



**Investment Office**

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November 21, 2003

Office of the Secretary

PCAOB

1666 K Street, N.W.

Washington, D.C. 20006-2803

Office of the Secretary:

Re: Rulemaking Docket Matter 008

I am writing to you on behalf of the California Public Employees' Retirement System (CalPERS). CalPERS is the largest public pension system in the U.S., with approximately \$148 billion in assets. We manage the retirement benefits and health insurance on behalf of nearly 1.4 million members.

CalPERS is very supportive of the PCAOB efforts to improve standards of financial reporting by publicly-traded companies and to improve standards of auditing those financial statements. CalPERS appreciates the opportunity to comment on the Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. CalPERS expresses general support of the objectives of the Proposed Auditing Standard.

In addition, CalPERS would like to offer the following comments on some of the specifics of the Proposed Auditing Standard which is pursuant to Section 404(b) as well as Section 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002.

1. Management Assessment of Internal Controls. Section 404(b) of Sarbanes-Oxley requires that "each registered public accounting firm that prepares or issues the audit report for each issuer shall attest to, and report on, the assessment {of internal controls} made by management of the issuer." The intent seems to be that management should make the assessment and the audit firm shall then gather sufficient competent evidence to attest to the validity, degree of validity, or non-validity of the assertion. We believe that the opinion on management's internal control assessment should have a graded scale rather than simply pass or fail. Implicit in this section of Sarbanes-Oxley is that the auditors will not be auditing their own work in preparing their opinion.

As a best practice for corporate governance, CalPERS believes that the Audit Committee should be involved in setting internal control policies and that management should execute these policies. We believe that part of the rationale in having management prepare the assessment is to encourage management to continually be involved in the internal control structure, procedures and evaluation, and to take ownership of the assessment. This serves to keep management informed of and contributing to improvements in the internal control structure, which is essential to the success of the internal control structure.

The proposed standard raises the question of reliance on the work of management and “others” by the external auditors. We will address this question by first discussing reliance on the work of management, then the internal auditors, and finally address the question of reliance on work of the remaining “others.”

*Work of Management:* the external auditors should not simply rely on the work of management, but should review the process by which the assessment was obtained, and re-perform and test the assessment *as necessary*. Nevertheless, we agree an integrated audit of internal control and financial statements is necessary. However, reliance on the work of Internal Auditors should assist the external auditor in formulating an opinion. (Question 1-3, 6 of the Proposed Auditing Standards) (AICPA’s Statements on Standards, AT Section 501.13 – Components of an Entity’s Internal Control and Section 501.14-.15 Limitations of an Entity’s Internal Control)

*Reliance on Work of Internal Auditors.* An important responsibility of the internal auditors is to continually evaluate, test and monitor internal controls of an entity. Therefore, the external auditors would determine if the Chief Internal Audit Executive is organizationally independent and review the qualifications of the internal auditors and the quality of their work so that they can determine the degree of reliance on the work of the internal auditors. The *International Standards for the Professional Practice of Internal Auditing* provides the framework for independence and objectivity and competence of work performed by internal auditors. Ideally, the Chief Audit Executive should report functionally to the Audit Committee and administratively to the Chief Executive Officer. We also believe that the relationships of the Audit Committee, the External Financial Statement Auditor, other External Auditors, and the Internal Auditors are well outlined in the Example Audit Committee Charter endorsed by the Association of Public Pension Fund Auditors (APPFA). This Example Audit Committee Charter is available on their web site ([www.appfa.org](http://www.appfa.org)) in the References and Links section, and is enclosed as an attachment. (Also, guidance in AU Section 322, The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements provides direction to the external auditors in assessing the competence and objectivity of internal auditors.)

*Reliance on Outsourced Internal Audit Work – Potential Conflicts of Interest.* Previously, we commented on the independence of and qualifications of internal auditors as factors that the external financial statement auditor should evaluate when determining whether or not they could rely on the work of the internal auditors. We believe a potential conflict of interest would occur if internal audit work is totally outsourced to another CPA firm. Because of mergers and restructuring there are few audit firms that are the dominant members of the AICPA in which these firms would be evaluating each others work. This situation has the same potential problems that occurred when the AICPA members performed the PEER reviews of each other and did not find any substantial problems. Consequently, it would be counter-productive to create a similar situation with respect to the relationship between the external financial statement auditor and the outsourced internal audit function.

*Reliance on the Work of the Remaining “Others.”* Reliance on the work of the remaining “others” should be up to the discretion of the External Financial Statement Auditor. They should use the same criteria as when determining whether or not to rely on the work of internal auditors. These criteria are independence, qualifications, competence and the quality of the work.

In conclusion, CalPERS believes that the external audit firm should first review the process by which management arrived at its assessment of internal control, and then look directly at and test the company’s internal control as required in order to gather sufficient competent evidence for forming an attestation opinion on management’s assessment of the internal control structure. The external financial statement auditors may rely on the work of internal auditors and others as described above. (Questions 4-5, 9-16 of the Proposed Auditing Standard)

2. Evaluation of the Audit Committee’s Role in Internal Control. The question of who should evaluate the Audit Committee’s role in internal control deserves careful attention. Ideally, this evaluation should be performed by experts who are independent of the Audit Committee and independent of the company. Since the external audit firm is hired by the Audit Committee, the external audit firm cannot be independent of the Audit Committee. Therefore, we believe that the full Board should hire specialists from a different firm to perform this evaluation. We suggest that an optimal solution is to seek this evaluation from a firm that is not a CPA firm and is free from this potential source of conflicts of interest. This will allow the CPA firms to concentrate their core business of audit and attestation work, and to be in a position to review and evaluate the work performed by others without potential conflicts of interest.

In the event that the External Financial Statement Auditor determines that there is an internal control weakness with regard to the Audit Committee, then this should be reported in writing to the full Board. The full Board is then responsible for investigating and correcting the deficiencies. In addition, the

external auditor should consider the facts in rendering their opinions on the internal control assessment by management and their opinion on the financial statements. (Questions 22-24 of the Proposed Auditing Standard)

3. Experience Levels of Audit Staff. CalPERS believes that the PCAOB should define the minimum experience levels expected of various levels of audit staff. In addition, we believe that companies should formulate their own contracts with the audit firms so they can add experience requirements beyond the PCAOB minimum. Contract terms should include minimum qualifications and specifications of experience for the audit firm, key personnel, and audit staff. These terms should include the right to approve changes in key personnel. (Question 5 of the Proposed Auditing Standard)

Although, we do not directly respond to all 31 questions we believe our comments provides the PCAOB an overview of CalPERS' response.

In summary, CalPERS reiterates its appreciation of the work that the PCAOB is performing and the opportunity to participate in the process. CalPERS believes that this work is essential for the integrity of the financial markets, and CalPERS looks forward to continual interchange of information and ideas with the PCAOB. If you have any questions regarding our comments on the two proposed rules, please contact Ted White, Director of Corporate Governance, at (916) 341-2731, or Larry Jensen, Chief of the Office of Audit Services, at (916) 795-0802.

Sincerely,



Mark Anson  
Chief Investment Officer

Attachment: Audit Committee Charter – Endorsed by the Association of Public Pension Fund Auditors (APPFA)



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We would like to elaborate on our comment # 2, Evaluation of the Audit Committee's Role in Internal Control, in our prior correspondence dated November 21, 2003. In our prior letter we questioned whether the external audit firm can perform an independent review of the Audit Committee. We believe that a *potential* conflict of interest arises if the external audit firm reviews the role of the Audit Committee in internal control. However, we would look to the PCAOB to determine whether a conflict *in fact* has occurred, and we would further look to the PCAOB to exercise its authority to enforce the independence of the external audit firm with respect to a review of the Audit Committee.

Again, CalPERS wishes to express its continued support of the PCAOB in its efforts to improve the standards of financial reporting by publicly-owned companies and the standards of auditing by external audit firms. We appreciate the opportunity to participate in the process of enhancing the financial integrity of our financial markets.

Sincerely,

Mark Anson  
Chief Investment Officer

# **Example Audit Committee Charter**

## **Endorsed by the Association of Public Pension Fund Auditors (APPFA)**

The following Example Audit Committee Charter captures many of the best practices used at the present time, July of 2003. Of course, no example charter encompasses all activities that might be appropriate to a particular audit committee, nor will all activities identified in an example charter be relevant to every committee. Accordingly, this example charter may be tailored to each committee's needs and governing rules. Moreover, as applicable laws, rules and customs change, the audit committee charter should be updated.

Endorsement by the Association of Public Pension Fund Auditors (APPFA) means that this document is intended as a starting point of reference and as a guide to public pension systems in formulating and/or revising their own charters. To the extent that a public pension fund has unique circumstances, different applications and modifications of the example passages may be desirable.

## **Audit Committee Charter**

### **PURPOSE**

The purpose of this "Example Audit Committee Charter" is to assist the Board of Directors in fulfilling its fiduciary oversight responsibilities for the:

- (1) Financial Reporting Process,**
- (2) System of Risk Management,**
- (3) System of Internal Control,**
- (4) Internal Audit Process,**
- (5) External Audit of the Financial Statements,**
- (6) Engagements with Other External Audit Firms,**
- (7) Organization's Processes for Monitoring Compliance with Laws and Regulations and the Ethics Policy, Code of Conduct and Fraud Policy,**
- (8) Special Investigations and Whistleblower Mechanism, and**
- (9) Audit Committee Management and Reporting Responsibilities.**

### **AUTHORITY**

The audit committee has authority to conduct or authorize investigations into any matters within its scope of responsibility. It is empowered to perform the following functions, which are numbered according to the purposes listed above:

#### **(1) Financial Reporting Process**

- Oversee the reporting of all financial information.
- Resolve any disagreements between management, the external auditor and/or the internal auditor regarding financial reporting.

## **Example Audit Committee Charter**

### **(2) System of Risk Management**

- Provide the policy and framework for an effective system of risk management, and provide the mechanisms for periodic assessment of the system of risk management, including risks of the information systems, and risks of business relationships with significant vendors and consultants.
- Oversee all consultants and experts that make recommendations concerning the risk management structure and internal control structure.

### **(3) System of Internal Control**

- Provide the policy and framework for an effective system of internal controls, and provide the mechanisms for periodic assessment of the system of internal controls, including information systems, and internal control over purchases from significant vendors and consultants.
- Ensure that contracts with external service providers contain appropriate record-keeping and audit language.
- Seek any information it requires from employees-all of whom are directed to cooperate with the committee's requests, or the requests of internal or external parties working for the audit committee. These parties include the internal auditors, all external auditors, consultants, investigators and any other specialists working for the audit committee.

### **(4) Internal Audit Process**

- Appoint, compensate, and oversee the work of the Chief Audit Executive and oversee the work of the internal audit unit.
- Serve as the primary liaison and provide the appropriate forum for handling all matters related to audits, examinations, investigations or inquiries of the State Auditor and other appropriate State or Federal agencies.

### **(5) External Audit of the Financial Statements**

- Appoint, compensate, and oversee the work of the certified public accounting firm employed by the organization to audit the financial statements.
- Pre-approve all auditing, other attest and non-audit services performed by the external financial statement audit firm.

### **(6) Engagements with Other External Audit Firms**

- Appoint, compensate, and oversee the work of any other certified public accounting firm employed by the organization to perform any audits or agreed-upon-procedures other than the audit of the financial statements.

### **(7) Organization's Processes for Monitoring Compliance with Laws and Regulations and the Ethics Policy, Code of Conduct and Fraud Policy**

- Provide the policy and framework for compliance with laws and regulations, and provide the mechanisms for periodic assessment of compliance, including compliance by significant vendors and consultants.
- Communicate with the Board regarding the organization's policy on ethics, code of conduct and fraud policy as it relates to internal control, financial reporting and all auditing activities.

## **Example Audit Committee Charter**

### **(8) Special Investigations and Whistleblower Mechanism**

- Retain independent counsel, accountants, or other specialists to advise the committee or assist in the conduct of an investigation.
- Ensure creation of and maintenance of an appropriate whistleblower mechanism for reporting of financial statement fraud and other fraud and inappropriate activities.

### **(9) Audit Committee Management and Reporting Responsibilities**

- Receive and review reports on all public disclosures related to the purpose, authority and responsibilities of the Audit Committee. Consider having a Disclosure Subcommittee for this purpose.
- Report to the Board on the activities, findings and recommendations of the Audit Committee.

### **(1 – 9) Comprehensive Communication Responsibility**

- Meet with the organization's officers, external auditors, internal auditors, outside counsel and/or specialists, as necessary.

## **COMPOSITION**

The audit committee will consist of at least three and no more than seven members of the Board of Directors. The Board or its nominating committee will appoint committee members and the committee chair.

Each committee member will be both independent and financially literate. At least one member shall be designated as the "financial expert," as defined by applicable legislation and regulation.

## **MEETINGS**

The committee will meet at least four times a year, with authority to convene additional meetings, as circumstances require. All committee members are expected to attend each meeting, in person or via tele- or video-conference. Meeting notices will be provided to interested parties in conformance with applicable laws, regulations, customs and practices. The committee will invite members of management, external auditors, internal auditors and/or others to attend meetings and provide pertinent information, as necessary. It will hold private meetings with auditors {Subject to open meeting laws} and executive sessions as provided by law. Meeting agendas will be prepared and provided in advance to members, along with appropriate briefing materials. Minutes will be prepared.



# Example Audit Committee Charter

## RESPONSIBILITIES

The committee will carry out the following responsibilities:

### (1) Financial Reporting Process

- Obtain information and training to enhance the committee members' expertise in financial reporting standards and processes so that the committee may adequately oversee financial reporting.
- Review significant accounting and reporting issues, including complex or unusual transactions and highly judgmental areas, and recent professional and regulatory pronouncements, and understand their impact on the financial statements.
- Review with management, the external auditors, and the internal auditors the results of the audit, including any difficulties encountered.
- Review all significant adjustments proposed by the external financial statement auditor and by the internal auditor.
- Review all significant suggestions for improved financial reporting made by the external financial statement auditor and by the internal auditor.
- Review with the General Counsel the status of legal matters that may have an effect on the financial statements.
- Review the annual financial statements, and consider whether they are complete, consistent with information known to committee members, and reflect appropriate accounting principles.
- Review other sections of the annual report and related regulatory filings before release and consider the accuracy and completeness of the information.
- Review with management and the external auditors all matters required to be communicated to the committee under generally accepted auditing *Standards*.
- Understand how management develops interim financial information, and the nature and extent of internal and external auditor involvement.
- Review interim financial reports with management and the external auditors before filing with regulators, and consider whether they are complete and consistent with the information known to committee members.
- Review the statement of management responsibility for and the assessment of the effectiveness of the internal control structure and procedures of the organization for financial reporting. Review the attestation on this management assertion by the financial statement auditor as part of the financial statement audit engagement.

## **Example Audit Committee Charter**

### **(2) System of Risk Management**

- Obtain information about, training in and an understanding of risk management in order to acquire the knowledge necessary to adequately oversee the risk management process.
- Ensure that the organization has a comprehensive policy on risk management.
- Consider the effectiveness of the organization's risk management system, including risks of information technology systems.
- Consider the risks of business relationships with significant vendors and consultants.
- Reviews management's reports on management's self-assessment of risks and the mitigations of these risks.
- Understand the scope of internal auditor's and external auditor's review of risk management over financial reporting.
- Understand the scope of internal auditor's review of risk management over all other processes, and obtain reports on significant findings and recommendations, together with management's responses.
- Understand the scope of any other external auditor's or consultant's review of risk management.
- Hire outside experts and consultants in risk management as necessary.

### **(3) System of Internal Control**

- Obtain information about, training in and an understanding of internal control in order to acquire the knowledge necessary to adequately oversee the internal control process.
- Ensure that the organization has a comprehensive policy on internal control and compliance.
- Review periodically the policy on ethics, code of conduct and fraud policy.
- Consider the effectiveness of the organization's internal control system, including information technology security and control.
- Consider any internal controls required because of business relationships with significant vendors and consultants.
- Understand the scope of internal auditor's and external auditor's review of internal control over financial reporting, and obtain reports on significant findings and recommendations, together with management's responses.
- Understand the scope of internal auditor's review of internal control over all other processes, and obtain reports on significant findings and recommendations, together with management's responses.
- Review the role of the internal auditor's involvement in the corporate governance process, including corporate governance documentation and training.
- Ensure that contracts with external service providers contain appropriate record-keeping and audit language.
- Direct employees to cooperate with the committee's requests, or the requests of internal or external parties working for the audit committee. These parties include the internal auditors, all external auditors, consultants, investigators and any other specialists working for the audit committee.

## **Example Audit Committee Charter**

### **(4) Internal Audit Process**

- Obtain the information and training needed to enhance the committee members' understanding of the role of internal audits so that the committee may adequately oversee the internal audit function.
- Oversee the selection process for the chief audit executive.
- Assure and maintain, through the organizational structure of the organization and by other means, the independence of the internal audit process.
- Ensure that internal auditors have access to all documents, information and systems in the organization.
- Ensure there are no unjustified restrictions or limitations placed on the Chief Audit Executive and internal audit staff.
- Review with management and the Chief Audit Executive the charter, objectives, plans, activities, staffing, budget, qualifications, and organizational structure of the internal audit function.
- Receive and review all internal audit reports and management letters.
- Review the responsiveness and timeliness of management's follow-up activities pertaining to any reported findings and recommendations.
- Receive periodic notices of advisory and consulting activities by internal auditors.
- Review and concur in the appointment, replacement, or dismissal of the Chief Audit Executive, if allowed by state law.
- Review the performance of the Chief Audit Executive periodically.
- Review the effectiveness of the internal audit function, including compliance with The Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing*.
- On a regular basis, meet separately with the Chief Audit Executive to discuss any matters that the committee or internal audit believes should be discussed privately {Subject to open meeting laws}.
- Delegate to the Chief Audit Executive the management of the contract for the external financial statement auditor, and the management of the contracts for any other certified public accountants.
- Designate the Chief Audit Executive as the primary point of contact for handling all matters related to audits, examinations, investigations or inquiries of the State Auditor and other appropriate State or Federal agencies.

## **Example Audit Committee Charter**

### **(5) External Audit of the Financial Statements**

- Obtain the information and training needed to enhance the committee members' understanding of the purpose of the financial statements audit and the role of external financial statement auditor so that the committee may adequately oversee the financial statement audit function.
- Review the external auditor's proposed audit scope and approach, including coordination of audit effort with internal audit.
- Review the performance of the external financial statement audit firm, and exercise final approval on the request for proposal for, and the appointment, retention or discharge of the audit firm. Obtain input from the Chief Audit Executive, management and other parties as appropriate.
- Define the services that the external financial statement auditor is allowed to perform and the services that are prohibited.
- Pre-approve all services to be performed by the external financial statement auditor.
- Review the independence of the external financial statement audit firm by obtaining statements from the auditors on relationships between the audit firm and the organization, including any non-audit services, and discussing these relationships with the audit firm. Obtain from management a listing of all services provided by the external audit firm. Obtain information from the Chief Audit Executive and other sources as necessary.
- Review and approve the audited financial statements, associated management letter, attestation on the effectiveness of the internal control structure and procedures for financial reporting, other required auditor communications, and all other auditor reports and communications relating to the financial statements.
- Review and approve all other reports and communications made by the external financial statement auditor.
- Review the responsiveness and timeliness of management's follow-up activities pertaining to any reported findings and recommendations.
- On a regular basis, meet separately with the external financial statement audit firm to discuss any matters that the committee or auditors believe should be discussed privately {Subject to open meeting laws}.
- Provide guidelines and mechanisms so that no member of the audit committee or organization staff shall improperly influence the auditors or the firm engaged to perform audit services.
- Ensure production of a report of all costs of and payments to the external financial statement auditor. The listing should separately disclose the costs of the financial statement audit, other attest projects, agreed-upon-procedures and any non-audit services provided.

## **Example Audit Committee Charter**

### **(6) Engagements with Other External Audit Firms**

- Obtain the information and training needed to enhance the committee members' understanding of the role of the other external audit firm(s) so that the committee may adequately oversee their function(s).
- Review the other external audit firm's (firms') proposed audit or agreed-upon-procedures scope and approach, including coordination of effort with internal audit.
- Review the performance of the other external audit firm(s), and exercise final approval on the request for proposal for, and the appointment, retention or discharge of these audit firm(s).
- Pre-approve the scope all services to be performed by the other external auditor.
- Review the independence of the other external audit firm(s) by obtaining statements from the audit firm(s) on relationships between these audit firm(s) and the organization, including any non-audit or non-attest services, and discussing the relationships with the audit firm(s). Obtain from management a listing of all services provided by the other external audit firm(s). Obtain information from the Chief Audit Executive and other sources as necessary.
- Review and approve the reports of the audits and/or agreed-upon-procedures.
- Provide a forum for follow up of findings from the audit reports or agreed-upon-procedures.
- Meet separately with the other external audit firm(s) on a regular basis to discuss any matters that the committee or staff of the audit firm(s) believe should be discussed privately {Subject to open meeting laws}.
- Ensure production of a report of all costs of and payments to other external audit firm(s). The listing should separately disclose the costs of any audit, other attest projects, agreed-upon-procedures and any non-audit services provided.

### **(7) Organization's Processes for Monitoring Compliance**

- Review the effectiveness of the system for monitoring compliance with laws and regulations and the results of management's investigation and follow-up (including disciplinary action) of any instances of noncompliance.
- Review the findings of any examinations by regulatory agencies, and any auditor observations, including investigations of misconduct and fraud.
- Review the process for communicating to all affected parties the ethics policy, code of conduct and fraud policy to organization personnel, and for monitoring compliance therewith.
- Obtain regular updates from management and organization legal counsel regarding compliance matters.
- Monitor changes and proposed changes in laws, regulations and rules affecting the organization.

## **Example Audit Committee Charter**

### **(8) Special Investigations and Whistleblower Mechanism**

- Institute and oversee special investigations as needed.
- Provide an appropriate confidential mechanism for whistleblowers to provide information on potentially fraudulent financial reporting or breaches of internal control to the audit committee.

### **(9) Audit Committee Management and Reporting Responsibilities**

- Regularly report to the Board of Directors about all committee activities, issues, and related recommendations.
- Perform other activities related to this charter as requested by the Board of Directors, and report to the Board.
- Provide an open avenue of communication between internal audit, the external financial statement auditors, other external auditors, management and the Board of Directors.
- Review any other reports that the organization issues that relate to audit committee responsibilities.
- Confirm annually that all responsibilities outlined in this charter have been carried out. Report annually to the Board, members, retirees and beneficiaries, describing the committee's composition, responsibilities and how they were discharged, and any other information required by rule, including approval of non-audit services.
- Evaluate the committee's and individual member's performance on a regular basis, and report to the Board.
- Review and assess the adequacy of the committee charter annually, requesting Board approval for proposed changes, and ensure appropriate disclosure as may be required by law or regulation.