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November 5, 2012 Via E-Mail: sajjad.karim@europarl.europa.eu

Sajjad Karim, Rapporteur
Committee on Legal Affairs
European Parliament
Rue Wiertz
Willy Brandt 04M107
B-1047 Brussels

Dear Mr. Karim,

RE: DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL – SPECIFIC REQUIREMENTS REGARDING STATUTORY AUDIT OF PUBLIC-INTEREST ENTITIES AUDIT REFORM

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 significant holdings in Europe. As of September 28, 2012, CalPERS owns 3.1 billion shares of companies listed on European exchanges valued at $28.1 billion.

CalPERS supports the European Commission's (Commission) work on audit reform as part of its efforts to ensure effective financial market regulation. We believe there are a number of structural failures in the audit market that pose a threat to the quality of financial reporting. As a significant long-term investor, CalPERS relies on the integrity and efficiency of the capital markets. Hence, we strongly urge you to retain key provisions as outlined in the European Commission's Proposals on audit reform.

Financial reporting plays an integral role by providing transparent and relevant information about the economic performance and condition of businesses. The audit is critical in ensuring standardization and discipline in corporate accounting. This in turn enhances investor confidence. Robust audit is key to re-establishing trust and market confidence and developing an environment where investors can rely on the integrity of financial reporting to evaluate investment risk and returns in capital allocation decisions.

Shareowners are the client of the auditor, and the prime audience for the accounts. For this reason, we consider the audit is of vital importance. CalPERS sees the need for reform to achieve the audit quality investors need.

CalPERS is supportive of the letter (dated the 18th September 2012) sent to Commissioner Barnier by the coalition of European institutional investors highlighting their concerns over the proposed amendments by the Legal Affairs Committee set out in your draft reports dated 5 October. Specifically, there are eight areas in your recommended amendments for regulation that we would request that you consider strengthening in audit reform. These areas, also highlighted in *CalPERS Global Principles of Accountable Corporate Governance,* include[1]:

1. **Auditor Independence -** Text proposed by the Commission identified that "…statutory auditors and audit firms should be completely independent when carrying out statutory audits of such entities and conflicts of interests should be avoided." Amendment 4 weakens the proposed text by removing the word completely and gives the perception that that independence is defined solely for the term of the audit. Auditor independence must be rooted in a robust and transparent system of accountability to shareowners. We believe that Audit Committees should assess the independence of their external auditor on an annual basis and request written disclosure on all relationships that may have a bearing on independence and how the auditor's independence is preserved in both appearance and in fact.

2. **Audit Firm Rotation and Tendering -** Text proposed by the Commission identified mandatory rotation with a maximum duration to not exceed 6 years. Amendment 168 proposes the maximum unbroken duration of an audit engagement to a public-interest entity shall not exceed 25 years. Audit Committees have a fiduciary responsibility to their shareowners and should determine the appropriate maximum length of tenure with possible tendering every five to seven years. The Audit Committee should disclose to its shareowners the reasoning of its developed policy and on an annual basis share this policy with shareowners. Although CalPERS does not have a policy on the maximum number of years an auditor should be employed by a company, we do believe that 25 years, equivalent to a generation is unacceptable in ensuring the independence of the auditor. Mandatory auditor rotation is an effective means of increasing auditor independence. CalPERS principles support that Audit Committees should promote rotation of the auditor to ensure a fresh perspective and review of the financial reporting framework.

3. **Non-Audit Services -** The Commission suggested that it is appropriate to require the statutory auditor, the audit firm and the members of their network, not to provide non-audit services to their audited entities. Amendment 7 allows the statutory auditor to provide certain non-audit services other than prohibited non-audit services to their audited entities. The Audit Committee should disclose its role in safeguarding the independence and objectivity of its auditor. Non-audit, consulting services can impair the objectivity of the auditor. The independent Audit Committee should ensure that

[1] 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

excessive non-audit fees are prohibited and should explain why individual non-audit service engagements were provided by the company's independent auditor rather than by another party. To limit the risk of possible conflicts of interest and independence of the auditor, non-audit services and fees paid to auditors should both be approved in advance by the Audit Committee and disclosed in the proxy statement on an annual basis.

4. **Going Concern/Unqualified Audits –** The Commission's report pointed out the question of how auditors could give unqualified audit reports to their clients during the financial crisis, where banks revealed huge losses. The external, independent auditor is an expert who is well-positioned to, if necessary, can challenge management's judgment on accounting elements, assessment of risks and whether an entity has the ability to continue as a going concern. Amendment 2 removes reference from this issue and does not directly address the responsibilities of auditors, management and audit committees on identifying when a company may not continue as a going concern. CalPERS has proposed wider reforms to the going concern standard via our role on the Investor Advisory Group to the U.S. Public Company Accounting Oversight Board (PCAOB). 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 U.S. Troubled Asset Relief Program (TARP) recipient companies.[2]

5. **Audit Report and Communication –** The Commission proposed that the audit report should include sufficient information on the methodology used, the scope of the audit, materiality, reasons for opinion and whether the audit is designed to include fraud. Amendment 9 removes this language which would increase investors' confidence in the audit report. Investors rely on a vigorous external audit to strengthen the veracity and quality of financial reporting. Auditors should provide reasonable and balanced assurance on financial reporting matters and should expand their reporting directly to investors. Both the U.S. Public Company Accounting Oversight Board (PCAOB) and the International Accounting and Assurance Standards Board (IAASB) are currently vetting the need for improvements in auditor reporting.

6. **Auditor Selection – Concentration –** The Commission identified the importance to monitor the developments in the market, particularly to limiting the choice of auditor and the risks that arise from high market concentration. Amendment 15 addresses the role of audit committees in monitoring the quality of audit work and safeguarding the independence of auditors. It does not address the original concern regarding

[2] 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

concentration as highlighted by the Commission. Competition and concentration among auditors are chief concerns for investors. Tendering appears to be rare. Audit firms retain a FTSE 100 client on average for 48 years and it is not uncommon for this to rise above 100 years with some clients. In 2010 the Big Four audited 99 of the FTSE 100 leading firms and around 240 of the next-biggest FTSE 250. They also had about 80% of the FTSE small capitalization firm audits.[3] CalPERS believes not only should the selection of the independent external auditor be ratified by shareowners annually but that Audit Committees should promote expanding the pool of auditors considered for the annual audit. This would help improve market competition and thereby minimize the concentration of only a small number of audit firms from which to engage for audit services.

7. **Audit Committee Expertise –** The Commission originally required Audit Committees to require 2 directors to have financial expertise, one competent in auditing and another one competent in auditing and or accounting. The Parliament's proposed amendment identifies the need for only one expert. Audit Committee financial expertise should be vetted and specifically identify both accounting and auditing skill-sets. The quality of financial reporting can be increased by appropriately structuring the Audit Committee with effective financial expertise.

8. **Audit fees –** The Commissioner's report identifies a concern regarding the structure of audit fees as it relates to the quality of an audit. It also identifies a concern of dependence on a single client which is excessive and states the statutory auditor or the audit firm should refrain from taking the audit. Amendment 6 removes this concern. CalPERS believes that Audit Committees should annually asses the appropriateness of total fees charged by the auditors and ensure that quality of the audit is of utmost importance and the key component of audit fees.

Please accept our comments as the European Parliament and Commission continue its work to ensure high quality audits, improvements to the competitive audit market, as well as its work on preventing and combating corporate and financial malpractices through the defense and role and the usage of auditors. 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

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[3] House of Lords Select Committee on Economic Affairs, "Auditors: Market concentration and their role", Vol 1: Report 30 March 2011. Research based on Oxera report published in 2006 by the FRC.

cc: Michel Barnier, Internal Market and Services - European Commission – Michel.Barnier@ec.europa.eu
Mary Hartman Morris, Investment Office – CalPERS