Ceres | Ceres Accelerator for Sustainable Capital Markets

February 1, 2023

Phoebe Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 46

Dear Ms. Brown:

Thank you for the opportunity to comment on the PCAOB's proposal to revise the standards governing quality control systems implemented by accounting firms that audit public companies and registered broker-dealers.

As you may know, Ceres is a nonprofit organization working with the most influential capital market leaders to solve the world's greatest sustainability challenges. The Ceres Accelerator for Sustainable Capital Markets works to transform the practice and policies that govern capital markets in order to reduce the worst financial impacts of the climate crisis. It spurs action on climate change as a systemic financial risk – driving the large-scale behavior and systems change needed to achieve a net zero emissions economy.

Ceres also includes the Investor Network on Climate Risk and Sustainability, which consists of 221 institutional investors – including Blackrock, State Street Global Advisors, Franklin Templeton – managing a combined $60 trillion in assets, who advance leading investment practices, corporate engagement strategies, and policy and regulatory solutions to address sustainability risks and opportunities. These investors have indicated that mandatory corporate climate disclosure is a top priority for them.

Furthermore, our Company Network, with more than 55 corporation members, 70% of which are among the Fortune 500 – including Ford, Amazon, Apple and Coca-Cola – drives business leaders to stabilize the climate, protect water and natural resources, and build a just and inclusive economy. Our Policy Network, with members including Microsoft, Mars, Siemens and General Mills, plays a critical role in passing some of the most ambitious climate laws in the country.

Because of our leading role in working with both investors and issuers, we thought it important to briefly provide our views on the proposal.

Accounting firm quality control measures are not a traditional area of involvement for Ceres, but we have a long-standing interest in the impact of climate change and the energy transition on companies' financial results and positions, including the assumptions and estimates that make up those financial statements. As a consequence, we strongly support the PCAOB's mission to protect investors' interest in high quality audits. This is why we have also had considerable concern about the PCAOB's ongoing silence on how audits should take climate-related financial risk into account, in contrast to the helpful guidance that the Financial Accounting Standards Board, the IFRS Foundation and the International Federation of Accountants' International Auditing & Assurance Standards Board (IAASB) have issued. We have urged the PCAOB to take appropriate action to address the role of climate change and the energy transition on audits and audit oversight in several comment letters.[1][2][3][4] We have also asked for a meeting with the PCAOB Chair to discuss these issues. To date, we are not aware of any specific actions the PCAOB has taken with respect to climate risk.

Outside of the US, the need for standards governing assurance of climate information has been an active concern for many years. The PCAOB's non-US counterpart, the IAASB, has issued an audit practice alert on applying ISAs to ensure that climate risks are addressed in the financial statement audit.[5] In April of 2022, the IAASB issued non-authoritative guidance on issues relating to sustainability assurance engagements. And the IAASB has approved a major project to develop "an overarching standard for assurance on sustainability reporting."[6] That is a significant development, prompting a statement from the International Organization of Securities Commissions, of which the SEC is an active member, "welcoming" the IAASB's activity. IOSCO called it "an important response to the accompanying market demand for robust standards applicable to all providers of sustainability assurance that can be used to foster independent, high-quality engagements and consistent practices."[7]

Without a regulatory initiative, the accounting profession on its own is not doing enough. For example, CAMs must include audit matters that are "especially challenging, subjective, or

[1] Jun 21, 2022 letter Ceres signed onto a Carbon Tracker letter re: Interim Analysis No. 2022-001, Estimates and Specialists Audit Requirements

[2] Sept 15, 2022 Ceres submission re: "Substantial Implementation, Duplication, and Resubmission of Shareholder Proposals Under Exchange Act Rule 14a-8," Exchange Act Release No. 95267 (File No. S7-20-22)

[3] Sept 15, 2022: Ceres Submission re: PCAOB Strategic Plan 2022-2026

[4] In addition to Ceres' comment letters, the Harvard Law School Forum on Corporate Governance published a blog written by a member of our staff that addressed the PCAOB's inaction. Thomas Riesenberg, *The PCAOB Is Missing In Action on Climate Risk*, November 26, 2022.

[5] "IAASB Issues Staff Audit Practice Alert on Climate-Related Risks", October 1, 2020.

[6] International Auditing and Assurance Standards Board, Assurance on Sustainability Reporting, (September 2022).

[7] The Board of the International Organization of Securities Commissions, *IOSCO encourages standard-setters' work on assurance of sustainability-related corporate reporting* (September 15, 2022).

Ceres Headquarters: 99 Chauncy Street, Boston, MA 02111 ceres.org

California Office: 369 Pine Street, Suite 620, San Francisco, CA 94104

complex."[8] PCAOB data shows that CAMs are declining in number, a development that should prompt a concern about quality control. Moreover, a number of complex and difficult risk areas rarely make an appearance.[9] Further evidence in this regard was provided in reports issued by CarbonTracker's "Flying Blind" and "Still Flying Blind" in 2021 and 2022. [10] The 2022 report found that "most companies still do not appear to be including the financial impacts of [net zero] commitments, or indeed climate change risks, in their financial statements" and, further, "there was little evidence that auditors considered the impact of material climate-related matters." CarbonTracker urged the PCAOB to adopt "rigorous standards" so that auditors would more thoroughly examine this issue, including rigorous quality control requirements to ensure that climate-related risks are consistently considered and addressed in audits.

A rigorous system of audit quality that focuses on the quality of financial disclosure should help address these concerns and should also increase trust in the financial disclosure process.

We have the following specific observations on the proposal:

1. Quality control represents a critical component in ensuring proper audits of public companies. Quality is a foundational issue that is needed to properly address climate and other specific risk issues. The proposal contemplates that firms will set up a system that is built around the identification of quality objectives, the determination of risks in achieving the objectives, and the proactive management of the risks. The proposal describes this as a "feedback loop" that will drive "continuous improvement" in audit quality. The proposal borrows from international standards, even though, as noted, the PCAOB does not pick up or even comment on the IAASB's statements about the role of climate risks in audits.

Applying a "principles-based" approach, the proposal largely leaves the development and implementation of the feedback loop to the discretion of audit firms. They decide on the quality objectives in each category, including physical and transition climate risks; they decide the relevant risks; they decide whether there are deficiencies in the system of quality control (in addition to those identified through the PCAOB's inspection process); and they decide whether the deficiencies have been adequately remediated.

Despite this extraordinary degree of discretion, the feedback loop operates almost entirely with little public accountability. The proposal considered but declined to provide investors and the public with any meaningful disclosure about the operation of the system of quality control.

[8] AS 3101.

[9] One former board member pointed this out with respect to CAMs addressing the impact of climate change on the valuation of long-term assets. Nor, as our research suggests, has the situation improved in subsequent years.

[10] CarbonTracker, *Flying Blind: The glaring absence of climate risks in financial reporting* (September 16, 2021); CarbonTracker, *Still Flying Blind: The Absence of Climate Risk in Financial Reporting* (October 6, 2022).

Ceres Headquarters: 99 Chauncy Street, Boston, MA 02111 ceres.org

California Office: 369 Pine Street, Suite 620, San Francisco, CA 94104

Nor does the standard sufficiently ensure that the objective of the system will adequately meet the expectations of investors. The proposal largely defines audit quality – the objective of the system – as meeting the existing auditing standards. This, however, does not sufficiently take into account the relationship between the audit and the quality of financial disclosure.

We recommend that the proposal be revised to (1) add an objective that relates quality control over audits to the quality and credibility of financial reporting, (2) provide for greater transparency on the operation of the system of quality control, (3) strengthen the obligations with respect to expertise and training, especially with respect to emerging risks such as climate change and energy transition and (4) include a more meaningful mechanism for independent oversight of quality control.

2. The proposal does not adequately provide for sufficient public transparency with respect to the organization and operation of a firm's system of quality control.[11]

The proposal would require firms to submit to the PCAOB a Form QC. The Form includes substantial disclosure about the system of quality control. The proposal considered making the Form public but rejected the approach mostly because the Form might sometimes include deficiencies in the system of quality control identified by the PCAOB. Under SOX, the PCAOB is prohibited from making its criticism of a firm's quality controls public unless the firm fails to address the concern to the Board's satisfaction, within 12 months of the issuance of the inspection report. The proposal notes that the Form could be disclosed without these deficiencies but that doing so would result in a "potentially incomplete" or "potentially misleading" picture of a firm's QC system.

We do not agree with this approach. The proposal would "protect" investors and the public by denying them information. The securities laws favor disclosure, leaving to investors the assessment of the relative importance of the information. Any concerns about completeness or accuracy are typically addressed through accompanying disclosure and explanations. The PCAOB and other financial regulatory agencies routinely use this approach in other areas.[12] The same

[11] The lack of public disclosure about a firm's system of quality control is a troubling gap in the PCAOB's disclosure regime. Congress mandated that firms registering with the PCAOB include "a statement of the quality control policies of the firm for its accounting and auditing practices". Firms therefore furnish the information in the registration application. Yet the PCAOB does not require that the disclosure be updated. As a result, investors and the public remain unaware of how they have changed. Providing the public with additional disclosure about a firm's quality control system would provide an updating function and better align PCAOB disclosure standards with what Congress intended.

[12] This is the case, for example, with inspection reports. *See* https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/inspections/reports/documents/104-2022-201-mazarsusa.pdf?sfvrsn=e113ff07_4 ("Our selection of audits for review does not necessarily constitute a representative sample of the firm's total population of issuer audits. Additionally, our inspection findings are specific to the particular portions of the issuer audits reviewed. They are not an assessment of all of the firm's audit work nor of all of the audit procedures performed for the audits reviewed.").

Ceres Headquarters: 99 Chauncy Street, Boston, MA 02111 ceres.org

California Office: 369 Pine Street, Suite 620, San Francisco, CA 94104

approach can be applied to Form QC. Moreover, it is unclear why the Form would likely include discussion of PCAOB-identified deficiencies that the PCAOB already knows about.

3. The proposal defines audit quality and the objective of any system of quality control as conformity with existing auditing standards and relevant regulatory requirements.[13] This is too narrow and objective.

First, the existing standards are out of date and simply conforming to these requirements will not necessarily ensure a sufficiently high-quality audit.

Second, the principles-based approach used throughout the proposal provides firms with considerable discretion in selecting the procedures and approaches that will meet relevant audit standards. Some will be better for audit quality than others. By defining audit quality only with respect to conformity with existing standards, the proposal provides little if any incentive to select the approaches that will improve investor trust and the quality of the audit.

Third, the approach does not recognize the connection between audits and the quality of financial disclosure, including disclosure relating to climate related transition and/or physical risks. The entire purpose of an audit is to provide assurance as to whether the financial statements are fairly presented in conformity with the stated reporting framework and free of material misstatements, whether due to error or fraud. The relationship between audit quality and "high financial reporting quality"[14] and detecting GAAP violations[15] is widely recognized among academics and within the investor community.[16]

With respect to the risks associated with climate change, we have been concerned that audits are sometimes not sufficiently rigorous in reviewing financial reporting processes, controls, estimates

[13] The proposal would require that the system of quality control provide reasonable assurance that "the work performed by engagement personnel meets applicable professional standards" and any other "regulatory requirements." *A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms* PCAOB Release No. 2022-006, November 18, 2022, p. 21

[14] *See* Mark DeFond & Jiying Zhang, *A Review of Archival Auditing Research,* 58 Journal of Accounting and Economics, 275, 279 (2014) ("we define higher audit quality as greater assurance of high financial reporting quality.").

[15] *See* Mark DeFond & Jiying Zhang, *A Review of Archival Auditing Research,* 58 Journal of Accounting and Economics, 275, 276 (2014) ("We observe that most of the commonly used definitions of audit quality portray auditing as a binary process, whereby auditors either succeed or fail in detecting GAAP violations.").

[16] *See* Carol Callaway Dee, et al., *Client Stock Market Reaction to PCAOB Sanctions against a Big Four Auditor*, 28 Contemporary Accounting Research 263-291 (Spring 2011) ("Audits are valued by investors because they assure the reliability of and reduce the uncertainty associated with financial statements"); *see also Fehribach v. Ernst & Young LLP*, 493 F.3d 905 (7th Cir. 2007) ("The purpose of an audit report is to make sure the audited company's financial statements—which are prepared by the company, not by the auditor, correspond to reality, lest they either have been doctored by a defalcating employee or innocently misrepresent the company's financial situation.") (citation omitted).

Ceres Headquarters: 99 Chauncy Street, Boston, MA 02111 ceres.org

California Office: 369 Pine Street, Suite 620, San Francisco, CA 94104

and assumptions. An approach that focused on the purpose of quality control, that is, to further the audit objective of detecting and addressing risks of material misstatement, could encourage audit firms to take a more thorough approach to matters in the financial statements affected by climate change.

4. The proposal recognizes the need for some independent oversight of audit quality. We commend the staff for taking steps in this direction. The approach in the proposal, however, requires strengthening.

The proposal would require that the largest firms (those with more than 100 issuer audits) include a "non-employee" in the oversight of quality control.[17] In designing this requirement, the proposal takes a principles-based approach. The proposal does not specify "how the firm would establish its governance structure or assign authority" and specifically provides that the non-employee need not be in the "chain of command."[18] Under the proposal, it would appear that a firm can fulfill the requirement by adding a single non-employee to an advisory council, a model that is less than what most of the large accounting firms already have in place.[19]

A single individual on a board or council will often not be enough to shape group decisions with respect to quality. Nor under the proposal will investors necessarily be informed as to the role played by non-employees in the governance structure, or the criteria used in selecting the individual. There is no requirement that the non-employee have the authority to call meetings with management or obtain relevant documentation. The proposal should include specific requirements with respect to the role and authority of non-employees, including the ability to meet with management and obtain relevant information.

5. The training requirements should be strengthened.

The proposal will require training but takes a principles-based approach. The standard does not set out any specifics about the training. No mention is made about training on complex issues such as a range of climate risk issues or crypto products; about areas of particularly importance to investors, including materiality; about training with respect to technology, fraud detection or critical audit matters. The proposal instead includes a vague mandate to provide annual training to address "ethics and independence requirements" and "professional and legal requirements".

Indeed, the proposal would remove the one specific existing requirement with respect to training. Auditors currently must dedicate 40% of their continuing professional education hours to auditing

[17] The definition largely seeks to require an "independent" non-employee. The individual cannot be "a partner, shareholder, member, other principal, or employee of the firm. . ." In addition, the individual may "not have other relationship with the firm that would interfere with the exercise of independent judgment with regards to matters related to the QC system."

[18] Regulation S-X Rule 2-01(f)(8), 17 C.F.R. § 210.2-01(f)(8).

[19] Most firms have more than one non-employee serving on the board or an advisory council. Most advisory councils used by the largest firms consist entirely, or have a majority, of non-employees.

and accounting topics. Rather than strengthen this requirement by specifying in more detail the topics that must be covered, including ethics, the proposal eliminates the requirement.

The use of a principles-based approach and the elimination of the requirement with respect to CPE hours does not ensure that auditors will receive the requisite level of training. Moreover, violations of this requirement will likely be limited to circumstances where audits were inadequately staffed, an after the fact approach.

Training is particularly important with respect to the growing impact climate risk because this is not an area in which audit staff have traditionally received instruction. Investors have clearly stated their concerns about climate risk and the importance to receive more comprehensive and consistent information through their recent filings with the SEC. Accordingly, Ceres recommends that the proposal should set out more specific requirements with respect to training, identifying areas or categories that must be regularly addressed and should not eliminate the CPE obligation in the existing standard.

* * *

The PCAOB's QC proposal reflects an enormous amount of work by the Board and its Staff, and we commend this effort and recognize all of the hard work from many people. As discussed, we also believe there are areas of potential improvement. Please feel free to reach out to Steven M. Rothstein (srothstein@ceres.org) or Tom Riesenberg (triesenberg@ceres.org) on the Ceres staff.

Thank you for your consideration. It is greatly valued.

Sincerely,

Steven M. Rothstein
Managing Director
Ceres Accelerator for Sustainable Capital Markets

CC: Erica Y. Williams, Chair, PCAOB
Duane M. DesParte, Board Member, PCAOB
Christina Ho, Board Member, PCAOB
Kara M. Stein, Board Member, PCAOB
Anthony C. Thompson, Board Member, PCAOB
Omid Harraf, Chief of Staff, PCAOB