-related risk in their reviews of accounting estimates and must consider climate impacts to be an area of higher audit risk, necessitating greater scrutiny of reliance on company-employed specialists who may exhibit management biases.

1. **Companies are not adequately incorporating climate-related risk when developing accounting estimates.**

Climate-related risk refers to both the physical impacts of climate change and the energy transition, which can have material effects on a company's immediate financial condition and long-term business outlook. According to Willie Botha, Technical Director for the International Auditing and Assurance Standards Board (IAASB): "climate-related-events or conditions are impacting entities worldwide."[1] Along with IAASB, both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have confirmed that companies must account for climate-related risks when preparing their financial statements.[2] FASB, for instance, has said that "an entity may consider certain ESG matters as an input to an accounting analysis; for example, a material decline in demand during the reporting period may be a consideration when estimating future cash flows used in a long-lived asset or goodwill impairment analysis."[3] The Securities and Exchange Commission has approvingly cited these existing requirements in prescribing the form and content of disclosure for climate-related financial assumptions and estimates.[4]

Under these existing requirements, where climate-related risks are material, they should be integrated into drawing up company accounts. Based on guidance from accounting standard setters, climate-related financial statement assumptions that are quantitatively or qualitatively material should be disclosed under US GAAP, and those assumptions should be consistent with statements made elsewhere in a registrant's annual filings. The standard setters have also highlighted a non-exhaustive list of instances where climate-related matters are relevant to estimates and assumptions including:

- Sources of estimation uncertainty, such as estimates of future cash flows when testing an asset for impairment or estimates of expenditures required to settle decommissioning obligations.
- Any material uncertainties related to events or conditions that cast doubt upon a company's ability to continue as a going concern, as well as any significant judgments involved in concluding that no such doubt exists.
- The obsolescence of inventory, its selling price, or costs of completion, as well as how those inform the net realizable value of inventory.
- The estimated residual value and expected useful lives of assets, because of obsolescence, legal restrictions, or inaccessibility.
- Exposure to credit losses caused by severe weather and transition activities' effects on a borrower's ability to meet debt obligations or the value of collateral.

[1] International Auditing and Assurance Standards Board (IAASB). 2020. "IAASB issues staff audit practice alert on climate-related risks." Press Release, October 1, 2020. https://www.iaasb.org/news-events/2020-10/iaasb-issues-staff-audit-practice-alert-climate-related-risks.

[2] International Financial Reporting Standards Foundation (IFRS). 2020. "Effects of Climate-Related Matters on Financial Statements." IFRS, November, 2020. https://www.ifrs.org/content/dam/ifrs/supporting-implementation/documents/effects-of-climate-related-matters-on-financial-statements.pdf#:~:text=IFRS%20Standards%20do%20not%20refer%explicitly%20to%20climate-related,significant%20judgements%20and%20estimates%20that%20%20has%20made.
Financial Accounting Standards Board (FASB). 2021. "Intersection of Environmental, Social, and Governance Matters with Financial Accounting Standards." FASB, March 19, 2021. https://www.fasb.org/page/ShowPdf?path=FASB_Staff_ESG_Educational_Paper_FINAL.pdf&title=FASB%20Staff%20Educational%20Paper-Intersection%20of%20Environmental..

[3] See FASB, *supra* note 2.

[4] The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334, 21362 (April 11, 2022).

US GAAP also already requires discussion of estimates when it is reasonably possible that the estimates will change within one year and that the change will be material.[5] For industries with significant exposure to either the effects of changing climate (e.g., agriculture, real estate), the energy transition (e.g., oil and gas, petrochemicals) or both (e.g., finance, insurance), this likely already requires nearly annual updating and disclosure of changes to key assumptions based on the progress of the energy transition. IAASB has encouraged auditors to take this into account, noting that "new models may need to be developed to capture the effects of the changing climate" and that climate change may change the degree to which accounting estimates are subject to subjectivity.[6]

A recent study by climate accounting watchdog the Carbon Tracker Initiative (Carbon Tracker) has concluded that even for firms where climate-related risk is unquestionably material—such as oil and gas companies whose viability is based on certain commodity price levels threatened by the transition—these requirements for financial statement disclosures are likely not being properly followed.[7] To date, only a small percentage of registrants in the most climate-impacted industries who report using US GAAP are disclosing the effect of climate-related risks on their assumptions and estimates.[8] Only 13% of companies studied avoided a rating of "significant concern" based on Carbon Trackers assessment of their disclosures.[9] Given the direct financial impact these assumptions and estimates have as well as investors' interest in the information, the lack of disclosure should raise concerns about whether companies are actually incorporating climate-related risks into their estimates.

Investors have expressed their need for this information to better understand how a company is affected by climate-related impacts. These estimates and assumptions provide perhaps the single clearest view into those effects and management's assessment of future impacts. Reflecting this need, in 2020, a large consortium of investors representing over $100T in global assets under management called on companies and their auditors to consider climate in their 2020 financials and audits thereof.[10]

Among the reasons investors need this information is that the collective failure of firms to adapt to climate-related risks has created market-wide inefficiencies and near ubiquitous mispricing.[11] As much as 93 percent of the U.S. equities market is exposed to

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[5] Ross, Samantha. 2021. *Lifting the Veil: Investor Expectations for Paris-Aligned Financial Reporting at Oil and Gas Companies.* Boston, MA: Ceres. https://www.ceres.org/sites/default/files/reports/2021-05/Ceres%20Lifting%20the%20Veil%20Oil%20and%20Gas%205.18.pdf, at 6.

[6] International Auditing and Assurance Standards Board (IAASB). 2020. "Staff Audit Practice Alert: The Consideration of Climate-Related Risks in an Audit of Financial Statement", October 1, 2020. https://www.ifac.org/system/files/publications/files/IAASB-Climate-Audit-Practice-Alert.pdf at 9.

[7] Carbon Tracker Initiative. 2021. *Flying Blind: The Glaring Absence of Climate Risks in Financial Reporting.* London: Carbon Tracker Initiative. https://carbontracker.org/reports/flying-blind-the-glaring-absence-of-climate-risks-in-financial-reporting/.

[8] *Id.* at 23.

[9] *Id.* at 23.

[10] See Investor groups call on companies to reflect climate-related risks in financial reporting

[11] Rhodium Group. 2019. "Clear, Present and Underpriced: The Physical Risks of Climate Change." Rhodium Group, April 3, 2019. https://rhg.com/research/physical-risks-climate-blackrock/; O'Donnell,

climate-related risk according to some estimates.[12] Globally, one study found that $1.4 trillion in assets may become worthless as a result of the transition.[13] Much of this exposure comes from carbon-intensive sectors and firms that are not taking what the credit rating agency Moody's describes as "early action" to address climate-related financial risks.[14] As Moody's explains, taking "delayed action" could increase default risks for individual firms and increase the likelihood of value destruction throughout the market. This value destruction arises in part out of the present-day misvaluation of assets that are unlikely to provide their projected economic return.

2. **Auditors are not assessing how climate-related risk affects accounting estimates, in part because of overreliance on management specialists.**

Despite the importance of and demand for assessments of climate impacts on financial statements, most PCAOB-covered audits have not visibly addressed this issue. Every PCAOB audit report reviewed by Carbon Tracker, all of which related to highly carbon-intensive companies, raised significant concerns. Not a single PCAOB audit report reviewed even appeared to consider climate, even where ISA audit reports for the same company identified a climate-related Key Audit Matter (KAM). Several of the PCAOB audit reports relied on management specialists in making this assessment or made no note of which specialists they used. The lack of climate consideration in PCAOB audit reports is especially concerning because impairment of tangible or intangible assets, which is strongly linked to climate risk, is the most frequent topic covered in critical audit matters.[15] This high level of audit risk means that the use of management specialists should be particularly scrutinized, as the new standard says that the higher the audit risk, particularly in areas that rise to the level of being Critical Audit Matters (CAMs), the more persuasive the evidence from a specialist's work needs to be.[16]

There is mounting global evidence that investors in US securities may be relying on financial statements that are based on undisclosed and overly rosy assumptions. This is contrary to the purposes of PCAOB's auditing accounting estimates standard, which is intended to enhance auditors' procedures to address management bias. International

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Grace. 2021. "ESG: The Majority of Climate Risk Repricing 'Is Yet to Occur,' Strategist Says." *Yahoo News*, December 9, 2021, sec. Finance.
https://news.yahoo.com/climate-risk-repricing-to-occur-strategist-131339540.html; O'Donnell, Grace. 2021. "Only 6% of Financial Firms Think Climate Risk Is Fully Priced In: GARP Survey." *Yahoo News*, October 6, 2021, sec. Finance.
https://finance.yahoo.com/news/financial-firms-climate-risk-garp-survey-155453199.html.

[12] Herren Lee, Allison. 2020. "Big Business's Undisclosed Climate Crisis Plans." *New York Times*, September 27, 2020, sec. Opinion.
https://www.nytimes.com/2020/09/27/opinion/climate-change-us-companies.html.

[13] Semieniuk, Gregor, et al. 2022. "Stranded Fossil-Fuel Assets Translate to Major Losses for Investors in Advanced Economies." *Nature Climate Change.* https://www.nature.com/articles/s41558-022-01356-y.

[14] Moody's On Climate. N.d. *Ready or Not? Sector Performance in a Zero-Carbon World.* Moody's. https://www.moodys.com/sites/products/ProductAttachments/Moodys_ReadyOrNot.pdf.

[15] Flying Blind, *supra* note 7 at 31.

[16] Public Company Accounting Oversight Board (PCAOB). 2019. "Staff Guidance: Using the Work of a Company Specialist" at 7. August 22, 2019.
https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/standards/documents/staff-guidance-using-work-companys-specialist.pdf?sfvrsn=5a504ee_0.

standard setters and auditors have called attention to this developing risk area. The IAASB's 2020 Staff Audit Practice Alert specifically instructed auditors to consider how all entities might be affected by climate change, because of impacts on supply chains or changes to customer preferences, financing, insurance, and laws and regulations.[17] Indeed, IAASB Technical Director Willie Botha noted that "while the phrase 'climate change' does not feature in the ISAs, the auditor's responsibilities…encapsulate the consideration of events or conditions relevant to the misstatement of amounts and disclosures in an entity's financial statement, which would include climate-change risk."[18]

The IAASB also highlighted specific existing auditing standards where auditors could consider the implications of climate-related risks, including materiality, response to assessed risks, and auditing accounting estimates and related disclosures. With such explicit guidance in place, audits performed under IAASB standards are far more likely to identify climate-related key audit matters than those performed under PCAOB standards.[19] Auditors that operate under both standards have provided no principled rationale for the failure of US audit reports to acknowledge these risks.

Some auditors using ISA standards are also beginning to recognize the way that climate-related matters can affect key assumptions and estimates for companies most exposed to climate change and the energy transition. For instance, Shell's audit report under ISA standards explicitly discussed the auditor's procedures to address the risk associated with critical accounting estimates impacted by climate risks and the energy transition, including the estimation of oil and gas reserves, the useful economic lives of assets, the recognition of decommissioning and restoration obligations, and climate change-related litigation.[20] Many of these assumptions are influenced by the estimation of future oil and gas prices, which the auditor noted is subject to increased uncertainty. Yet despite this risk, Shell's US audit did not include a discussion of climate change and the energy transition in its CAMs.[21] In at least three other audit reports for large companies listed in both the US and Europe, auditors removed all references to climate change in the reports filed under PCAOB standards from reports filed for the same companies under ISAs.[22] There does not appear to be a prohibition on including discussion of climate-related matters in CAMs and the auditors have not identified any clear basis for excluding such matters. <u>Investors cannot have confidence in PCAOB audit reports if they continue to ignore or actively omit material information about climate-related risk's effect on accounting estimates in ways that make the reports less informative.</u>

There is some evidence that a similar international divide may exist in the use of management specialists to assess the validity of climate-related accounting estimates. Both Exxon and Apache's PCAOB auditors used management specialists in assessing

[17] IAASB, *supra* note 6.
[18] IAASB, *supra* note 1
[19] Flying Blind, *supra* note 7 at 30.
[20] Shell, 2021. "Independent Auditor's Report."
https://reports.shell.com/annual-report/2021/consolidated-financial-statements/independent-auditors-report.html0.
[21] Flying Blind, *supra* note 7 at 30.
[22] *Id.*.

certain climate-related accounting estimates for those firms.[23] In contrast, bp's ISA auditor and Shell's (which is also Apache's) used their own climate change specialists to assess the effect of the energy transition. This reliance on management specialists to assess climate-related risk stands in contrast to PCAOB's skepticism about reliance on internal audit procedures in areas where the risk associated with those controls is high.[24] Permitting auditors to rely on management specialists to assess climate-related impacts, a potentially serious source of audit risk, threatens to undermine the objectivity of the audit and subject investors to serious risk.

3. PCAOB should update its guidance to quickly address the identified shortcomings in financial statements and audit reports.

To remedy this gap, PCAOB should immediately issue guidance calling on auditors to consider climate-related risks as part of their audits under existing requirements and to reduce their reliance on management specialists in assessing these risks. This step would reflect PCAOB's statement, at the time of adopting the standard, that it would "facilitate the development of timely guidance for specific issues when needed."[25] The PCAOB guidance should, as a matter of risk assessment, emphasize comparison of any stated emissions reductions goals with the effect achieving those goals would have on financial statement items. The guidance should also cover the lack of consistency checks across different required disclosures, lack of reporting of Critical Accounting Matters related to climate, and the removal of climate discussion from the PCAOB version of audit reports for foreign private issuers.[26] Once PCAOB adopts this guidance confirming existing requirements, it should also make it a point of emphasis in its inspections program.

PCAOB should also begin preparing additional guidance for reviewing the specific form and content of the climate-related disclosures required by the SEC's proposed rule. The standard should reiterate what is already required and apply it in the context of reviewing the newly required financial metrics and disclosures. This updated guidance should help ensure that future assessments of assumptions and estimates affected by climate-related matters meet the level of independence and diligence required elsewhere in the audit.

4. Conclusion

US and international accounting standard setters have acknowledged that climate change and the energy transition can affect the assumptions and estimates that underlie a company's financial statements. Climate-related risk is a rapidly developing form of financial risk whose financial statement impacts are not receiving enough attention from companies or auditors. As both climate change and the energy transition shift the global

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[23] Flying Blind *supra* note 7 at 33.
[24] Public Company Accounting Oversight Board (PCAOB). 2007. "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements" at ¶19. https://pcaobus.org/oversight/standards/auditing-standards/details/AS2201.
[25] Public Company Accounting Oversight Board (PCAOB). 2018, "Auditing Accounting Estimates Including Fair Value Measurements" at 40-41, (Dec 20, 2018). https://pcaobus.org/Rulemaking/Docket043/2018-005-estimates-final-rule.pdf
[26] IAASB, *supra* note 6 at 33.

economy, they will continue to drive changes in those assumptions and estimates. Yet few US reporting companies disclose any such changes to their financial statements. Despite PCAOB's new standard on estimates, there is little evidence of a consistent and rigorous review of the impacts of climate change or the energy transition on estimates in US audit reports, especially in comparison to non-US audit reports. PCAOB must update its guidance to improve disclosure of both these estimates and the risks they pose to investors.

We thank you for reviewing this comment. If you have any questions, please contact Yevgeny Shrago (yshrago@citizen.org).

Sincerely,
Public Citizen
Americans for Financial Reform Education Fund