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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC. 20006-2803

June 26, 2023

Re: General Responsibilities of the Auditor in Conducting an Audit

Dear Chair Williams,

On behalf of Public Citizen and Americans for Financial Reform Education Fund, we welcome the opportunity to respond to the Public Company Accounting Oversight Board's request for comment on General Responsibilities of the Auditor in Conducting an Audit (AS 1000).[1] The fundamental obligation of auditors in reviewing financial statements is to assure the "fair presentation" of a company's financial position that is not misleading to investors. We commend the PCAOB for proposing to extend an auditor's evaluation of fairness in AS 2810 beyond "mere technical compliance with the applicable financial reporting framework," to more broadly "prohibit the financial statements and company disclosures from being materially misleading."[2]

This proposed update is a crucial step to align PCAOB standards with over 60 years of judicial precedent holding that fair presentation requires more than adherence to generally accepted accounting principles (GAAP). The landmark case *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), decided by the Second Circuit, established the legal liability of accountants under Section 11(a) of the Securities Act of 1933.[3] It clarified that accountants are liable not only for compliance with GAAP but also for the "fair presentation" of financial statements.[4] The court held that adherence to accounting rules, while persuasive, is not necessarily conclusive evidence of good faith and absence of material falsehood or misleading statements. Since then, courts have upheld auditors' responsibility to provide assurance of "fair presentation," not merely technical compliance with GAAP.[5]

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[1] Public Company Accounting Oversight Board (PCAOB). 2023. "Proposed Auditing Standard – General Responsibilities of the Auditor in Conducting an Audit and Proposed Amendments to PCAOB Standards."
[2] *Id.* at 30.
[3] United States v. Simon, 425 F.2d 796 (1969).
[4] Mark, DeFond et al. 2018. "The Primacy of Fair Presentation: Evidence from PCAOB Standards, Federal Legislation, and the Courts." *American Accounting Association*. https://publications.aaahq.org/accounting-horizons/article-abstract/32/3/91/2361/The-Primacy-of-Fair-Presentation-Evidence-from.
[5] The Second Circuit reaffirmed that fair presentation holds primacy over GAAP compliance in *United States v. Ebbers*, 458 F.3d 110 (2d Cir. 2006). There, the court upheld that under securities law the government is not required to prove that accounting standards were violated, only that financial reports were intentionally materially misleading

In practice, accountants can easily conceal the true financial health of a company while complying with GAAP. Creative accounting lies at the core of many financial scandals. Arthur Andersen's sole focus on GAAP-compliance led to rubber-stamping Enron's fraudulent financial statements, which used loopholes in GAAP to mislead investors.[6] At the PCAOB's recent investor advisory group meeting, former Enron CFO Andy Fastow, who was convicted for his central role in the most notorious accounting scandal, stated the following:

> I'd like to talk about a distinct type of fraud, the type of fraud that occurs when companies aren't simply putting in the wrong numbers intentionally, but when companies are exploiting the rules to make their financial statements look different than reality. When this occurs, very often the government enforcement agencies will make the case look as if the company has simply been committing black and white fraud, putting in the wrong numbers.
>
> But in reality, many of these cases, where you have fraud occur—especially in large companies—[it is] because these companies are exploiting accounting rules, accounting assumptions and they're using structured finance in order to make their financial statements look healthier than they really are. ***I would emphasize again the importance of creating a distinction in the minds of auditors between what is accurate according to the rules and what is accurate in reality.***
>
> My experience in talking to a variety of auditors is that their standard is that the company is following the rules. There's an entire industry of bankers, accountants, and attorneys who do nothing but help these large companies exploit rules.[7]

To combat fraud, the PCAOB must adopt fair presentation standards for auditors that do not solely rely on technical compliance with accounting rules. Recent events have underscored the need to strengthen auditing standards to protect investors and the public. Silicon Valley Bank's collapse exemplifies how accounting choices, such as stating securities as held-to-maturity rather than presenting mark-to-market values, can hide material losses in plain sight, leading to grave harm when a firm is forced to sell assets at a fair market value for a loss.[8]

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to investors. Additionally, *United States v. Rigas*, 490 F.3d 208 (2d Cir. 2007) concluded that financial statements can be materially misleading even if a defendant complies with GAAP..

[6] Congressional Research Service (CRS). 2004. "The Enron Collapse: An Overview of Financial Issues" at 3. https://www.everycrsreport.com/files/20040812_RS21135_d3ccc53ec06a45476370a0cd5255b99c69afea08.pdf ("Enron's auditor, Arthur Andersen, not only turned a blind eye to improper accounting practices, but was actively involved in devising complex financial structures and transactions that facilitated deception.")

[7] Public Company Accounting Oversight Board - PCAOB, *3/9/23 Investor Advisory Group Meeting (Part 1 of 2)*, YouTube (Mar. 13, 2023), https://www.youtube.com/watch?v=3eFSFNtdYz0.

[8] Eaglesham, Jean. 2023. "Auditors Didn't Flag Risks Building Up in Banks." *Wall Street Journal,* April 10, 2023. https://www.wsj.com/articles/auditors-didnt-flag-risks-building-up-in-banks-6506585c; Lugo, Denise. 2023. "Silicon Valley Bank's Failure Sparks Speculation that FASB Accounting Rules for Held-to-Maturity Debt

The ubiquitous gaming of GAAP obscures and distorts financial reporting and has contributed to past systemic financial crises.[9] At present, these practices are obscuring the growth of climate-related financial risks associated with stranded assets that are systematically and materially misrepresented in financial statements. Consequently, coal, oil, and gas companies are able to mask the risks associated with stranded assets, the systematic overvaluation of which is commonly referred to as the "carbon bubble." A global study indicated that the carbon bubble will result in $1.4 trillion in assets becoming worthless in a low-carbon economy.[10] Regrettably, auditors have been slow to identify and disclose corporate climate-related financial risks and raise critical audit matters.[11]

The climate crisis and the economy-wide decarbonization transition are creating new incentives and opportunities for companies to misrepresent their financial position while remaining GAAP compliant. For example, many companies today are making net-zero commitments that they opine on in their 10-Ks but fail to substantiate in their financial statements. To address this misleading conduct, the PCAOB must bridge the existing gap between "accuracy according to the rules" and "accuracy in reality" by charging auditors with an explicit responsibility to look beyond mere compliance with GAAP, and to assure the fair presentation of climate-related financial risk. In addition, the PCAOB should direct auditors to look more closely at the alignment between climate commitments and actual financial statements. The adoption of fair presentation auditing standards, with greater enforcement by the PCAOB, is essential to help auditors avoid past mistakes and stop facilitating what amounts to financial fraud. For instance, existing accounting standards permit potentially misleading climate-related accounting estimates and assumptions to determine future cash flows and valuations of carbon-intensive assets. In addition, accounting norms allow energy companies to hide significant off-balance-sheet liabilities: asset retirement obligations and environmental liabilities.

Accounting estimates and assumptions are obscuring climate-related financial risks.

Unsound climate-related accounting estimates and assumptions pose a significant risk to the fair presentation of financial statements. Overly rosy accounting assumptions and estimates in

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Securities Should be Revised" *Reuters,* March 12, 2023, sec. Tax & Accounting. https://tax.thomsonreuters.com/news/silicon-valley-banks-failure-sparks-speculation-that-fasb-accounting-rules-for-held-to-maturity-debt-securities-should-be-revised/.

[9] U.S. Securities and Exchange Commission (SEC). 2011. "Testimony Concerning the Role of the Accounting Profession in Preventing Another Financial Crisis." https://www.sec.gov/news/testimony/2011/ts040611jlk.htm

[10] 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; 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.

[11] 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/.

financial statements fail to reflect the future viability and valuation of carbon-intensive assets. Certain line items in the financial statements are calculated using estimates and assumptions about the future. To determine these estimates and assumptions, accounting rules sometimes allow backwards looking assessments—historical assumptions of carbon pricing and fossil fuel use that may overestimate future cash flows and underestimate stranded asset risk.[12]

Relying on historical cost or conservative models does not adequately account for the potential devaluation of assets resulting from energy transition risks. Several factors will lead to shorter estimated useful lives for productive assets or changes to the assumptions used to determine expected future cash flows for impairment testing, including declining demand for oil and gas, the switch to renewable energy, regulations to limit emissions, and the phase out of internal combustion engines.[13] By relying on unsound assumptions, companies are ignoring transition risk, and this can result in overstating assets and understating liabilities. For example, in 2020, BP wrote off $17.5 billion in oil and gas assets due to its forecasts of an accelerating transition away from fossil fuels, a material impact to a fossil fuel company's projected valuations.[14] This highlights the fact that fossil fuel companies often significantly overvalue their assets in their financial statements.

Unreasonable assumptions and estimates significantly change asset valuations and impairment tests in financial statements, effectively concealing the stranded asset risk faced by energy companies. In a recent SEC enforcement action, auditors at KPMG were fined $1 million for rubber-stamping Miller Energy Corporation's inaccurate estimates that served to overvalue its oil and gas reserves by $400 million.[15] A 2013 survey showed that 74% of KPMG employees in the energy and natural resources department had knowledge of misconduct in the industry.[16] The failure of KPMG highlights the need for increased guidance from the PCAOB on fair presentation to prevent auditors from becoming complicit in fossil fuel misrepresentations and fraud. Auditors' duty of fair presentation should extend to assessing the sensitivity of

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[12] 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 20.

[13]Jenkins, J.D., et al. 2022. *Preliminary Report: The Climate and Energy Impacts of the Inflation Reduction Act of 2022*. Princeton, NJ: REPEAT Project. https://repeatproject.org/docs/REPEAT_IRA_Prelminary_Report_2022-08-04.pdf. The REPEAT Project estimates that a decrease in U.S. consumption of petroleum products and natural gas could lead to a reduction of roughly 5% in crude oil prices and a decrease of approximately 10-20% in U.S. natural gas prices by 2035.

[14] Reuters Staff. "BP to write off up to $17.5 bln after reduced oil price forecast." *Reuters*, June 15, 2020, sec. Integrated Oil & Gas. https://www.reuters.com/article/bp-writeoffs/bp-to-write-off-up-to-17-5-bln-after-reduced-oil-price-forecast-idUSL8N2DS0VA

[15] National Whistleblower Center. 2020. *Exposing a Ticking Time Bomb: How Fossil Fuel Industry Fraud is Setting Us Up for a Financial Implosion – and What Whistleblowers Can Do About It.* Washington: National Whistleblower Center at 25. https://www.whistleblowers.org/wp-content/uploads/2020/07/NWC-Climate-Risk-Disclosure-Report.pdf.

[16] *Id.* at 26.

climate-related estimates and assumptions in a companies' financial statements, in a manner free from management's biased risk assumptions, and verifying that companies are in alignment with their own climate-related commitments.

In response to Enron-era accounting fraud, the SEC issued guidance to reduce the use of unreasonable estimates, including a requirement that companies disclose significant estimates and assumptions that affect their financial statements. An SEC memo clarifies as follows:

> A company should address material implications of uncertainties associated with the methods, assumptions and estimates underlying the company's critical accounting measurements…When preparing disclosure under the current requirements, companies should consider whether they have made accounting estimates or assumptions where:
> - the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and
> - the impact of the estimates and assumptions on financial condition or operating performance is material.[17]

Accounting measurements, as the SEC notes, could reflect material errors due to the uncertainties associated with estimates or assumptions or due to difficult to accurately measure value. The SEC requires that a company clearly explain the reasons for its accounting estimates or assumptions, which includes "analyzing factors such as the methodology used to arrive at the estimate, the historical accuracy of the estimate/assumption, the extent of past changes to the estimate/assumption, and the likelihood of future changes."[18]

Under these existing requirements, auditors' lack of disclosure surrounding misleading climate-related estimates and the sensitivity of assumptions associated with carbon-intensive assets and liabilities constitutes a failure to fairly present financial statements to investors. Climate-related risks are material and should be integrated into their financial statements. The following are instances where auditors should assess how climate-related matters are relevant to estimates and assumptions:

- 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.

[17] U.S. Securities and Exchange Commission (SEC). 2003. "Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations." https://www.sec.gov/rules/interp/33-8350.htm.
[18] *Id.*.

- Any material uncertainties related to events or conditions that cast doubt on 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 factors 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 or transition activities' effects on the value of collateral or a borrower's ability to meet debt obligations.

To reasonably assure fair presentation, auditors should aid in disclosing and providing transparency around the sensitivity and accuracy of climate-related estimates and assumptions. A study from Carbon Tracker found that few companies that use GAAP disclose the effect of climate-related risks on their assumptions and estimates, which raises concerns about the extent to which companies are truly integrating climate-related risks into their estimation practices.[19]

Carbon-intensive companies' are using creative accounting to conceal environmental liabilities and asset retirement obligations.

Asset retirement obligations (AROs) are legal and financial obligations associated with the retirement of long-lived assets, such as wells, pipelines, mines, power plants, or other carbon-intensive infrastructure. These obligations can include, but are not limited to, oil well plugging and underground storage tank removal. AROs are a significant cost for oil and gas companies. In 2006, Standard & Poor's estimated that 50% of European fossil fuel companies' debt obligations were AROs.[20] Yet these costs are largely hidden. Fossil fuel companies fail to disclose their environmental decommissioning liabilities to remove or remediate pollution or contamination, and asset retirement obligations in their financial statements by using accounting practices that are unreasonable but technically GAAP-compliant.[21]

Auditors should disclose these liabilities to fairly present an energy company's financials, but PCAOB-compliant audits rarely question the lack of disclosures of oil and gas companies' AROs. Instead, most auditors rubber stamp companies' misrepresentation of fossil fuel liabilities, keeping investors in the dark over significant and material asset retirement obligations and environmental remediation liabilities.

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[19] Flying Blind, *supra* note 8 at 23.
[20] Carbon Tracker Initiative. 2020. *Flip Side: How Stranded Assets Will Give Rise to Stranded Liabilities.* London: Carbon Tracker Initiative.
https://carbontracker.org/wp-content/uploads/2020/02/Decommissioning-Analyst-Note_vwebsite-1.pdf?lang=ja, at 2.
[21] Ross, Samantha. 2021. *The Role of Accounting and Auditing in Addressing Climate Change.* Washington: Center for American Progress,
https://www.americanprogress.org/article/role-accounting-auditing-addressing-climate-change/.

One such misleading technique entails discounting AROs over the span of 60 to 80 years, a timeline unrealistic for net-zero goals. Some companies, like Valero Energy Corporation, provide no disclosure of AROs by claiming that it has no ability to estimate the retirement of its fossil fuel assets. In Valero's annual report, it claims: "It is our practice and current intent to maintain all our assets and continue making improvements to those assets based on technological advances. As a result,we believe that assets at our refineries and plants have indeterminate lives for purposes of estimating asset retirement obligations because dates or ranges of dates upon which we would retire such assets cannot reasonably be estimated at this time."[22] Energy companies use spurious claims of indeterminate life to keep massive ARO liabilities off their balance sheets. Some auditing firms, such as Deloitte, are starting to signal that the concept of "indeterminate life" should only be used in rare circumstances. But in practice, most auditors permit fossil fuel companies' use of misleading accounting.[23]

As the energy transition speeds up, companies will increasingly need to recognize asset retirement obligations previously thought to have indefinite or unrealistically long lifespans. Carbon Tracker estimates that premature asset retirements for the seven super oil majors alone (BP, Chevron, ENI, Exxon, Shell, Total, and ConocoPhillips) could cause costs and commitments to soar from a reported $87 billion to a staggering $294 billion.[24] This is a clear instance of companies misleading investors about their financial health by failing to disclose liabilities they will face due to the energy transition. Many carbon-intensive assets will require earlier retirement than anticipated in previous audited financial statements. Consequently, auditors will need to accelerate the recognition of decommissioning costs and asset retirement obligations, leading to a sudden increase in reported liabilities.[25] For now, energy companies are pushing AROs off their balance sheets and delaying recognizing the cost of these liabilities due to accounting and audit failures. PCAOB fair presentation standards should spur auditors to recognize that AROs are often unreasonably—and misleadingly—minimized in statements that technically comply with GAAP.

Investors at Exxon have already put forth a shareholder resolution to request a full disclosure of the quantitative impact of off-balance-sheet asset retirement obligations in a net-zero by 2050 scenario.[26] Investors—and more scrupulous accounting firms—recognize this information is financially material. Unfortunately, a study from the Government Accountability Office determined that without access to company records, it is extremely difficult to evaluate an oil and

[22] Valero, 2022. "Form 10-K." https://www.sec.gov/ix?doc=/Archives/edgar/data/0001035002/000103500223000027/vlo-20221231.htm.
[23] Deloitte, 2022. "Environmental Obligations and Asset Retirement Obligations" at 83. https://dart.deloitte.com/USDART/pdf/b702f3de-7b0f-11e8-85b9-f5946165e692
[24] Flip Side, *supra* note 16 at 1.
[25] The Role of Accounting and Auditing in Addressing Climate Change, *supra* note 17.
[26] Carbon Tracker Initiative. 2023. *Carbon Tracker Initiative's Response to Exxon's 14A filing*. London: Carbon Tracker Initiative. https://carbontracker.org/response-to-exxons-14a-filing/.

gas company's environmental remediation liabilities and asset retirement obligations.[27] Auditors have access to company information and can require transparent disclosure of liabilities. But auditors rarely question oil and gas companies' ARO disclosures when adhering solely to compliance standards. Without auditors flagging undisclosed liabilities, financial statements do not fairly present a company's financial health.

Conclusion

PCAOB auditors have a responsibility to be independent and skeptical of management's financial statements. This begins with addressing GAAP-compliant mispricing of assets and liabilities, including those associated with climate-related estimates and hidden or understated AROs. To foster a more transparent, sustainable, and resilient financial system, auditors must bridge the gap between companies' climate-related commitments, many of which are discussed in SEC filings, and how they represent climate-related financial risks in their financial statements. Auditors must disrupt this pattern of overvaluing assets and understating liabilities that misleads investors by giving them an inaccurate understanding of the financial viability of fossil fuel companies. Without strong PCAOB fair presentation standards that go beyond technical GAAP compliance, auditors are enabling greenwashing, and in some instances, accounting fraud. The PCAOB's guidance on the responsibilities of auditors should codify the spirit of the law by directing auditors to opine on fair presentation of climate risks in financial statements, beyond just GAAP compliance.

For questions, please contact Mekedas Belayneh at mbelayneh@citizen.org and Clara Vondrich at cvondrich@citizen.org.

Sincerely,

Public Citizen
Americans for Financial Reform Education Fund

[27] Government Accountability Office (GAO). 2004. "Environmental Disclosure: SEC Should Explore Ways to Improve Tracking and Transparency of Information, United States Government Accountability Office: Report to Congressional Requesters."