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October 28, 2011

Via E-Mail: [www.iaasb.org](http://www.iaasb.org)

James Gunn, Technical Director  
International Auditing and Assurance Standards Board  
545 Fifth Avenue, 14<sup>th</sup> Floor  
New York, NY 10017 USA

Dear Mr. Gunn:

**Re: Consultation Paper on “Enhancing the Value of Auditor Reporting: Exploring Options for Change”**

CalPERS is the largest public pension fund in the United States with approximately \$232 billion in global assets in more than 9,000 public companies worldwide, within 47 markets. CalPERS invests these assets on behalf of more than 1.6 million public workers, retirees, their families, and beneficiaries in order to fund retirement and health benefits.

Thank you for your staff's outreach to CalPERS and this opportunity to comment on the International Auditing and Assurance Standards Board (IAASB) consultation paper - Enhancing the Value of Auditor Reporting: Exploring Options for Change. Attached is CalPERS comment letter to the PCAOB on their rulemaking docket No. 34 – Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards (Auditor Reporting) as many questions are similar with the focus on enhanced auditor reporting.

Our letter to the PCAOB highlights the following critical themes which we believe is important in enhancing the value of the auditor reporting. These include:

- A robust external audit strengthens the integrity and quality of financial reporting;
- The auditor's assurance is critical to investor's confidence;
- The development of global best audit practices is critical in preparation for the next global financial crisis;
- The independence, objectivity and professional skepticism of an auditor is acute to the overall process and

- A heightened role for those charged with governance<sup>1</sup> regarding financial reporting is necessary with enhanced reporting directly by the external independent auditor to shareowners.

The external independent auditor is in a unique position and as an independent financial expert could provide an unbiased view of the audit and financial statements through an enhanced auditor's reporting model. This enhanced auditor reporting should focus on:

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 and how the auditor arrived at that assessment.
3. The quality 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.

Other items should be considered in expanding the narrative reporting, such as:

5. The methods and judgments made in valuing assets and liabilities (with discussion of sensitivity analyses, and any stress tests).
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 or obtained in the course of the audit.
7. Key audit issues and their resolution, which the audit partner documents in a final, summary audit memorandum to the audit committee.
8. Quality and effectiveness of the board governance structure and risk management.
9. The completeness and reasonableness of the audit committee report.
10. The effectiveness of the company's internal controls over financial reporting.<sup>2</sup>
11. Policies regarding the provision of non-audit services to avoid compromising auditor independence.

CalPERS supports leveraging change to the auditor's report to also improve management disclosure in the financial statements. We believe this impetus to change will not only provide for improved disclosures and transparency, but will also increase the baseline of information to allow investors to make better informed capital allocation decisions.

Thank you for considering our comments. CalPERS supports the IAASB's review of the auditor's reporting model, including issues that go beyond the independent auditor's report.

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<sup>1</sup> The underlying tenet for CalPERS Core Principles of Accountable Corporate Governance is that fully accountable corporate governance structures (Management, Audit Committees – Board of Directors and External Auditor) produce, over the long term, the best returns to shareowners. CalPERS Global Principles of Accountable Corporate Governance, Updated February 16, 2010.

<sup>2</sup> Although required in the US, this is not required outside the US.

James Gunn  
Technical Director, IAASB  
October 28, 2011  
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We strongly support and encourage the IAASB and the PCAOB to jointly work at improving the appropriate governance structure as it relates to enhancing the value of auditor reporting. Should you wish to discuss any of these points, please do not hesitate to call me at 916-795-4129.

Sincerely,



MARY HARTMAN MORRIS  
Investment Officer  
Global Corporate Governance

cc: Anne Simpson, Senior Portfolio Manager - CalPERS  
Bill McGrew, Portfolio Manager – CalPERS  
Martin F. Baumann, Chief Auditor and Director of Professional Standards – PCAOB



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October 20, 2011

Via E-Mail: [comments@pcaobus.org](mailto:comments@pcaobus.org)

J. Gordon Seymour  
Office of the Secretary  
PCAOB  
1666 K Street, N.W.  
Washington, DC 20006

Dear Mr. Seymour:

**RE: PCAOB No. 2011-003, Rulemaking Docket No. 34 – Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

CalPERS is the largest public pension fund in the United States with approximately \$225 billion in global assets in more than 9,000 public companies worldwide within 47 markets. CalPERS invests these assets on behalf of more than 1.6 million public workers, retirees, their families, and beneficiaries in order to fund retirement and health benefits.

Thank you for this opportunity to comment on the concept release on the auditor's reporting model following CalPERS participation in the September 15 roundtable on this topic. We applaud the PCAOB's work to improve the auditor's report in order to increase its transparency and relevance to financial statement users.

CalPERS is fundamentally a long-term, fiduciary investor, with a vested interest in the stability of the markets and the integrity of financial reporting. We believe financial reporting should provide users the information needed to make informed capital allocation decisions. The integrity and quality of financial reports is strengthened by a robust external independent audit, carried out objectively and undertaken with appropriate professional skepticism on the part of the auditor.

The auditor's assurance is critical to investors' confidence in the integrity of financial reporting and its consistency with U.S. Generally Accepted Accounting Principles (GAAP). We also support the development of global best practice in this arena.

We outline in the attached Appendix CalPERS responses to the questions in this release which includes comments on: (1) Auditor's Discussion and Analysis (AD&A), (2) Required and Expanded Use of Emphasis Paragraphs, (3) Auditor Assurance on Other Information Outside the Financial Statements, and (4) Clarification of Language in the Standard Auditor's Report and Other Alternative.

We believe the PCAOB has the opportunity to make some substantive, robust changes that will improve auditor reporting and provide real value to investors and other users of financial reporting.

If you have any questions or concerns, please call me at 916-795-9672 or my colleague Mary Hartman Morris at 916-795-4129.

Sincerely,

A handwritten signature in black ink, appearing to read "Anne Simpson". The signature is fluid and cursive, with the first name "Anne" being more prominent than the last name "Simpson".

ANNE SIMPSON  
Senior Portfolio Manager  
Investment Office  
Head of Corporate Governance

cc: Board Members - PCAOB  
Mary L. Schapiro, Chairman - SEC  
Jim Kroeker, Chief Accountant - SEC  
Joe Dear, Chief Investment Officer – CalPERS  
Janine Guilliot, Chief Operating Investment Officer – CalPERS

## Appendix – Responses to Questions in PCAOB Release No. 2011-003

### **Content of the Auditor's Report**

*1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

*a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

Yes, we believe improvement to the auditor's reporting model is necessary. CalPERS believes information provided in an AD&A would provide more congruent disclosures and provide a better tool for investors in their capital allocation decisions.

A study done in September 2009 "Investors', Auditors', and Lenders' Understanding of the message conveyed by the Standard Audit Report (SAR)"<sup>1</sup> highlighted group differences within three patterns:

- I. Type I communication gap – whether the user groups investors and lenders differ from the auditor group.
- II. Type II gap - The user groups differ from each other.
- III. Type III gap – the user groups differ from each other as well as from the auditor group.

The purpose of the study was to evaluate the congruence or alternatively the communication gap between the three groups in their understanding of the objectives and limitations of the SAR and secondly, to evaluate the congruence in the interpretation of the technical language used in the SAR.

Participants rated the SAR as important in investing and lending decisions as well as for assessing whether financial statements are free from material fraud. This study showed that the SAR provided relatively lower level of confidence that a company is well managed, a sound investment or that the company would meet its strategic goals. Overall the results showed that the current Standard Auditor Report results in communication gaps and expectations between users and the auditor. We believe expanding the auditor's report through a narrative AD&A would narrow this gap.

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<sup>1</sup> Report prepared for the AICPA Auditing Standards Board (ASB) and International Auditing and Assurance Standards Board (IAASB) to better understand communications conveyed in the standard audit report. [http://web.ifac.org/download/Study\\_3\\_AICPA\\_IAASB\\_Paper.pdf](http://web.ifac.org/download/Study_3_AICPA_IAASB_Paper.pdf), Sept. 2009.

*b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

The Auditor is in a unique position, and as an independent financial expert could provide an unbiased view of the audit and financial statements. See response to 2c.

*c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

Discussed in auditor assurance on page 11 question 19.

*2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

*a. Should the auditor's report retain the pass/fail model? If so, why?*

*b. If not, why not, and what changes are needed?*

We believe the current model needs improvement though better disclosure. We see where the current pass-fail model provides some value in expressing a standard opinion.

*c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

We believe there is some value in the pass/fail model but support expansion of the auditor's report. The specific model should be determined by the PCAOB.

We suggest this expanded report focus on:

- I. 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.
- II. The auditor's assessment of the key estimates and judgments made by management and how the auditor arrived at that assessment.

- III. The quality of the accounting policies and practices adopted by management including accounting applications and practices that are uncommon to the industry.
- IV. Unusual transactions and significant changes to accounting policies.

Other items should be considered in expanding the narrative reporting, such as:

- V. The methods and judgments made in valuing assets and liabilities (with discussion of sensitivity analyses, and any stress tests).
- VI. Identification of any matters in the annual report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of the audit.
- VII. Key audit issues and their resolution, which the audit partner documents in a final, summary audit memorandum to the audit committee.
- VIII. Quality and effectiveness of the board governance structure and risk management.
- IX. The completeness and reasonableness of the audit committee report.
- X. The effectiveness of the company's internal controls over financial reporting.<sup>2</sup>
- XI. Policies regarding the provision of non-audit services to avoid compromising auditor independence.

*3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

CalPERS believes the auditor should provide from their perspective expanded information. We do not discount the value and the fiduciary responsibility of the Audit Committee. We recognize the auditor is in a unique position. The auditor has extensive knowledge of the company and industry which is obtained through the audit process and experiences; is an independent third party; and we believe the auditor can provide an unbiased view of the company's financial statements.

We also emphasize that in our opinion, the auditor could use the disclosure requirement to leverage change and enhance management disclosure in the financial statements. This impetus to change would provide better disclosures and transparency to investors.

We also support greater transparency by Audit Committees on how as an effective monitor and fiduciary on behalf of shareowners, does the Audit Committee discharge

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<sup>2</sup> Although required in the US, this is not required outside the US. We list here as global regulators will be reviewing comment letters with the IAASB also considering the auditor's report.



their responsibilities in relation to the integrity of the Annual Report, including oversight of the external auditors.

*4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

We supported during the comment period the development of Auditing Standard No. 5 (AS5), "An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements". We support and believe the proposed changes to the audit report do not increase the scope of the audit but provide better clarity of the work performed through AS 5. AS5 already requires the auditor to address the role of risk assessment, the risk of fraud, identifying significant accounts and relevant assertions, understanding the likely sources of misstatement, identifying and assessing risks of material misstatement, relationship of risk to the evidence to be obtained, evaluating identified deficiencies, indicators of material weaknesses, and forming an opinion based on this work. The work performed as required by AS5 should be the basis on which the auditor should provide additional information through a narrative format in an AD&A. We are unsure of what additional amendments are necessary to AS5 as it currently covers information that investors are requesting.

**Potential Alternatives for Changes to the Auditor's Report – Auditor's Discussion and Analysis**

*5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

*a. If you support an AD&A as an alternative, provide an explanation as to why.*

*b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

*c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*

*d. If you do not support an AD&A as an alternative, explain why.*

*e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

Yes, we support an AD&A as an alternative for providing additional information in the auditor's report. We believe an expansion of the auditor's report will provide added

value to investors. CalPERS supports the auditor reporting on the financial statement, on broader company information and on the audit process itself. We believe a narrative format would not be too prescriptive and would allow the auditor to explain the mitigation of financial statement and audit risks and how the auditor formed their overall opinion.

We do not see any alternatives other than an AD&A where the auditor could provide robust discussion and analysis.

*6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

We have highlighted the main areas of interests (Response to question 2c) that we believe would provide added value to investors and other users of financial reporting. We believe a narrative format would allow the auditor to customize an AD&A report appropriately to the specific company. Investors are interested at a high level where are the financial statement and audit risks; what conceptually was the work performed to understand those risks; and how did the auditor become comfortable in their testing to come to the conclusion in the opinion expressed.

*7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?*

CalPERS supports the PCAOB developing certain criteria the auditor should always include and other criteria the auditor should consider in providing an AD&A. We believe there is a qualitative aspect that the auditor will provide through a narrative on the company, the work performed and how they came to their conclusions. See response to question 2c.

*8. Should a standard format be required for an AD&A? Why or why not?*

We do not believe the format should be standardized as we would not encourage boiler plate language. We do suggest specific criteria be required and others considered in developing an AD&A.

*9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

It is the responsibility of management to comment on business, strategic and operational risks through the Management Discussion and Analysis (MD&A). The auditor should focus on risks associated with the audit, internal controls and risks that impact financial statements such as risks that may impact the valuation of assets and liabilities, critical accounting judgments and estimates and communicate how the auditor assessed these risk factors through their audit program and in their opinion.

CalPERS believes through lessons learned from the financial crisis that management, the board and the auditor should identify all risks, determine the impact of these risks, how to mitigate these risks and the appropriate oversight and disclosure of these risks.

*10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

CalPERS recommends the PCAOB articulate the objective of an AD&A and expectations on how the auditor should respond and develop a customized narrative on each company they audit.

*11. What are the potential benefits and shortcomings of implementing an AD&A?*

Investors would benefit from an expanded report including:

- I. Greater objectivity and possibly improved audit quality.
- II. Increased transparency into the audit process and the significant judgments made in forming the auditor's opinion.
- III. Better understanding of the auditor's opinion taken as a whole and how the auditor reached that opinion.
- IV. Improved perception of the integrity of reporting.
- V. Improved usefulness of the audited financial statements in making informed investment decisions.
- VI. Better information to inform shareowners with respect to their auditor ratification decision.

The one shortcoming of implementing an AD&A may be the issue of who is the customer of the auditor? Shareowners are the customers of the audit, although a

potential conflict may exist, as auditors are paid by the company and may not want to challenge management.

*12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

CalPERS does not believe having inconsistent or competing information between the auditor and management is necessarily a concern. Shareowners are the owners of a company and obtaining both management's and the board's perspective along with an independent auditor's would provide a better understanding from different perspectives on the stewardship of the company

**Required and Expanded Use of Emphasis Paragraphs (Questions 13-18)**

*13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

*14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

*a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

*b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

*15. What specific information should require and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

*16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

*17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

*18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

As emphasis paragraphs are already permitted but not required, CalPERS does not believe this would be the optimum area for additional disclosure.

Currently Emphasis paragraphs are allowed and can be used to expand on significant:

- I. Issues in the financial statements, and how disclosed in the financials.
- II. Measurement uncertainty.
- III. Management judgments and estimates.
- IV. Areas where in the opinion of the auditor, need additional clarification for a better understanding of the financial statements.

The issue is that most auditors do not use emphasis paragraphs.

Providing this type of information in emphasis paragraphs may need additional disclosures on procedures the auditor performed relating to each of these matters.

It is our belief that the PCAOB should remain focused on making the necessary and immediate changes to the existing auditor's reporting model. However, if the Board decides against an AD&A, then emphasis paragraphs should be required and should address:

- I. 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.
- II. The auditor's assessment of the key estimates and judgments made by management and how the auditor arrived at that assessment.
- III. The quality of the accounting policies and practices adopted by management including accounting applications and practices that are uncommon to the industry.
- IV. Unusual transactions and significant changes to accounting policies.

Other items should be considered if emphasis paragraphs are required, such as:

- V. The methods and judgments made in valuing assets and liabilities (with discussion of sensitivity analyses, and any stress tests).
- VI. Identification of any matters in the annual report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of the audit.
- VII. Key audit issues and their resolution, which the audit partner documents in a final, summary audit memorandum to the audit committee.
- VIII. Quality and effectiveness of the board governance structure and risk management.
- IX. The completeness and reasonableness of the audit committee report.
- X. The effectiveness of the company's internal controls over financial reporting.<sup>3</sup>

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<sup>3</sup> Although required in the US, this is not required outside the US. We list here as global regulators will be reviewing comment letters with the IAASB also considering the auditor's report.

- XI. Policies regarding the provision of non-audit services to avoid compromising auditor independence.

**Auditor Assurance on Other Information Outside the Financial Statements**

- 19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*
- a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*
- b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*
- c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*
- d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*
- e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*
- f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*
- g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

Currently the auditor's assurance is critical to investor confidence in the integrity of financial reporting and its comparability based on US Generally Accepted Accounting Principles (GAAP). It has long been recognized that financial statements alone are not sufficient to communicate the overall performance of an entity. In particular, MD&A has become a core element of the communication package for external reporting purposes. We utilize other information such as MD&A, earnings releases, to obtain a better understanding of a company and its peers.

The MD&A is a very important section of an annual report, especially to investors in our review of a company's fundamentals. MD&A provides a context within which the financial results and financial position can be interpreted. As underscored by the Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities by the IOSCO Technical Committee, an issuer should provide all information that would be material to an investor's investment decision, including disclosures in the MD&A. The

MD&A requirements are intended to satisfy four principal objectives which benefit investors and other users of the MD&A:

- I. Enables investors to see the company “through the eyes of management.”
- II. Improves financial disclosure overall and provides the context within which financial statements should be analyzed.
- III. Provides information about the different components of earnings and cash flow and the extent to which they are recurring elements, thereby enabling investors to make a better prediction about the sustainability of earnings and cash flow in the future.
- IV. Provides information about the risks to a company’s earnings and cash flow.

MD&A provides a context within which the financial results and financial position can be interpreted. Currently auditors as part of their engagement review the MD&A and consider whether such information or the manner of its presentation is materially inconsistent with the financial restatements or represents a material misstatement of fact. We believe the auditor could provide a statement based on their current responsibilities as it relates to MD&A within the AD&A. Although the auditor would not be providing assurance on future performance, CalPERS believes the auditor could through an AD&A provide a statement whether the MD&A is reasonable, whether assumptions and conclusions are rational based on the current work of the auditor and its review of a company’s financial performance.

We recommend the PCAOB focus on the AD&A and address additional assurance in a separate project.

CalPERS would support a fuller discussion of the MD&A, specifically as a framework for integrated reporting is developed further. The International Integrated Reporting Committee released a request for comment on an integrated reporting framework in September 2011.

*20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

Investors, like CalPERS would recommend the PCAOB focus on the AD&A and provide clarity within the AD&A on the responsibilities of the auditor on MD&A. We see the value of additional assurance but would need to understand what additional work will be performed and what additional assurance means to investors.

We agree if assurance on other information such as the MD&A is recommended – we would defer to the current attestation engagement procedures as issuers currently have the option to engage the auditor to attest on MD&A.

This would be a great opportunity to determine which issuers if any, currently request their external auditor firms to attest to the MD&A. If an issuer requested an attestation, then the benefits and challenges should have been outlined to the audit committee and discussion of the benefits may be well articulated. We believe the greatest benefit of reviewing the auditor's role in other assurance would be the impetus to issuers, specifically management in fulfilling the current SEC standards for appropriate disclosures in the MD&A.

### **Clarification of the Standard Auditor's Report**

*21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- Reasonable assurance*
- Auditor's responsibility for fraud*
- Auditor's responsibility for financial statement disclosures*
- Management's responsibility for the preparation of the financial statements*
- Auditor's responsibility for information outside the financial statements*
- Auditor independence 42/ AU sec. 550.04 - .06.*

*a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

*b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

*c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

*d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

CalPERS supports providing additional clarification of each of the areas listed above. We agree that language should be further clarified as these areas are not necessarily fully articulated and understood.

CalPERS as a part of its testimony to the US Treasury Department Advisory Committee on the Auditing Profession (ACAP) in February 2008, provided comments on auditors' responsibility for detecting fraud and auditor independence. We believe that the responsibility of auditors to detect fraud and improve the timely communication of these frauds to current shareowners and potential investors is critically important. We believe the standard audit report should indicate the auditor's responsibility for detecting material fraud and define that the auditor has a responsibility to obtain reasonable



assurance (defined as a high, although not absolute, level of assurance) as to whether the financial statements are materially misstated, whether caused by error or fraud.

We also believe in defining the auditor's responsibility relating to fraud that "inherent limitations" be defined in detecting material misstatements resulting from fraud. In our opinion, there may not necessarily be inherent limitations, but rather time and cost limitations. In our view fraud detection would improve the quality of the audit and with time and effort may have detected many of the major frauds during the last few years. We believe that if during an audit it is found that the control environment is weak and presents opportunities for fraud, auditors should highlight this to management and the audit committee and offer to undertake additional work.

*22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

We do not see any shortcomings to providing clarification of the language in the standard auditor's report. CalPERS believes better articulation and clarity will provide better transparency, understanding and narrow existing expectation gaps.

CalPERS does not see clarification as an alternative to the expansion of the auditor's report through an AD&A. We support clarification as it would be beneficial to investors to fully understand the role of the auditor and the extent of the work the auditor is performing during the financial statement review. We do not necessarily see this as an expansion of the auditor's report and support the focus on the AD&A.

### **Questions Related to all Alternatives**

*23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

*24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

*25. What alternatives not mentioned in this concept release should the Board consider?*

*26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

CalPERS supports the expansion of the auditor's reporting through an AD&A. It is our belief that the PCAOB should remain focused on making the necessary and immediate changes to the existing auditor's reporting model.

Additionally, CalPERS believes corporate reporting needs to integrate key financial and non-financial information. We support that each company should consider an integrated report to identify risks related to the company's operational, financial, environmental, social, and governance status. Integrated reporting is necessary to understand risk management at a company and the drivers of value creation. CalPERS seeks financial and non-financial information that is relevant, timely, comparable, and of high quality.

As the International Integrated Reporting Committee has commented, "There is a need to develop more comprehensive and comprehensible information about an organization's total performance, prospective as well as retrospective, to meet the needs of the emerging, more sustainable, global economic model."<sup>4</sup>

CalPERS has a fiduciary duty of prudence, which requires that we take into account all information which identifies and enables the mitigation of risk and assists in identifying drivers of value creation. To fulfill this, investors require comprehensive financial and non-financial disclosures by investee companies. We mention this as we believe long-term, the auditor's reporting model, and framework should address the integration of financial and non-financial information, including relevant environmental, social and governance factors.

*27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

The focus of any changes in auditor reporting should be the value to investors. Yes, we believe addressing emphasis paragraphs, other assurance and clarification of language would provide a piecemeal approach. CalPERS preference would be for the PCAOB to focus on expanding the auditor's report through an AD&A.

Additionally, CalPERS supports changes to the auditor report or changes that may include a new style of auditor report, such as the AD&A. We suggest the PCAOB consider the current work on integrated reporting in its assessment of the auditor's reporting model.

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<sup>4</sup> "Why we Need Integrated Reporting", Discussion Paper, by Sir Michael Peat, Chairman of the IIRC, IIRC website <http://iirc.newsweaver.co.uk/newsletter/1ja775usz5leq5jjkzjymy>.

*28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

From our perspective we believe an AD&A would better convey to users of the financial statements the auditor's role in the performance of an audit.

*29. What effect would the various alternatives have on audit quality? What is the basis for your view?*

We believe that an AD&A would improve audit quality as its preparation would strengthen dialogue between the auditor, management and the Audit Committee. We also believe enhancing this three-way dialogue may allow the auditor to leverage discussions with management in accepting potential best practice reporting alternatives.

As we expressed in our response to question #12, CalPERS does not believe having inconsistent or competing information between the auditor and management is necessarily a concern. Shareowners are the owners of a company and obtaining both management's and the board's perspective along with an independent auditor's would provide a better understanding from different perspectives on the stewardship of the company

*30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such exclusion.*

We support application to all SEC registrants. We do not support exemptions or application scaling based on company size in public markets. We support moving all audits of public companies in a direction which provides better disclosure and insight into the valuable work performed by auditors.

### **Considerations Related to Changing the Auditor's Report**

*31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

*a. Are any of these considerations more important than others? If so, which ones and why?*

*b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

*c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*

*d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

CalPERS believes that additional transparency will increase the quality of the audit and provide better disclosure of the added value which currently exists in the work performed by the auditor. We do not see where there would be additional cost as the AD&A would not increase the amount of audit work performed, it would be articulating the current work performed by an auditor, and how they came to the conclusion in the audit opinion.

*32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

CalPERS believes this will strengthen and expand more robust discussions between management, the audit committee and the auditor.

As previously stated, CalPERS does not believe having inconsistent or competing information between the auditor and management is necessarily a concern. Shareowners are the owners of a company and obtaining both management's and the board's perspective along with an independent auditor's would provide a better understanding from different perspectives on the stewardship of the company