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August 15, 2016

Ms. Phoebe W. Brown, Secretary
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 034, Reproposed Auditing Standard - The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards

Dear Madam Secretary

On behalf of the California Public Employees' Retirement System (CalPERS), thank you for the opportunity to provide our comments on the Public Company Accounting Oversight Board (PCAOB) Release No. 2016-003 proposed auditing standard titled "The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB standards" (Reproposal).

CalPERS is the largest public defined benefit pension fund in the United States with approximately $300 billion in global assets. CalPERS provides benefits to more than 1.8 million employees, retirees, and beneficiaries. CalPERS strives to achieve long-term, sustainable, risk-adjusted returns consistent with our fiduciary duty. To do so, we are guided by CalPERS Global Governance Principles[1] (Principles) which frame our approach to governance issues that impact the integrity and efficiency of capital markets. Embedded in our Principles is the expectation that shareowners are provided with fair, accurate and timely reporting on how companies manage and identify risks related to the three forms of capital: financial, physical, and human. We believe that PCAOB audit standards help protect these shareowner interests and strengthen investors' confidence in capital markets.

[1] See, CalPERS Global Governance Principles , dated March 14, 2016

As stated in our Principles, effective financial reporting depends on high quality accounting standards, consistent application, enforcement, and rigorous independent audits. Accordingly, it is critical that auditors bring integrity, independence, objectivity, and professional competence to the financial reporting process. As providers of capital, we have a strong interest in standards which strengthen the auditor's objective and unbiased audit of financial reports. Therefore, we support the efforts of the PCAOB to enhance the form and content of the auditor's report to make it more relevant and informative for investors. We believe that enhancing the audit report will help improve how we understand and use the information provided in financial statements thereby strengthening investor confidence in the use of financial statements to allocate capital and make informed investment decisions.

We commend the PCAOB for taking action on the comments received in the 2013 proposal about the proposed auditor reporting standard on an audit of financial statements when the auditor expresses an unqualified opinion, as well as the auditor's responsibilities regarding other information in certain documents containing audited financial statements and related amendments. In our response[2] to the 2013 proposal, we expressed support for the PCAOB's proposed auditor reporting standard that introduced the concept of critical audit matters (CAMs) and included new requirements for auditors to communicate CAMs as well as additional improvements to the auditor's report. Like the 2013 proposal, the Reproposal would retain the pass/fail model of the existing auditor's report. However, the Reproposal would also require auditors to include significantly more information in their reports including details on auditor tenure and independence. In particular, the Reproposal would require auditors to include CAMs that were communicated to the audit committee that related to material accounts or disclosures and involved especially challenging, subjective or complex auditor judgments.

Although some of the requirements in the Reproposal differ from the 2013 proposal, we understand that the requirements in the Reproposal have been narrowed to address the comments and concerns received, analysis of economic considerations, academic research, as well as international developments following the 2013 proposal. Specifically, the reproposed requirements have been narrowed by:

- Limiting the source of potential CAMs to matters communicated or required to be communicated to the audit committee;
- Adding a materiality component to the definition of CAM;
- Narrowing the definition to only those matters that involved especially challenging, subjective, or complex auditor judgments; and
- Revising the related documentation requirement.

We are happy to see some of our concerns addressed in the Reproposal. For example, we appreciate the inclusion of expanded communications requiring the auditor to

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[2] See, https://www.calpers.ca.gov/docs/2014-05-02-enhanced-auditor-reporting.pdf, dated May 2, 2014

describe how the critical audit matter was addressed in the audit. The expanded communications would give shareowners a better understanding of the auditor's opinion taken as a whole and how the auditor reached that opinion. We believe the auditor is best suited to provide insights on how and on what basis the auditor developed its opinion. As highlighted in an article[3] published by the Analyst's Accounting Observer, "if auditors are going to bring attention to a financial reporting area that caused them concern as auditors, and draw investor attention to a soft spot in the company's financial statements, the managers are going to have a hard time pushing back against the auditors who are arguing for proper accounting." Accordingly, whether a CAM is disclosed or not, there is still value in the fact that bad company behavior may be altered by virtue of the threat of CAM disclosure.

Additionally, we are pleased to see progress on the requirement to provide an auditor statement regarding independence and a disclosure of auditor tenure. From our perspective, a statement regarding auditor independence and the disclosure of auditor tenure provides necessary context for shareowners with respect to auditor objectivity, ratification, and rotation. However, we note that the Reproposal considers the inclusion of a materiality component in the definition of CAM. We believe that, if used, the materiality standard should be in line with the actual holding in TSC Industries, Inc. v. Northway, Inc. (1976).[4] In TSC Industries, Inc. v. Northway, Inc. (1976) the Supreme Court explicitly defined the standard of materiality in securities fraud cases, holding that:

> "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[5]

The holding narrowed the focus of materiality to issues that impact shareowner judgment in making voting decisions. Our Principles set out the expectation that shareowners should annually ratify the selection of the independent external auditor. Therefore, the additional insights as to how a firm addressed a CAM will have a direct impact on how shareowners vote on ratifying the auditor.

We are delighted to see PCAOB make progress on this standard in light of the global efforts to enhance auditor reports that have already started to take shape. For example, the Financial Reporting Council (FRC) in the United Kingdom[6] already requires disclosure in the auditor's report of key audit matters (KAMs) that go beyond the binary pass/fail model similar to those found in the Reproposal. Additionally, new standards for enhanced auditor reports including discussion of KAMs and how the matter was

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[3] See, p. 3, Volume 25, No. 8, The Analyst's Accounting Observer, dated July 25, 2016

[4] See, TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976)

[5] See, *id*

[6] See, https://www.icas.com/technical-resources/international-standards-on-auditing-uk-and-ireland-the-frcs-key-proposed-changes

addressed in accordance with the International Standards on Auditing issued by the International Federation of Accountants (IFAC) through the International Auditing and Assurance Standards Board (IAASB)[7] which will become effective December 2016. Finally, in April 2014 the European Union (EU) adopted legislation[8] for newly expanded auditor reporting requirements for audits of public interest entities such as listed companies, credit institutions, and insurance companies. In April 2016, the FRC updated its auditor reporting requirements to incorporate the EU and IAASB requirements including adopting the IAASB's definition of KAM. Although the detailed requirements and processes may differ in each jurisdiction, the Reproposal notes[9] that all of these initiatives would result in expanding the auditor's report beyond the traditional pass/fail model to communicate information specific to the particular audit.

As the Reproposal builds on more than five years of PCAOB outreach and the consistent request by commenters to make the auditor's report more relevant and informative, we find comfort in the fact that PCAOBs Reproposal is analogous in many respects to auditor reporting requirements recently established in other jurisdictions. As the Reproposal notes, there are commonalities in the underlying criteria regarding CAMs to be communicated and the communication requirements, such that expanded auditor reporting could result in the communication of many of the same matters under the various approaches. Therefore, CalPERS' overall message in support of an auditor standard that includes requirements related to disclosure of CAMs in the auditor report is consistent with our May 2, 2014 letter[10] to the PCAOB. Consequently, in our responses to the Reproposal, we do not provide answers to the specific questions; instead we highlight certain points made in our responses to the PCAOB's 2013 proposal.

Critical Audit Matters

As stated in our prior response[11] to the PCAOB, we believe the PCAOB's proposed auditor reporting standard would provide four important attributes - transparency, relevance, reliability, and credibility. The reproposed standard revised the definition of a CAM to any matter arising from the audit of the financial statements that was

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[7] See, https://www.ifac.org/system/files/uploads/IAASB/Auditor-Reporting-Fact-Sheet.pdf, dated January 2015

[8] See, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0537, dated April 16, 2014

[9] See, p. 10, Public Company Accounting Oversight Board (PCAOB) Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards, Release No. 2016-003, Rulemaking Docket No. 034, dated May 11, 2016

[10] See, https://www.calpers.ca.gov/docs/2014-05-02-enhanced-auditor-reporting.pdf, dated May 2, 2014

[11] See, *ibid.*

communicated or required to be communicated to the audit committee and that relates to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgment. We believe that auditors should provide independent assurance and attestation as to the quality of financial statements to investors in narrative reports including a statement demonstrating that the financial statements and disclosures are complete, materially accurate, and free of material misstatement, whether caused by error or fraud.[12] Since the purpose of CAMs is to provide disclosures that document the basis and determination for the auditor's opinion regarding financial accounts, we believe that requiring the auditor to communicate CAMs in the auditor's report provides investors with a better range of information about the audit thereby increasing the relevance and usefulness of the auditor's report. From our perspective, mandating CAMs and CAM-related communications will help users to better utilize and value the audit report, enhanced reporting, and the audit opinion.

Furthermore, our Investment Beliefs[13] includes an understanding that long-term value creation derives from the effective management of both risk and opportunities in the oversight of financial, physical, and human capital. As providers of financial capital, shareowners need a detailed explanation as to how a company employs, identifies and addresses CAMs to provide greater context for assessments of risk and return. Therefore, we continue to support the opinion proffered by others that insights on CAMs would be relevant in analyzing and pricing risk.

Auditor Independence and Tenure

As stated in our prior response to the PCAOB, we believe that confidence in a company's audited financial statements is key to the efficient functioning of capital markets. This relies on auditors bringing integrity, independence, objectivity and professional competence to the financial reporting process. Therefore, we agree that adding a statement by the auditor on their independence from the company and board of directors reinforces investors' understanding of the auditor's obligations to be independent and objective in expressing the audit opinion. Furthermore, including an affirmative statement concerning the auditor's independence could help demonstrate that the audit opinion is not simply a "rubber stamp" for information prepared by management. Additionally, as supporters of periodic tendering and auditor rotation we support the disclosure of the auditors' tenure. Tenure disclosures help advance the fiduciary responsibility of the audit committee in determining the appropriate length of tenure to ensure the independence of the auditor.

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[12] See, p. 34, CalPERS Global Governance Principles, dated March 16, 2016

[13] See, https://www.calpers.ca.gov/docs/forms-publications/calpers-beliefs.pdf

We applaud the work of the PCAOB in its efforts to address investor concerns regarding the Reproposal thereby reinforcing your mission to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Accordingly, we will continue to support the PCAOB in initiating meaningful change to the audit reporting model. Thank you for your consideration of our responses. If you have any questions, please do not hesitate to contact me at (916) 795-9058 James.Andrus@calpers.ca.gov.

Sincerely,

JAMES ANDRUS
Investment Manager
CalPERS Global Governance