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

March 18, 2024

Re: Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations

Dear Chair Williams and PCAOB Board Members,

On behalf of Public Citizen and the undersigned groups, we urge the strengthening and finalization of the Public Accounting Oversight Board's ("PCAOB") proposal to update AS 2405, *A Company's Noncompliance with Laws and Regulations*, and AS 2110, *Identifying and Assessing Risks of Material Misstatement*.[1] The climate crisis and the economy-wide decarbonization transition are creating new incentives, risks, and opportunities for companies to misrepresent their financial position. Auditors serve as a "public watchdog" to reasonably assure the absence of material misstatements and financial fraud.[2] With a focus on the growing material threat of climate change to corporations and their investors, PCAOB should direct auditors to scrutinize companies' systemic noncompliance with environmental laws and regulations, that leads to the overestimation of assets and understatement of liabilities. Auditors too often have served as enablers of corporate misconduct rather than bolstering social trust to investors and the public writ large.

The fundamental obligation of auditors in reviewing financial statements is to ensure that there are no material misstatements of a company's financial position. By directing auditors to identify all applicable laws and regulations—including new environmental regulations and corporate disclosure regimes on climate-related risks—and to examine more sources of publicly available information about a company's operations, strategy, and financials, the proposed rule will align guidance with auditors' implicit role to detect fraud and noncompliance that give rise to material misstatements in financial reporting. The proposal also rightly tasks auditors to evaluate and bolster a company's internal controls, the first line of defense to identify and detect fraud and noncompliance, such as the treatment of whistleblowers. To promote a sustainable and resilient financial system, auditors must fulfill their critical role of preventing material misstatements and detecting noncompliance with laws and regulations.

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[1] Public Company Accounting Oversight Board (PCAOB). 2023. "Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations"
[2] *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984)

Increased detection of noncompliance and fraud yields greater benefits than the costs associated with regulatory compliance among auditors. A recent study estimated that only about one third of corporate fraud is detected, and that undetected and detected fraud combined annually causes a 1.6% equity value loss, totaling $830 billion in 2021.[3] This estimate does not account for the societal spillovers from fraud and noncompliance with laws and regulations that have resulted in greater harm to the public. For instance, at the firm level, the consequences of fraud impacts lower-level employees, who often aren't involved in the wrongdoing, but suffer from financial instability due to reduced wages or lost work.[4] In addition, the frequent noncompliance with environmental and occupational standards has resulted in rampant health and safety risks for workers and communities. A heightened vigilance in fraud and noncompliance detection can safeguard investments from corporate misconduct and capital losses stemming from financial fraud, as well as deter illegal acts and allow for prompt remediation of societal harms to communities and workers.

Specifically, the proposal emphasizes auditors' duty to evaluate and identify compliance with environmental regulations. Fossil fuel companies have failed to comply with environmental laws and regulations that require disclosing their environmental decommissioning liabilities to clean up or remediate pollution or contamination in their financial statements.[5] This has led to underestimation of environmental liabilities due to oil and gas companies using creative accounting to keep massive legal liabilities, asset retirement obligations (AROs) and environmental remediation liabilities (ERLs), off their balance sheets and hidden from investors. For instance, in North Carolina, growing concerns about Duke Energy Corporation's coal ash ponds contaminating waterways and drinking water prompted communities to pursue legal action over environmental damages due to exposure to hazardous waste. Consequently, Duke Energy company reached a $1.1 billion settlement agreement to clean up its coal ash ponds, resulting in a net income decreased to $1.37 billion in 2020 compared to $3.755 billion in 2019.[6]

Ongoing community organizing that challenges the social license of fossil fuel companies over harms to communities, especially communities of color, together with litigation risk over financial remediation for environmental cleanup, will force companies to confront environmental liabilities that they are neglecting to include in their financial statements.[7] Oil and gas

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[3] Dyck, I.J & Morse, A. 2023. *How Pervasive is Corporate Fraud?* George J. Stigler Center for the Study of the Economy & the State. http://dx.doi.org/10.2139/ssrn.4590097.
[4] Choi, J. & Gipper, B. 2024. *Fraudulent financial reporting and the consequences for employees.* Journal of Accounting and Economics. https://www.sciencedirect.com/science/article/pii/S016541012400003X?via%3Dihub,
[5] 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/.
[6] North Carolina Utilities Commission. 2021. *Coal Combustion Residuals Settlement Agreement.* https://starw1.ncuc.gov/NCUC/ViewFile.aspx?Id=53aa44a2-73e0-4908-8c9e-b7fc1663d5e2
[7] Davis, R., & Franks, D. M. 2014. *Costs of Company-Community Conflict in the Extractive Sector (*Corporate Social Responsibility Initiative Report No. 66). Harvard Kennedy School. http://www.csrm.uq.edu.au/media/docs/603/Costs_of_Conflict_Davis-Franks.pdf.

companies' concealment of environmental liabilities underscores the necessity for auditor vigilance to detect and identify environmental noncompliance.[8] By proactively uncovering financial liabilities stemming from health and environmental harms, auditors can safeguard investors from potential material misstatements while enabling impacted communities to access financial compensation for corporate misconduct.

Noncompliance with existing laws and regulations is leading to increasing scrutiny of fossil fuel and other extractive industries' environmental harms, human rights abuses, and Indigenous rights violations.[9] Yet, auditors often rubber stamp companies' misrepresentation of fossil-fuel-related litigation and environmental liabilities, and investors remain in the dark over significant and material risk from noncompliance with laws and regulations. For example, the Dakota Access Pipeline's (DAPL) final costs exceeded $7.5 billion when initial project estimates were $3.8 billion.[10] Increased expenses stemming from legal challenges and social unrest are often underestimated or unaccounted for in estimates and assumptions, and subsequently unchecked by auditors. The proposal's renewed attention to contingent liabilities will prevent material misstatements of the true cost of fossil fuel-related projects and offer investors a clearer understanding of the risks involved with fossil fuel-related projects.

As the energy transition accelerates, driven by the climate crisis and a rapidly evolving regulatory environment, fossil fuel companies' rosy accounting in financial statements will fail to reflect realistic assumptions and estimates for future cash flows and asset valuations. In addition, new climate regulation at the state, federal, and international levels will create new risks of material misstatements of asset valuations.[11] The PCAOB should underscore— as shown through the recent substantial write-downs in the oil and gas industry— that reliance on estimates and assumptions tied to past conditions is no longer an acceptable proxy for the many forward-looking estimates and assumptions required, such as remaining useful lives and recoverable values in impairment testing.

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 on a fossil fuel company's projected

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[8] Carbon Tracker Initiative. 2021. *Flying Blind: The Glaring Absence of Climate Risks in Financial Reporting.* London: Carbon Tracker Initiative.

[9] Davis, R., & Franks, D. M. 2014. *Costs of Company-Community Conflict in the Extractive Sector (*Corporate Social Responsibility Initiative Report No. 66). Harvard Kennedy School. http://www.csrm.uq.edu.au/media/docs/603/Costs_of_Conflict_Davis-Franks.pdf.

[10] Fredericks, C. F., Meaney, M., Pelosi, N., & Finn, K. R. 2018. *Social cost and material loss: The Dakota Access Pipeline*. First Peoples Worldwide. https://www.colorado.edu/program/fpw/sites/default/files/attachedfiles/social_cost_and_material_loss_0.pdf

[11] 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.

valuations.[12] This year, due to new climate policies in California and contingent environmental liabilities in the Gulf of Mexico, Chevron wrote down over $3.5 billion in assets.[13] Despite these examples, oil and gas companies are still generally ignoring transition risk and materially overvaluing their assets, increasing the likelihood of noncompliance with emerging climate-related regulations. Auditors should update their assumptions to align with the emerging regulatory environment and ensure fossil fuel firms are doing the same in their asset valuations.

Moreover, companies today are making net-zero commitments in public statements and corporate sustainability reports, but often fail to substantiate these claims in their 10-Ks and financial statements. Various public oil and gas companies and financial firms have committed to achieving net-zero greenhouse gas emissions by 2050, while their financial statements estimate future cash flows from certain fossil fuel assets and investments based on them having "indefinite lives" with decommissioning "more than 50 years away."[14] Put simply, many firms are using public climate-related commitments to attract investors, customers, employees, and to generate positive press, while not attempting to actually achieve those goals, and in many cases privately pursuing opposing strategies.[15]

The mismatch between corporate sustainability pledges and business practices is a significant source of greenwashing and investor confusion. To address this misleading conduct, we strongly support the proposal's language to charge auditors with an explicit responsibility to look beyond the financial statements to probe inconsistencies and material misstatements between publicly stated commitments and internal strategy. The PCAOB should direct auditors to look more closely at the alignment between sustainability disclosures, public climate commitments, decarbonization strategies, and SEC filings.[16]

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[12] 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

[13] Joe Ryan, "Chevron blames a $4 billion writedown mostly on California's regulations as its war with the state's Democratic-led government heats ups," January 2024,
https://fortune.com/2024/01/02/chevron-4-billion-writedown-california-regulations-democratic-led-government/.

[14] 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/.

[15] CarbonBrief, "Oil Majors not walking the talk on climate action, study confirms," Feb 16, 2022.
https://www.carbonbrief.org/oil-majors-not-walking-the-talk-on-climate-action-study-confirms/;
Houston Chronicle, "Big Oil companies renege on climate change promises, inviting government regulations," June 19, 2023.
https://www.houstonchronicle.com/business/columnists/tomlinson/article/shell-bp-climate-break-promises-18152812.php;
The Guardian, "Big Oil quietly walks back on climate pledges as global heat records tumble," July 16, 2023,
https://www.theguardian.com/us-news/2023/jul/16/big-oil-climate-pledges-extreme-heat-fossil-fuel.

[16] Net Zero Tracker, "Net Zero Stocktake 2023," June 2023.
https://ca1-nzt.edcdn.com/Reports/Net_Zero_Stocktake_2023.pdf?v=1689326892

To ensure the fair presentation of financial statements, auditors must at the very least evaluate the efficacy of a company's internal controls to detect and prevent fraud, as well as proactively identify the ways that companies may be noncompliant. An audit that does not consider emerging climate-related regulation and growing social and environmental litigation risk misunderstands the actual financial position of and risks to a company. We strongly support these proposals from the PCAOB and urge expeditious strengthening and finalization.

Sincerely,

Public Citizen
Americans for Financial Reform Education Fund
Sierra Club
Greenpeace USA
Better Markets
Revolving Door Project
Green America
Earth Action, Inc.
Micah Six Eight Mission
Texas Campaign for the Environment
The Phoenix Group
Habitat Recovery Project
Centre for Citizens Conserving Environment & Management (CECIC)
The People's Justice Council
Alabama Interfaith Power & Light
350 Hawaii
350 Colorado
350 Humboldt
FreshWater Accountability Project
Zevin Asset Management