CalPERS

California Public Employees' Retirement System
Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
TTY: (916) 795-3240
(916) 795-3400 phone • (916) 795-2842 fax
www.calpers.ca.gov

October 29, 2012

Arnold Schilder, Chairman
International Auditing and Assurance Standards Board
545 Fifth Avenue
New York, NY10017

Dear Arnold,

RE: INVITATION TO COMMENT – IMPROVING THE AUDITOR'S REPORT

I am writing on behalf of the California Public Employees' Retirement System (CalPERS). CalPERS is the largest public pension fund in the United States with $243 billion in global assets and equity holdings in over 9,000 companies in 43 countries.

Thank you for the opportunity to participate in the International Accounting and Auditing Standards Board's (IAASB) roundtable in New York City on 10 September, 2012. I found the roundtable informative and hope my comments on issues around going concern were helpful.

As a long-term shareowner, CalPERS has a vested interest in the integrity and efficiency of the capital markets. The auditing profession plays a critical role in ensuring this through their independent review and opinion. The financial interests of CalPERS beneficiaries are most effectively served in an environment where investors can justifiably expect reliable financial reporting to evaluate investment risks and returns.

There are a number of attributes which are important to building a substantive and robust framework for an Auditor Commentary. Investors rely on a vigorous external audit to strengthen the veracity and quality of financial reporting. The validity of the auditing profession is undermined when investors lack confidence in the independence of the auditor's assurance. Therefore, improvement of global audit practices is essential to address systemic risk and the current perceived lack of independence, objectivity and professional skepticism within the profession.

As outlined in the invitation to comment (ITC), and within CalPERS Global Principles of Accountable Corporate Governance, we agree that a heightened role for those charged with governance is necessary and should be expanded with regards to financial reporting. [1] We view enhanced reporting directly by the external independent auditor to shareowners as a critical improvement to audit reform.

The audit committee's role is paramount and should be emphasized in the process of improving the auditor's reporting role. This sentiment is reflected in the recent adoption (August 15, 2012) by the U.S. Public Company Accounting Oversight Board (PCAOB) of Auditing Standard No. 16, "Communications with audit committees to enhance communications between auditors and audit committees."

CalPERS Global Principles of Accountable Corporate Governance outline areas that auditors should consider in the narrative reporting of an Auditor Commentary, which we refer to as enhanced reporting. [2] These include:

1. Key financial statement and audit risks the auditor has considered when conducting the audit, and the extent, if any, as to how the auditor addressed those risks.
2. The auditor's assessment of the key estimates and judgments made by management that materially affect the financial statements, whether those assumptions are at the low or high end of the range of possible outcomes and how the auditor arrived at that assessment.
3. The quality and appropriateness of the accounting policies and practices adopted by management including accounting applications and practices that are uncommon to the industry.
4. Unusual transactions and significant changes to accounting policies that have a significant impact on the financial statements.
5. Methods and judgments made in valuing assets and liabilities.
6. Identification of any matters in the Annual Report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements, other information (such as the Management Discussion and Analysis) obtained in the course of their audit.
7. Audit issues and their resolution which the audit partner documents in a final audit memo to the Audit Committee.
8. The quality and effectiveness of the governance structure of the board and risk management.
9. Completeness and reasonableness of the Audit Committee report.

The IAASB, in conjunction with national regulators, has an opportunity to introduce robust improvements to auditor reporting, and provide real value to investors and other users of financial reporting. We believe this coordinated effort with regulatory bodies

---

[1] The underlying tenet for CalPERS Core Principles of Accountable Corporate Governance is that fully accountable corporate governance structures (Management, Audit Committees – Boards of Directors and External Auditors) produce, over the long term, the best returns to shareowners. CalPERS Global Principles of Accountable Corporate Governance, Updated November 14, 2011.

[2] CalPERS Global Principles of Accountable Corporate Governance, Updated November 14, 2011.
http://www.calpers-governance.org/docs-sof/principles/2011-11-14-global-principles-of-accountable-corp-gov.pdf

and standard setters is critical to the success of acceptance and implementation by the auditing profession.

The financial crisis highlighted the importance of clear and timely corporate reporting. Lessons can be learned and actions can be taken, for example, with respect to going concern issues that entities may be facing. There is clear need for improvement by auditors, regulators, standard setters and enforcers surrounding this issue. As I explained in my remarks at the PCAOB Investor Advisory Group's (IAG) annual meeting on 28 March 2012, Audit firms during the financial crisis did not provide any forewarning of Troubled Asset Relief Program (TARP) recipient companies.[3] Current rules require a warning when the auditor has substantial doubt about a company's ability to continue as a going concern which is too high a hurdle and needs to be changed. Our IAG working group completed a survey of investors and found that 68% of the responders believed going concern comment should be included in the auditor's report. [4]

The IAG recommended that accounting standards be improved by defining and requiring disclosure of key performance metrics so as to provide better trend information regarding the operations and risks of a company. Accounting standards should also improve on the current definition of going concern and reduce the high thresholds which may hamper management in providing early warning disclosures until a company is in the stage of liquidating, ceasing business.

We request that the IAASB revise its standards to be more explicit and require the issuance of a going concern supplementary paragraph in the Auditor Commentary when it is *more likely than not* that the auditor is aware of conditions and events that it is *reasonably foreseeable* that an entity may not be able to meet its obligations as they become due. The IAG recommended that the auditor's assessment not be limited to just 12 months from the balance sheet date but rather where events are reasonably foreseeable beyond 12 months that would affect the auditor's assessment of an entity's ability to continue as a going concern.

Accounting and auditing standards to assess whether an entity is a going concern or not should address the responsibility of both management and the independent auditor. Auditing standards should require the auditor to give the significant reasons, considerations, assumptions and basis for concluding a company is or may not be a going concern in this supplementary paragraph in the Auditor Commentary. Also, the auditor should be required to communicate to the audit committee whether or not they have concerns as to whether it is reasonable to expect the company will continue as a going concern and whether the company's disclosures are appropriate in light of the evidence the auditor obtained.

---

[3] The exception was General Motors, but the warning was late. Slide on Top Ten U.S. Issuers Receiving TARP Funds, page 4, 28 March, 2012.
http://pcaobus.org/News/Events/Documents/03282012_IAGMeeting/Going_Concern_Working_Group_Report.pdf

[4] PCAOB Investor Advisory Group Meeting, Working Group's presentation and recommendations on "Going Concern & Related Global Initiatives", 28 March, 2012
http://pcaobus.org/News/Events/Documents/03282012_IAGMeeting/Going_Concern_Working_Group_Report.pdf .

going concern and whether the company's disclosures are appropriate in light of the evidence the auditor obtained.

Additionally, the IAG reflected on the role of the regulators and enforcement entities to ensure accounting and auditing standards are appropriately implemented. CalPERS believes the IAASB should continue its work with the International Forum of Independent Audit Regulators (IFIAR) to stress enforcement.

The external, independent auditor is an expert who is well-positioned to judge objectively a company's approach to risk and control. If necessary, the external auditor can challenge management's judgment on accounting elements, assessment of risks and whether an entity has the ability to continue as a going concern.

The Auditor Commentary needs to reflect investors' needs for greater transparency about the financial statements and the audit itself. The illustrative improved auditor's report outlined in the invitation to comment is helpful but should be tested to see whether the outlined recommendations, if applied to companies in financial difficulty, would increase the value and insight of the auditor's reporting.

Please see the attached appendix for our responses outlined in the invitation to comment. If you have any questions or concerns, please call me at 916-795-9672 or my colleague Mary Hartman Morris at 916-795-4129, mary.morris@calpers.ca.gov.

Sincerely,

ANNE SIMPSON
Senior Portfolio Manager, Investments
Director of Global Governance

cc: Mary Hartman Morris, Investment Office - CalPERS

APPENDIX

Questions outlined in the Invitation to Comment (ITC) and CalPERS viewpoints:

Overall Considerations

1. Overall, do you believe the IAASB's suggested improvements sufficiently enhance the relevance and informational value of the auditor's report, in view of possible impediments (including costs)? Why or why not?

Yes, we believe improvement to the auditor's reporting model is necessary. The value of the additional content, changes to the audit report and expanding information to an Auditor Commentary will provide better disclosures and insight for investors in their capital allocation decisions.

2. Are there other alternatives to improve the auditor's report, or auditor reporting more broadly, that should be further considered by the IAASB, either alone or in coordination with others? Please explain your answer.

We believe there are certain aspects of improvement to the auditor's reporting that should be synchronized with accounting and auditing standard setters, regulators and enforcers. For example, we agree with the need for the auditor to conclude on the appropriateness of management's use of going concern assumption and an explicit statement as to whether material uncertainties in relation to going concern have been identified. However, additional work needs to be done by accounting standard setters and regulatory agencies to ensure an in-depth review defining the thresholds of going concern as well as defining management's and the auditor's responsibilities. CalPERS is a member of the PCAOB Investor Advisory Group (IAG), which at its annual meeting on 28 March 2012 highlighted concerns and recommendations in addressing going concern.[5]

Auditor Commentary

3. Do you believe the concept of Auditor Commentary is an appropriate response to the call for auditors to provide more information to users through the auditor's report? Why or why not? (See paragraphs 35–64.)

Yes, we support the proposed concept of Auditor Commentary. The concept offers external auditors an appropriate framework to provide additional, entity specific information regarding the financial statements and audit conducted, without affecting the auditor opinion. As part of our principles we believe an Auditor Commentary or as we

[5] PCAOB Investor Advisory Group Meeting, Working Group's presentation and recommendations on "Going Concern & Related Global Initiatives", 28 March, 2012
http://pcaobus.org/News/Events/Documents/03282012_IAGMeeting/Going_Concern_Working_Group_Report.pdf

describe it as Auditor's Discussion and Analysis, would improve the informative value and compliment the pass/fail nature of the opinion.

We agree that Audit Commentary should not be used as a substitute for (a) either a qualified or an adverse opinion (b) or management responsibility to make required disclosures in the financial statements.

4. Do you agree that the matters to be addressed in Auditor Commentary should be left to the judgment of the auditor, with guidance in the standards to inform the auditor's judgment? Why or why not? If not, what do you believe should be done to further facilitate the auditor's decision-making process in selecting the matters to include in Auditor Commentary? (See paragraphs 43–50.)

We believe a framework as outlined in this ITC provides important guidance to auditors in developing their commentary report. However, we believe the external auditor should be allowed to determine which matters are important to address in Auditor Commentary for users' understanding of the financial statements and the audit process. In doing so, the commentary could be tailored to the entity features and circumstances rather than becoming overly standardized. Notwithstanding auditor's discretion, we believe that, at the minimum, the key audit matters mentioned in paragraph 45 should always be considered in determining whether or not to include Auditor Commentary. These include: significant management judgment, significant unusual transactions, difficult or contentious matters during the audit and the other areas we outlined in our letter. These include:

1. Key financial statement and audit risks the auditor has considered when conducting the audit, and the extent, if any, as to how the auditor addressed those risks;
2. The auditor's assessment of the key estimates and judgments made by management that materially affect the financial statements, whether those assumptions are at the low or high end of the range of possible outcomes and how the auditor arrived at that assessment;
3. The quality and appropriateness of the accounting policies and practices adopted by management including accounting applications and practices that are uncommon to the industry;
4. Unusual transactions and significant changes to accounting policies that have a significant impact on the financial statements;
5. Methods and judgments made in valuing assets and liabilities;
6. Identification of any matters in the Annual Report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements, other information (such as the Management Discussion and Analysis) obtained in the course of their audit;
7. Audit issues and their resolution which the audit partner documents in a final audit memo to the Audit Committee;
8. The quality and effectiveness of the governance structure of the board and risk management; and
9. Completeness and reasonableness of the Audit Committee report.

5. Do the illustrative examples of Auditor Commentary have the informational or decision-making value users seek? Why or why not? If not, what aspects are not valuable, or what is missing? Specifically, what are your views about including a description of audit procedures and related results in Auditor Commentary? (See paragraphs 58–61.)

We generally believe that the five illustrative examples provide a clear concept of Auditor Commentary and agree they provide additional informational value for institutional investors and other users. The examples, topics, content and tone of the illustrative auditor commentary show that the concept offers flexibility and could be tailored to the entity's features and circumstances based on the auditor's judgment of what is important for users. As outlined in question # 4 we believe there are key audit matters that should always be considered in an Auditor Commentary. CalPERS would also welcome a description of specific aspects of audit procedures within in the Auditor Commentary if information would enhance the transparency and value of the reporting as well as provide insight to the conclusions of the auditor.

Although, the illustrative improved auditor's report examples are helpful, we believe they should be "parallel" tested to see whether the outlined recommendations, if applied to "problem companies", would increase the value and insight of the auditor's reporting and provided "warnings" of potential failures of these companies.

6. What are the implications for the financial reporting process of including Auditor Commentary in the auditor's report, including implications for the roles of management and those charged with governance (TCWG), the timing of financial statements, and costs? (See paragraphs 38 and 62–64.)

Audit Commentary will be prepared and issued by the auditor, not by the company, and shall in principle refer to topics presented or disclosed in the financial statements and reporting process. In addition, as mentioned in paragraph 42, the new concept of Auditor Commentary is consistent with and builds upon the existing concepts of Emphasis of Matter and Other Matter paragraphs. We do not believe Audit Commentary will significantly affect the existing roles and responsibility of management in the financial reporting process. A company's management will continue to be primarily responsible for the provision of relevant, reliable and understandable financial reporting. The TCWG's (audit committee and board of directors) role could be strengthened through increased transparency through Auditor Commentary through communication between the auditor and audit committee as well as with management.

We support that changes would mean that management; the auditor and the audit committee of the board would give closer scrutiny to their going concern, estimates and judgments made.

We believe the benefits in terms of increased confidence in corporate reporting, the integrity of financial reporting and audit quality will outweigh possible additional costs associated with the preparation of Auditor Commentary. The increased confidence creates value of itself, for example through reducing risk and we believe in the reduction of the cost of capital.

7. Do you agree that providing Auditor Commentary for certain audits (e.g., audits of public interest entities (PIEs)), and leaving its inclusion to the discretion of the auditor for other audits is appropriate? Why or why not? If not, what other criteria might be used for determining the audits for which Auditor Commentary should be provided? (See paragraphs 51–56.)

CalPERS supports and agrees that the concept of Auditor Commentary is relevant and beneficial for all companies. We also see great merit in the principle of consistent reporting by all companies, regardless of size.

Going Concern/Other Information

8. What are your views on the value and impediments of the suggested auditor statements related to going concern, which address the appropriateness of management's use of the going concern assumption and whether material uncertainties have been identified? Do you believe these statements provide useful information and are appropriate? Why or why not? (See paragraphs 24–34.)

We believe strongly that the auditor needs to provide a conclusion regarding the appropriateness of management use of the going concern assumption, and a statement on whether or not material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern are included in Auditor Commentary.

CalPERS believes these proposals would be helpful and informative to investors, as the external auditor will be required to provide explicit statements on the entity's going concern judgments in terms of appropriateness, material uncertainties and how the auditor came to that conclusion of a going concern in the audit report.

We feel strongly that the threshold of the period covered by the going concern assumption be reviewed and possibly increased based on the appropriateness for each business. The external auditor should subsequently assess whether there is sufficient evidence for the use of going concern assumption given that review period involved and include an explicit statement of their findings and how the conclusion was determined in the audit report.

Audit standards setters should revise standards to be more explicit and require the issuance of a going concern supplementary paragraph in the Auditor Commentary when it is *more likely than not* that the auditor is aware of conditions and events that it is *reasonable foreseeable* that an entity may not be able to meet its obligations as they become due.

CalPERS is a member of the PCAOB Investor Advisory Group (IAG), which at its annual meeting on 28 March 2012 highlighted concerns and recommendations in addressing going concern. See cover letter footnote.

> 9. What are your views on the value and impediments of including additional information in the auditor's report about the auditor's judgments and processes to support the auditor's statement that no material uncertainties have been identified? (See paragraphs 30–31.)

We believe that if there are no material uncertainties, that it may be helpful for the auditor to state this. Under certain circumstances adding additional information may have value, as in situations when the external auditor has determined that no material uncertainties exist, despite the fact that events or conditions have been identified that may casts significant on the entity's ability to continue as a going concern (described in paragraph 30).

> 10. What are your views on the value and impediments of the suggested auditor statement in relation to other information? (See paragraphs 65–71.)

CalPERS supports the suggested requirement to include an explicit statement in audit reports on whether material inconsistencies in the audited information and other information have been identified. Also important is the proposal to specifically identify the other information read by the auditor. When the auditor has identified a material inconsistency for which revision is necessary and management refuses to make a revision, the auditor statement on other information should imply a detailed explanation as highlighted in the ITC, appendix 2, paragraph 2.

The suggestion to include a disclaimer that the auditor has not audited the other information as part of the audit might also add value in terms of avoiding misinterpretation of the works and findings of the auditor.

Clarifications and Transparency

> 11. Do you believe the enhanced descriptions of the responsibilities of management, TCWG, and the auditor in the illustrative auditor's report is helpful to users' understanding of the nature and scope of an audit? Why or why not? Do you have suggestions for other improvements to the description of the auditor's responsibilities? (See paragraphs 81–86.)

CalPERS supports the suggested enhancements to the description of the auditor's responsibility in explaining more fully the concept of a risk-based audit, thereby clarifying the technical terms in the framework of an audit. A sophisticated description of the auditor's responsibilities in relation to specific matters could be of great value for many institutional investors in identifying the auditor's responsibilities to disclosing fraud, internal controls, etc.

The auditor should articulate to the Audit Committee, risks and other matters arising from the audit that are significant to the oversight of the financial reporting process, including situations where the auditor is aware of disputes or concerns regarding accounting or auditing matters.

> 12. What are your views on the value and impediments of disclosing the name of the engagement partner? (See paragraphs 72–73.)

We support and believe the engagement partner should sign the audit report. We believe this provides an additional amount of accountability. We do not see any impediments of the engagement partner signing.

> 13. What are your views on the value and impediments of the suggested disclosure regarding the involvement of other auditors? Do you believe that such a disclosure should be included in all relevant circumstances, or left to the auditor's judgment as part of Auditor Commentary? (See paragraphs 77–80.)

CalPERS believes providing disclosures on the involvement of other auditors provides additional insight into the audit process. However, we believe the signing auditor is responsible for the audit. We do not believe that identifying and disclosing the work of other auditors relieves the signing auditor of its responsibility of the audit as a whole.

An unrelated point would be the benefit of regional audit firms working with the larger audit firms to develop additional expertise which may allow for a wider depth of auditors to choose from in future audits.

> 14. What are your views on explicitly allowing the standardized material describing the auditor's responsibilities to be relocated to a website of the appropriate authority, or to an appendix to the auditor's report? (See paragraphs 83–84.)

We believe providing the relevance of descriptions on responsibilities; standardized wording in the audit report itself to fully describe auditor's tasks and what the audit is about may be helpful initially as the Auditor Commentary is developed. Though we could see where allowing auditor reports to make references to entities and audit firms websites may be helpful as the auditor report and commentary could focus on the entity specific information. The general references of procedures and audit firm governance could be included at the audit firm's website with reference in the report.

Form and Structure

> 15. What are your views on whether the IAASB's suggested structure of the illustrative report, including placement of the auditor's opinion and the Auditor Commentary section towards the beginning of the report, gives appropriate emphasis to matters of most importance to users? (See paragraphs 17–20.)

We support moving the auditor's opinion to the beginning of the report and ensuring specific topics as outlined in our response to question number 4 are covered in Audit Commentary.

16. What are your views regarding the need for global consistency in auditors' reports when ISAs, or national auditing standards that incorporate or are otherwise based on ISAs, are used? (See paragraphs 21–23 and 87–90.)

IAASB is right in trying to find the right balance for global consistency and comparability and the need to increase the value of the audit reporting by including flexibility to accommodate national circumstances. The suggested building block approach offers an appropriate concept to achieve this crucial balance. CalPERS also recommends the IAASB work closely with the U.S. PCAOB in developing the requirements for Auditor Commentary or what is being described in the U.S. as Auditor Discussion and Analysis or enhanced reporting.

17. What are your views as to whether the IAASB should mandate the ordering of items in a manner similar to that shown in the illustrative report, unless law or regulation require otherwise? Would this provide sufficient flexibility to accommodate national reporting requirements or practices? (See paragraph 17 and Appendix 4.)

We generally believe that the building block approach and possibly the ordering of items will provide a greater comfort level to users of these reports. We caution though that auditors should not use boiler plate language but provide entity specific information and disclosures.

18. In your view, are the IAASB's suggested improvements appropriate for entities of all sizes and in both the public and private sectors? What considerations specific to audits of small- and medium-sized entities (SMEs) and public sector entities should the IAASB further take into account in approaching its standard-setting proposals? (See paragraphs 91–95.)

CalPERS believes the suggested improvements are appropriate for entities of all sizes both in the public and private sectors. The focus should be based on the value and the audit of the specific entity and not in scaling back the approach based on the size of an entity.