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September 8, 2015 Via E-Mail: rule-comments@sec.gov

Brent J. Fields, Secretary
Office of the Secretary
U.S. Securities Exchange Commission
100 F Street NE
Washington, DC 20549

**Re: Concept Release on Possible Revisions to Audit Committee Disclosures
File No. S7-13-15**

Dear Mr. Fields:

On behalf of the California Public Employees' Retirement System (CalPERS), thank you for the opportunity to provide our comments on the Concept Release on Possible Revisions to Audit Committee Disclosures (the Concept Release). CalPERS is the largest public defined benefit pension fund in the United States (US) with approximately $301 billion in global assets.[1] We are strong advocates of reform that ensures the continual improvement and integrity of financial reporting.[2] We strongly support moving forward with additional audit committee disclosure requirements for the reasons expressed in this letter and in our responses to some of the detailed questions included in the Concept Release.

The Concept Release is necessary given the primary audit disclosure requirements have not been updated since 1999. As clearly stated in the Summary of the Concept Release (the Summary):

> The majority of these disclosure requirements, which exist in their current form principally in Item 407 of Regulation S-K, were adopted in 1999. Since then, there have been significant changes in the role and responsibilities of audit committees arising out of, among other things, the Sarbanes-Oxley Act of 2002, enhanced listing requirements for audit committees, enhanced requirements for auditor communications with the audit committee arising out of the rules of the Public Company Accounting Oversight Board, and changes in practice, both domestically and internationally.[3]

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[1] CalPERS investment fund values as of market close on August 3, 2015.
https://www.calpers.ca.gov/page/investments/asset-classes/asset-allocation-performance/investment-fund-values

[2] CalPERS Global Governance Principles, California Public Employees' Retirement System, Section 4. Integrity of Financial Reporting, Updated March 16, 2015. https://www.calpers.ca.gov/docs/forms-publications/global-principles-corporate-governance.pdf

[3] Securities and Exchange Commission, 17 CFR Part 240, Release No. 33-9862; 34-75344 File No. S7-13-15
RIN 3235-AL70, Possible Revisions to Audit Committee Disclosures, July 1, 2015.
https://www.sec.gov/rules/concept/2015/33-9862.pdf

The Sarbanes-Oxley Act of 2002 (SOX) was enacted as a reaction to a number of major corporate, accounting and auditing scandals, including Enron and WorldCom. It was designed to enhance the reliability of financial reporting and to improve audit quality. SOX implemented a variety of components geared toward improving the reliability and integrity of financial reporting. It established the Public Company Accounting Oversight Board (PCAOB) and shifted oversight responsibility of the external auditor from management to an independent audit committee. An important goal of SOX was to align the interests of management, auditors, independent audit committees and audit oversight authorities with shareowners' interests.[4] Interestingly, through all of this, the disclosure rules have not changed, and audit committees have not been required to communicate post-SOX changes in behavior to investors. In fact, it remains unclear whether all audit committees have in fact made such changes.

We welcome this Concept Release because there is a clear need to improve audit committee disclosures. Such disclosures should focus on the needs of investors and not simply on meeting a pre-SOX regulatory requirement. To provide additional value, the audit committee report must be tailored to the specific company (rather than boilerplated).[5] Investors would like audit committee reports to make clear that audit committees are acting as stewards of companies rather than just ratifying financial information that informs short-term pricing. The world has changed substantially since the disclosure requirements were put in place in 1999. It is time to bring them up to date with SOX and global trends that include better communications with investors.

CalPERS Global Governance Principles (Principles) drive us to request changes that ensure that audit committees provide useful disclosures.[6] The United Kingdom's (UK) audit committee disclosure requirements provide a great example of disclosure requirements that lead to much better reporting.[7] One need only read the Rolls Royce Audit Committee Report (Rolls Royce Report)[8] and compare it to the audit committee report of a US company to determine that US audit committees should provide better communications to investors. The standard US company audit committee report is a boilerplate document that fails to provide specific company and industry information. It refers the investor to a charter and mentions that Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 16 (AS 16)[9] has been followed. When coupled with a pass-fail auditor's report, shareowners of US

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[4] The Sarbanes-Oxley Act at 10, Enhancing the reliability of financial reporting and audit quality, Ernst & Young, 2012. http://www.ey.com/Publication/vwLUAssets/The_Sarbanes-Oxley_Act_at_10_-_Enhancing_the_reliability_of_financial_reporting_and_audit_quality/$FILE/JJ0003.pdf

[5] Enhancing the value of the audit committee report, Association of Chartered Certified Accountants, page 3, March 2014. http://www.accaglobal.com/content/dam/acca/global/PDF-technical/corporate-governance/tech-tp-etvoa.pdf

[6] CalPERS Global Governance Principles, Section 4, Integrity of Financial Reporting.

[7] Financial Reporting Council - UK Governance Code 2014. Audit Committee Report, Section C.3.8. https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf

[8] Rolls-Royce Holdings plc Annual Report 2014. Audit Committee Report. Pgs.69-73 http://ar.rolls-royce.com/2014/

[9] PCAOB Auditing Standard No.16. Communications with Audit Committees. http://pcaobus.org/Standards/Auditing/pages/auditing_standard_16.aspx

companies receive little information regarding the oversight of company financials, less information regarding oversight of the auditor and virtually no information regarding anything else that the audit committee does to fulfill its responsibilities. The disclosures of a great audit committee read the same as the disclosures of a poor one. No plain language information is provided in the audit committee report regarding SOX related requirements unless it is voluntarily provided.

Other jurisdictions around the world do a better job of communicating and upholding a robust informative tone with investors through the audit committee report. To highlight the issue, in the opening line of an Audit and Finance Committee Report of one select American company, the report reads:

> "The following is the report of the Audit and Finance Committee with respect to the Company's audited financial statements…"

Compare that opening to the Rolls Royce Report which is written by the audit committee chair of the Rolls Royce audit committee and opens:

> "I am pleased to present the 2014 report of the Audit Committee…"[10]

This change in perspective from an anonymous third party speaker to the chair of the audit committee instantly improves the quality of the communication. The chair takes ownership of the report and communicates directly to investors. Interestingly, in the US, many audit committees actually back-off of the report and more prominently state what they do not do than what they do. For example, one US audit committee report includes the following:

> "The Audit and Finance Committee does not itself prepare financial statements or perform audits, and its members are not auditors or certifiers of the Company's financial statements."

While across the Atlantic, in plain language, the Rolls Royce audit committee chair tells investors about the work of the audit committee. He outlines the responsibilities of the committee without relying on a reference to the UK equivalent of a charter, discusses, in detail, some of the work done during the year, reviews significant judgments and estimates, and highlights issues that might be addressed in the future. Through the report, shareowners learn more about the company, but more importantly, shareowners gain a sense that the audit committee is actually doing its job.

In the US, investors are expected to do much more to figure out what is being said in the audit report. For example, in response to question 1 of the Concept Release, Mr. Jack A. Henry, a former Anderson managing partner and chair of two audit committees said:

> "More disclosure is unnecessary. A stakeholder who wishes to understand more can read the charter, AS 16; understand

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[10] Rolls-Royce Holdings plc Annual Report 2014. Audit Committee Report., p.69.

> Sarbanes-Oxley and the relevant exchange requirements and SEC regulations."[11]

As an investor, it is not a hard choice to determine which would be preferable in a system of audit committee disclosure; 1) real communication about important aspects of a specific company or 2) a general review of legislation, accounting standards and a standard charter that applies to all companies. There is a clear need to provide better disclosures to investors in audit committee reports. There is a fundamental need to determine whether the SOX requirements have actually been enacted at companies. A casual review of the Deloitte[12] survey of the largest reporting companies shows that many companies do not communicate to investors that they are in fact complying with SOX when it comes to oversight of the auditor and other matters. We are not suggesting that any company is not in compliance. We are just pointing out that existing disclosure requirements do not compel audit committees to disclose to investors that they have done their jobs.

Audit committees' roles have evolved substantially since the establishment of SOX. Globally, the pace of this evolution increased substantially after the 2008 financial crisis, as highlighted by the UK regulations[13] which provides the foundation for the Rolls Royce Report. In the US, some audit committees' at the largest companies provide more than boiler plate information,[14] but it is clear others do not. In order to address some of the disclosure issues, our Principles identify specific audit committee disclosures that would enhance transparency and audit quality. Those Principles seek to have audit committees provide the following disclosures:[15]

a. Assessment of the independence and objectivity of the external auditor;
b. Assessment of the appropriateness of total fees charged by the auditors;
c. Assessment of non-audit services and fees charged including limitations or restrictions tied to the provision of non-audit services;
d. Explanation of why non-audit services were provided by the auditor rather than by another party and how the auditor's independence has been safeguarded;
e. Rational for recommending the appointment, reappointment or removal of the external auditor;
f. Assessment of auditor rotation period;
g. Assessment of issues which resulted in auditor resignation, if any.

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[11] Jack A. Henry. Comment Letter Comments on Concept Release: Possible Revisions to Audit Committee Disclosures August 31, 2015.. https://www.sec.gov/comments/s7-13-15/s71315-22.pdf

[12] Deloitte. Comment Letter dated September 2, 2015, Request for Public Comment on Concept Release on Possible Revisions to Audit Committee Disclosures, July 1, 2015 (Release No. 33-9862, File No. S7-13-15). https://www.sec.gov/comments/s7-13-15/s71315-26.pdf

[13] Financial Reporting Council, The UK Corporate Governance Code, September 2014. https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf

[14] Audit committee reporting to shareholders: going beyond the minimum, Ernst & Young, February 2013. http://www.ey.com/Publication/vwLUAssets/Audit_committee_reporting_to_shareholders:_going_beyond_the_minimum/$FILE/Audit_committee_reporting_CF0039.pdf

[15] CalPERS Global Governance Principles, Section 4.15 p.25.

The expectation is that there would be actual statements that address the issues and not a reference to a charter. Interestingly, at many companies, the charter reference often reads as follows:

> The Audit and Finance Committee has certain duties and powers as described in its written charter adopted by the Board. A copy of the charter can be found on the company's website.

There is often no affirmative statement that the audit committee complied with the charter. There is only a reference that one exists and where it can be found. The investor is left to assume compliance even after the implementation of SOX. If there is ever an issue, the audit committee would have clear deniability that it never stated that it complied with any specific duty included in the referenced charter.

We have attached a full copy of the Rolls Royce Report to provide a model of what may be possible. We also attach our responses to certain questions included in the Concept Release. We believe that most audit committees are doing a diligent job, but even those audit committees do not communicate to investors what they do. We also believe that requiring better disclosures of all companies will create a pathway for improved operations for certain audit committees. We urge you to listen to the call of investors and upgrade the audit disclosure requirements from the pre-SOX 1999 version.

If you have any questions, please do not hesitate to contact me at (916) 795-9058 or james.andrus@calpers.ca.gov.

Sincerely,

JAMES ANDRUS
Investment Manager,
Global Governance

cc: Anne Simpson, Investment Director, Director of Corporate Governance

Attachments: Rolls Royce Holdings plc 2014 Annual Report - Audit Committee Report
CalPERS Responses to SEC Audit Committee Disclosure Questions

AUDIT COMMITTEE REPORT

I am pleased to present the 2014 report of the Audit Committee.

Our key aim is to review and report to the Board on financial reporting, internal control and internal audit, and to ensure the relationship with the external auditors is open and effective. Our work to deliver this objective during 2014 is summarised later in this report. I would like to thank the members of the committee, the executive management team and KPMG for the open discussions that take place at our meetings and the importance they all attach to its work.

The terms of reference for the committee were reviewed during the year as part of the wider governance review. This has clarified some aspects of the committee's responsibilities, primarily around oversight of risk management. From 2015, we will be working to this revised version, which is available on the Group's website.

Responsibilities
Financial reporting
• reviewing the financial results announcements and financial statements and monitoring compliance with relevant regulations
• reviewing the appropriateness of accounting policies and the supporting key judgements and estimates
Internal control and internal audit
• assessing the scope and effectiveness of the systems to identify, manage and monitor financial and non-financial risks
• reviewing the procedures for detecting, monitoring and managing the risk of fraud
• reviewing the scope, resources, results and effectiveness of internal audit
External audit
• overseeing the relationship with the external auditor, reviewing the effectiveness of the external audit process and making recommendations to the Board regarding the external auditor's appointment

The Audit Committee consists of Non-Executive Directors and met five times in 2014.

Members	Attendance in 2014
Lewis Booth CBE (Chairman)*	5/5
Iain Conn (retired 1 May 2014)	3/3
Warren East CBE	3/5
John Neill CBE	5/5

* Lewis Booth has recent and relevant financial experience. His biography is on page 54.

SECTOR AUDIT COMMITTEES
In support of the committee's work, each of the Group's businesses now has its own sector audit committee. We felt that this would be helpful in building in a level of detailed executive oversight which would strengthen further accountability for the quality of financial reporting and internal control at the divisional and sector level. All the sector committees are chaired by the director of internal audit to introduce a degree of independence from management and to support their effective organisation and operation.

The sector committees meet twice a year to consider the accounting policies, judgements and estimates and the internal control environment of each business. We receive formal reports and discuss the results of these meetings. This gives us further insight into the extent of management control and accountability, broadens our reach within the Group and informs areas for further consideration at our meetings. Over the next year, their focus on internal control and risk management systems will develop further.

OUR WORK DURING 2014

FINANCIAL REPORTING

In meeting our responsibilities over the past year, we have devoted a lot of time to discussing accounting policies and judgements and our work and conclusions are discussed in detail below. Coming out of these discussions, we fully recognise the need for the Group to communicate clearly to shareholders and to give them confidence that our accounting policies are sound and subject to thorough review by the committee as well as the auditors and management.

We review financial announcements and financial statements with both management and KPMG. In 2014, we focused on:

- compliance with financial reporting standards and governance reporting requirements;
- the appropriateness of accounting policies, focusing on areas requiring significant judgements;
- the procedures and controls around estimates that are key in applying accounting policies;
- the response of senior executives to their perception of the increased risk relating to the pressure on, and incentives for, management to achieve financial targets;
- whether the Annual Report and Financial Statements, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's position and performance, business model and strategy; and
- any relevant correspondence from regulators.

AUDIT COMMITTEE REPORT
CONTINUED

We place considerable emphasis on making sure that the accounting policies are appropriate so that the financial statements faithfully represent the results and financial position of the Group and its underlying contractual arrangements. This is particularly so for the Civil aerospace business, where our business model includes a number of unique features.

As described in the business model on page 24, the development of gas turbine engines for use in civil aircraft applications involves large upfront investments, which may be shared with suppliers, and which are expected to be recovered over long periods from the sale of OE; and subsequently from the aftermarket from the sale of spare parts and engine maintenance work. Much of the aftermarket repair and overhaul is provided through long-term service agreements. Given this long exposure, which may extend for decades from the initial concept, the amount of revenue and profit recognised during any period requires a significant number of accounting judgements and estimates. Consequently, one of our primary responsibilities is to ensure that the bases for these judgements and estimates are robust.

As reported last year, we monitored the enquiry from the FRC's Conduct Committee on the accounting for risk and revenue sharing arrangements (RRSAs). I joined management and KPMG in meeting with the Conduct Committee to hear first-hand and to participate in the debate. We considered carefully the Conduct Committee's views and possible alternative approaches. The Audit Committee concurred with management's view that the revised policy adopted in 2013 best reflects the nature of the transactions.

We also monitored an enquiry from the Conduct Committee regarding the accounting for long-term contractual arrangements in Civil aerospace. No adjustments resulted from this. However, the discussions did lead us to conclude that we had been insufficiently clear in explaining how the different ways we do business with our Civil aerospace customers lead to our accounting policies. In response to this and the views of investors, the Group has taken two principal steps. Firstly, an investor day was held in June, at which management explained the different commercial arrangements that apply and how we account for each. Secondly we have made enhancements to this year's Annual Report, primarily:

ACCOUNTING POLICIES: SIGNIFICANT JUDGEMENTS AND ESTIMATES

Given the long-term nature of the Group's businesses it is inevitable that most of the accounting policies subject to significant accounting judgement will remain the same from year to year, though the facts and circumstances on which those judgements are based will vary. In 2014, our discussions were principally on whether:

Key issue	Activity
• the key accounting judgements set out on pages 101 to 103 are appropriate.	The Group finance department presented to the committee the key accounting judgements and the reasons why these judgements had been made. We were satisfied that these are the appropriate key judgements. For 2014, two new areas of judgement were identified. The first related to the disposal of the Energy business — see below. The second related to whether the leaseback of spare engines that the Group has sold to joint ventures should be classified as operating leases (when the profit on sale is recognised immediately) or finance leases (when it is spread over the lease term). We concluded that certain arrangements should be treated as finance leases and, accordingly, the profit has been deferred.
• there are any indications of impairment of the carrying values of the intangible assets in Civil aerospace.	We considered the business plans for the relevant engine programmes, including the key assumptions on which they are based, and which support the value in use assessments for the intangible assets. We were satisfied that no impairments were required. For 2014, we focused particularly on the intangible assets related to the Trent 900 programme.
• the estimates used in accounting for long-term contractual arrangements in Civil aerospace are appropriate.	We reviewed the forecasts of future contract performance on which the accounting is based. We also considered performance to date against these forecasts and the results of a detailed review of certain aspects of the processes supporting these forecasts. Where the accounting results in a contract asset, we assessed the recoverability of the asset against agreed criteria. We were satisfied that the forecasts have been prepared on an appropriate and consistent basis.
• the provisions for customer financing liabilities in Civil aerospace are adequate.	We considered the likelihood of the liabilities crystallising, based on an assessment of customers' fleet plans and their creditworthiness. We also considered the value of any security held, based on third-party valuations. We were satisfied that provisions have been made on an appropriate basis. For 2014, we considered in particular the release of previously established provisions relating to unexpired guarantees under which the Group's obligations are judged to have been terminated.
• the disposal of the Energy business has been appropriately accounted for.	We considered the estimates made in determining the amounts of the proceeds deferred in respect of the Group's continuing obligations for transitional commitments to provide future goods and services to Siemens. We were satisfied that the disposal has been accounted for appropriately.
• the disclosures of contingent liabilities, in particular those in respect of the possible outcome of the SFO enquiries are adequate.	We considered legal advice in respect of the SFO enquiries. We were satisfied that the disclosures appropriately reflect the current position.

- The description of the Civil aerospace business now emphasises that whenever we sell engines, we secure contractual rights to profitable aftermarket business even where there is no TotalCare agreement. Consequently, the description of the resulting intangible asset previously referred to as 'recoverable engine costs' has been changed to 'contractual aftermarket rights'.
- The accounting policies include a plain English description of the rationale for the accounting we apply and the detailed descriptions have been enhanced (see page 101).

We place considerable emphasis on making sure that the Group's accounting policies are appropriate."

Following these two enquiries, we instigated a review of all the Group's significant accounting policies as described in note 1 of the Financial Statements and the key judgements and estimates supporting them.

These reviews were undertaken by management and involved analysis of the relevant accounting standards and guidance, comparative analysis with other companies with similar or analogous transactions to the extent available, consideration of the pros and cons of options in the context of achieving the most faithful representation of the transactions in the Group's accounts, and informal discussions with accounting firms other than KPMG. KPMG also provided the committee with its views.

We were satisfied with the results of these reviews, which concluded that the accounting policies adopted by the Group were the most appropriate available and that enhancements and revisions in note 1 should be made to add clarity to the accounting policies and the rationale on which they are based.

Since the year end, we have reviewed the form and content of the Group's 2014 Annual Report together with the production process used to develop and verify the report. We have reported to the Board that, taken as a whole, we consider the Annual Report to be fair, balanced and understandable.

INTERNAL CONTROL AND RISK MANAGEMENT

To support the Board in carrying out its review of internal controls and risk management, we reviewed the process by which the Board reaches its conclusion. This involved consideration of the key findings from the ongoing oversight, monitoring and reporting processes, management representations and independent assurance reports.

We are currently assessing how we will develop our approach to meeting the revised Code standards requiring the monitoring of internal control and risk management as an ongoing process as well as evaluating effectiveness at least annually.

From 2015 onwards, as a result of a broad ranging review of our risk governance approach, our overall assessment will combine oversight of the principal risks management activities undertaken by each board committee or the Board (as explained in the Chairman's Introduction on page 56); the Audit Committee will consider financial control and reporting, fraud and IT risks together with an assessment of the integrated control and risk management approach covering all financial and non-financial risks. In this way we aim to make sure that the Board's oversight of risks and risk management is rigorous in its coverage and depth, making sure that principal risks are assessed in detail and that one committee has an integrated review of how the internal control framework is operating.

In line with this, during 2014, we carried out an assessment of financial controls, primarily based on a self-assessment of these controls by each of the businesses. A priority for 2015 is to standardise and, where necessary, enhance the Group's financial internal control framework, against which this assessment is made. This will create greater consistency, particularly in the Group's small operations, and reinforce ownership and accountability for effective internal control throughout the organisation.

We also schedule detailed reviews with the management of each of the Group's businesses and with key functions. The objective of these reviews is to have the opportunity to discuss and challenge key accounting judgements and estimates, and to assess the internal control and risk management systems. They also provide the committee members with the opportunity to meet and evaluate the financial and risk management personnel deeper in the Group.

At our meetings during 2014, we received presentations from:

- The **Civil aerospace** business — we discussed: the key business risks (including possible competitor actions, ensuring profitable delivery of the increased engine volumes, ensuring on-time delivery of new programmes, business continuity risks including supply chain disruption and market shock due to external events or factors reducing air travel); accounting policies; key accounting judgements, estimates and controls; credit risks associated with customers; and, CorporateCare and TotalCare accounting.
- The **Marine** business — we discussed: key challenges for the business (slower than anticipated recovery of the business's markets, cost reduction initiatives, and delivering critical systems changes); key business risks (competitor actions linked with failure to address our own cost base, market shock to which the offshore sector is particularly vulnerable, failure to invest in the right technologies, and failure to maintain customer satisfaction through poor quality or late delivery); the control environment in a widely dispersed business; ERP systems; and key accounting policies and judgements including warranty/reliability issues, with a focus on an emerging product quality issue.
- The **chief information officer** — we discussed: current trends in cyber security including inherent risks and vulnerabilities and the current landscape; the Group's 'defence in depth' approach to cyber security; the Group's recent experience of attacks; and plans

AUDIT COMMITTEE REPORT
CONTINUED

for the future. The committee asked for KPMG's views on the Group's approach. We agreed that committee members would visit the Group's key cyber-security centre in 2015 to see the approach being applied in practice.
- The **director of tax** — we discussed: the approach to managing the Group's tax affairs; the role of the tax function and its interaction with other areas of finance and external suppliers; key tax risks and how they are managed; the profile of tax payments over the last five years; the effective tax rate; the UK tax position (in particular the impact of R&D expenditure, pension contributions and the timing of tax payments on TotalCare profits); and key tax-related accounting policies and judgements (including accounting for advance corporation tax).

These reviews provide the committee with invaluable insights into the risks facing the Group and the management of them, and the application of key accounting policies, judgements and estimates.

We were also notified of any matters raised through the Group's whistle-blowing arrangements or otherwise that related to financial reporting, the integrity of financial management or fraud. There were no cases of fraud that were significant or that demonstrated weaknesses in internal controls. Additionally we monitor compliance with the Group's policies in respect of expenses incurred by the directors and other senior executives; no significant issues were identified.

INTERNAL AUDIT

The new director of internal audit has been working closely with the committee in undertaking a full review of our audit structure and approach. This has given us an opportunity to review internal audit's effectiveness. The discussions on his conclusions and suggestions for changes have formed the basis of the committee's review of internal audit effectiveness over the course of 2014.

We are very pleased with the progress that has been made. A number of changes have been made to improve the structure of audit reports and we are satisfied that the approach to reporting to the committee is now working well. A process for mapping risks, controls and assurance is underway and this will help ensure that our audit coverage is sound.

Twice a year, we review detailed updates on significant findings and audit operations. In particular, we review the nature and number of issues raised by internal audit and the time to complete the related actions, which during 2014 we considered to be reasonable. We were pleased to see that the responsiveness of management across all areas of the business to audit findings has improved and we consider that audit findings are being followed through effectively and promptly. Between these six-monthly updates, we review a dashboard which identifies key trends.

I meet the director of internal audit in private before each meeting and on an ad-hoc basis throughout the year, and the committee as a whole has a private meeting with him at least once a year. These discussions cover the activities, findings, resolution of control weaknesses, progress against the agreed plan and the resourcing of the department.

We were satisfied that the scope, extent and effectiveness of internal audit work are appropriate for the Group and that the director of internal audit has a sound plan for ensuring that this continues to be the case as our business progresses and the risks we face change.

EXTERNAL AUDITOR

The audit cycle is continuous. In April, following the completion of the 2013 audit, the lead audit partner presented the audit strategy for 2014, identifying KPMG's assessment of the key audit risks and the proposed scope of audit work. In addition to those described in the auditor's report (pages 154 to 159), these risks were: valuation of derivatives; accounting for RRSAs; warranties and guarantees; valuation of derivative financial instruments; valuation of pension liabilities; recoverability of tax assets and adequacy of tax provisions; litigation and claims; and the form and content of the Annual Report.

As part of the reporting of the half and full-year results, in July 2014 and February 2015, KPMG reported to the committee on their assessment of the Group's judgements and estimates in respect of these risks and the adequacy of the reporting.

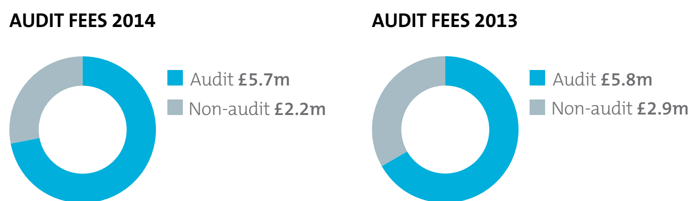
The 2013 Annual Report included, for the first time, an extended auditor's report under new auditing standards. We agreed to assist KPMG in their trialling of a report that went beyond the minimum requirements. We were pleased to note the positive comment that this report generated and have agreed to continue with this approach.

I meet the lead audit partner before each meeting and the whole committee meets with KPMG in private at least once a year. In 2014, I met senior members of the KPMG team to discuss key accounting policies, judgements and estimates in depth and, upon his appointment to the committee, Warren East was briefed by KPMG. In addition, I met with a small group of KPMG's senior partners to discuss emerging and leading audit committee practices in comparable UK listed companies as well as other topical matters.

NON-AUDIT SERVICES PROVIDED BY KPMG

In order to safeguard auditors' independence and objectivity, we do not engage KPMG for any non-audit services except where it is work that they must, or are clearly best suited to, perform. Fees paid to KPMG for audit, audit related and other services are set out in note 8 to the Financial Statements.

All proposed services must be pre-approved in accordance with an agreed policy which is approved annually. We also review the non-audit fees charged by KPMG quarterly.



Non-audit related fees paid to KPMG during the year were 39% of the audit fee, principally in respect of assurance work requested by Siemens in respect of the disposal of the Energy business, grant claims and tax compliance. The nature and level of all services provided by the external auditor is a factor taken into account by the Audit Committee in its annual review of the external auditor.

As described in last year's Annual Report, we took the decision to allow Power Systems to complete engagements already in progress. Non-audit related services provided to Power Systems in 2014 amounted to £0.9 million, a reduction of 57% compared to 2013.

Based on our review of the services provided by KPMG and discussion with the lead audit partner we concluded that neither the nature nor the scale of these services gave any concerns regarding the objectivity or independence of KPMG.

RE-APPOINTMENT OF AUDITOR AND AUDIT TENDERING

Following the completion of the audit, we reviewed the effectiveness and performance of KPMG with feedback from committee members, senior finance personnel and internal audit. A wide range of factors were considered including: independence and objectivity; business understanding; technical knowledge; quality, continuity and experience of the audit personnel, in particular the lead audit partner; responsiveness; planning and risk identification; working with management; the quality of reporting to, and discussions with, the committee; cost effectiveness; and the quality of the report to shareholders. We also considered the reports on KPMG by the FRC's audit quality review team. The audit of Rolls-Royce was not subject to their review in 2014. We also reviewed the fees of the external auditor.

Our conclusions were that the external audit was carried out effectively, efficiently and with the necessary objectivity and independence. The committee and the Board have recommended their re-appointment at the 2015 AGM.

KPMG were appointed as auditors in 1990 and this appointment has not been subject to a tender process since that date. No contractual obligations restrict our choice of external auditors. The lead audit partner is required to rotate every five years and other key audit partners are required to rotate every seven years. Jimmy Daboo took over as lead audit partner in 2013.

The new EU Directive requires that audits be tendered at least every ten years and that an incumbent auditor can only be re-appointed once. Under the transitional arrangements, we will be required to appoint a different auditor no later than the audit of the 2020 financial statements.

The Group is a complex and technologically advanced business with a long cycle from the development of an engine to its eventual retirement. We believe that KPMG's knowledge of this, built up over a number of years, enhances the effectiveness of the audit and that the existing professional requirements, such as the rotation of audit personnel, maintain independence.

In accordance with the requirements of the EU Directive, we plan to recommend a tender of the audit during the tenure of the current lead partner which, subject to KPMG's annual re-appointment, would end following the 2017 audit. Before we make such a recommendation, we will satisfy ourselves that: (i) it will not be unnecessarily disruptive, taking account of any other activities; and (ii) appropriate plans are in place to ensure audit effectiveness is maintained. We do not propose to tender the audit in 2015.

LOOKING FORWARD

The work of an audit committee is increasingly broad and complex. We are very conscious of the need to keep on top of developments in financial accounting and reporting and to stay alert to regulatory changes around external audit. There is also considerable change in our responsibilities to make sure that the internal control framework is working well and to give the Board confidence that the business is under control and risks are appropriately mitigated.

The external review undertaken in 2014 gave particular attention to the committee's work and how, as a Board and committee, we are approaching internal control and risk management. This risk governance assessment, along with the wider governance review conducted by the Board, has helped me consider how we will develop further the committee's work.

The reviews have highlighted areas where oversight and risk management need more structured review by the committee so that we receive an integrated picture of the effectiveness of the control framework in addition to our usual active oversight of financial controls. As described in this report, we have made good progress during the course of this year, very ably and actively supported by the management team. I look forward to seeing that progress continue with the implementation of the new risk management framework and other initiatives during 2015.

LEWIS BOOTH CBE
Chairman of the Audit Committee

CalPERS Responses to SEC Audit Committee Questions

1. Do the current audit committee reporting requirements result in disclosures that provide investors with useful information? Why or why not? Are there changes to the current audit committee disclosure requirements that the Commission should consider that would better inform investors about the audit committee's oversight of the audit and the independent auditor?

No, the current requirements do not result in the provision of useful information. The current disclosure requirements in Item 407 of Regulation S-K, which were adopted in 1999, results in boiler plate comments to meet the minimal requirements. The Commission should consider changing the requirements to better meet the needs of investors. A robust example of an approach can be found in the Financial Reporting Council's (FRC's) guidance to audit committees that details an approach with comprehensive instructions on the committee's role, responsibilities and communication with shareowners.[1]

3. Would investors find additional or different audit committee reporting requirements useful given the committee's strengthened and expanded role in overseeing a company's independent auditor that resulted from the Sarbanes-Oxley Act? For example, to what extent is information regarding how the audit committee discharges its responsibilities useful to investors given the nature of the requirements and likely variability in performance? Also, are there particular audit committee responsibilities for which information would be likely more or less useful and why?

Yes, we would find reports modeled after the audit committee report of Rolls Royce plc (Rolls Royce Report) useful.[2] The Rolls Royce Report represents an actual communication to shareowners rather than a boiler plate production that meets regulatory minimums. The distinction makes a difference. The Rolls Royce Report flows from the UK Governance Code[3] which outlines the main roles and responsibilities of the audit committee. The disclosures include the following:

> The significant issues that the committee considered in relation to the financial statements, and how these issues were addressed;

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[1] UK's Financial Reporting Council, Guidance on Audit Committees, September 2012. https://www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx

[2] Rolls-Royce Holdings plc, Annual Report 2014 Audit Committee Report, 12 February 2015. http://ar.rolls-royce.com/2014/assets/pdf/RR_Full_Annual_Report.pdf

[3] Financial Reporting Council, The UK Corporate Governance Code, C.3.8, September 2012. https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.pdf

> An explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor; and
>
> If the external auditor provides no-audit services, an explanation of how auditor objectivity and independence is safeguarded.

6. Should the audit committee provide disclosure of its work in other areas, for example, its oversight of the financial reporting process or the internal audit function? If so, what types of disclosures would be most useful and why?

Yes, it would be useful if the audit committee report explained in some detail the activities it undertook to accomplish its oversight role.

For example, the Chair of the Rolls Royce Audit Committee discusses the audit committee's work on financial reporting and internal audit in some detail. With regard to financial reporting, the Chair states:

> The amount of revenue and profit recognized during any period requires a significant number of judgments and estimates. Consequently, one of our primary responsibilities is to ensure that the bases for these judgments and estimates are robust.[4]

The report then includes a list of significant judgments and estimates. With regard to internal audit, the Chair states specifically what the committee did, down to the number of meetings with the director of internal audit. These types of disclosures are useful because they provide insight into the nature of the business, the audit committee's diligence in fulfilling its responsibilities as well as communicates to a shareowner that key governance measures and other important work is being accomplished.

15. Are there benefits, costs or unintended consequences that could result from requiring disclosure that goes beyond a statement that the required discussions have occurred? How would the disclosures be used by institutional and retail investors, investment advisers, and proxy advisory firms in making voting decisions and recommendations on matters such as director elections, executive compensation, or shareholder proposals, among others?

CalPERS, as a long-term investor, believes that effective stewardship benefits companies, investors and financial markets. We favor the level of transparency from an

[4] Rolls-Royce Holdings plc, Annual Report 2014 Audit Committee Report, 12 February 2015. http://ar.rolls-royce.com/2014/assets/pdf/RR_Full_Annual_Report.pdf

audit committee that fully complies with its duties, tells shareowners that the audit committee has reviewed specific difficult issues and become satisfied with critical judgments. There is no benefit in assuming the work is being done. We need only look back to Enron and WorldCom.[5] The costs and unintended consequences of having additional accounting and auditing related “blow ups” from minimalistic reporting outweighs the costs associated with having clear statements telling shareowners about the work of an audit committee.

16. Would the potential disclosures referenced here be decision-useful to investors? If so, would it be sufficient for the disclosure to address the consideration given by the audit committee without necessarily disclosing the underlying substance? Would disclosing the substance of the communications between the audit committee and the auditor be useful to investors? Why or why not?

Yes, the disclosures are decision useful in many ways. We are long-term investors and need to know that the board and the audit committee are providing useful oversight. The audit committee provides comfort that it is doing its job by clearly reporting on what it does. Existing audit committee reports are of little value unless a company goes beyond the minimum requirements. Companies and some commenters would like us to be satisfied with minimal disclosures. Jack A. Henry, a former Anderson managing partner stated:

> More disclosure is unnecessary. A stakeholder who wishes to understand more can read the charter, AS 16; understand Sarbanes-Oxley and the relevant exchange requirements and SEC regulations.

Our view is that the audit committee report should be an opportunity for members of the board to communicate with investors about a specific company not be a recitation of general audit regulations. Board members should communicate to investors in clear language. We would like the audit committee to tell us about their work and not force each investor to develop an understanding of legislation, regulations and accounting standards and then assume a particular audit committee is compliant it referenced the rules in an audit committee report. The Rolls Royce Report provides one example of what is possible.

[5] Ten things we haven’t learned from Enron Scandal, by Susanna Kim Dec 1, 2011. http://abcnews.go.com/Business/10-things-learn-enron-scandal-10-years/story?id=15048641

19. Should the audit committee report disclose the frequency with which it met privately with the auditor? Would confirmation that private conversations occurred be useful disclosure even if there are no disclosures about the topics discussed? Should there be a requirement to disclose the topics discussed?

Interestingly, from reading several US audit reports, it appears that some audit committees do not meet with the auditor without management present. At least, the audit committees do not communicate that this occurs. The private meetings should be standard. We have no information on what percentage of audit committees are meeting this standard. It would be good to know that the audit committee actually meets with the auditor without management present at least once during the course of the year.

26. What types of disclosures could be made regarding the process the audit committee undertook to evaluate the external audit and performance and qualifications of the auditor, including the rationale for selecting or retaining the auditor?

We include the Rolls Royce Report as Attachment 1. It provides an example of what can be communicated.

34. Would disclosure of the name of the engagement partner be useful to investors? Would disclosure of any additional members of the engagement team be useful and, if so, which? (For example, should the names of all partners who are required to rotate under SEC independence rules be disclosed? Why or why not?) Should there be other disclosures about the engagement team or others involved in the audit? If so, what additional information should be disclosed? Are there any costs to such disclosure?

In accordance with our Global Principles, we believe that including the engagement partner signature improves audit quality. We have consistently been in favor of including the engagement partner's signature in the audit report. In 2008, we agreed with the US Treasury's Advisory Committee on the Auditing Profession's (ACAP's) recommendation that the PCAOB consider mandating the engagement partner's signature on the auditor's report to affirm the accountability of the auditor.[6] In response to the PCAOB's 2009 concept release, we stated that:

> We believe requiring the engagement partner to sign the audit report will enhance audit quality by increasing the engagement partner's sense of accountability to financial

[6] CalPERS letter to the Advisory Committee on the Auditing Profession, Department of the Treasury, June 13, 2008. https://www.calpers.ca.gov/docs/governance/2008/acap-addendum-comment.pdf

> statement users (providers of capital), lead to greater care in performing the audit and possibly provide better investor protection.[7]

Last year, we expressed our view that:

> Requiring audit partners to sign the opinions they issue will enhance accountability and reliability in the audit process.[8]

35. Are there incremental benefits to disclosing the name (such as increased accountability)? Is disclosure of the name helpful in promoting audit quality? Are current risks of potential legal liability, regulatory sanction and significant reputational costs strong enough incentives to develop a team that is capable of executing the audit in accordance with professional standards? Why or why not? In addition to disclosure of the name, there could be disclosure regarding other qualifications, such as the length of time the individual has served in that role, professional licenses, or his or her experience. What, if any, additional information should be disclosed? Why?

Yes, disclosing the name improves audit quality and enhances accountability.

CalPERS has consistently expressed its view that the engagement partner signature will enhance transparency, and accountability. Recent research confirming this, in the September 2013 volume of The Accounting Review, the peer-reviewed journal of the American Accounting Association, Professors Joseph Carcello (University of Tennessee and member of the PCAOB Investor Advisory Group) and Chan Li (University of Pittsburg) states:

> The engagement partner's signature on the auditor's report would increase transparency and accountability.[9]

In their research, Carcello and Li conducted an experiment concerning whether an engagement partner signature requirement affects audit quality and concluded that audit quality improved in the UK after the effective date of the partner signature requirement.[10] Specifically, they found that abnormal accruals significantly declined,

[7] CalPERS letter to the PCAOB, Release 2009-005, Rulemaking Docket Matter # 029, September 14, 2009. http://pcaobus.org/Rules/Rulemaking/Docket029/022_CalPERS.pdf

[8] CalPERS letter to the PCAOB, Release 2013-009, Docket Matter # 029, March 17, 2014. http://pcaobus.org/Rules/Rulemaking/Docket029/066c_CalPERS.pdf

[9] Joseph V. Carcello and Chan Li, "Costs and Benefits of Requiring an Engagement Partner Signature: Recent Experience in the United Kingdom", *The Accounting Review*: September 2013, Vol. 88, No. 5, pp. 1511-1546. SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2225427&download=yes

[10] Ibid., pg.1512

frequency of small earnings increases declined, information value of earnings increased, and the incidence of qualified audit opinions increased significantly.[11] They concluded that when audit partners knew their names were on the line, they were more likely to issue qualified opinions and less likely to sign off on audits with managed earnings.

36. Is the audit committee the appropriate party to provide such disclosure? If not, what other party or parties should provide the disclosure and why?

We would prefer that the disclosure be provided in the auditor's report, but we do think that there is value in identifying the engagement partner in the audit committee report, as well. Please note that the Rolls Royce Report names the lead audit partner for Rolls Royce.

37. Would such disclosure be more appropriately disclosed in the auditor's report? Why or why not? Would it be better disclosed in a separate filing with the PCAOB? Why or why not? If the disclosure is provided in a separate filing with the PCAOB, what information should the disclosure include?

Including the engagement partner name in a separate filing does not replicate the enhanced accountability that occurs when the engagement partner signs the audit report, but it represents an improvement to current disclosure requirements.

38. If the name of the engagement partner is available elsewhere (e.g., included in the auditor's report or a supplemental filing with the PCAOB), would investors benefit from having it also reported as part of the audit committee's disclosures? Why or why not? Also, if the name of the engagement partner is available elsewhere, should the audit committee's report refer to where the disclosure is otherwise located?

There should be no problem adding the name of the engagement partner in the audit committee's report. This makes it easy for the investor. There is no need to search elsewhere for a name. It highlights that the audit committee is actually engaged to some degree with a specific person regarding the audit.

[11] Ibid., pg. 1513

42. Are there any liability implications (e.g., for engagement partners, audit committee members, the company or other participants) with respect to disclosure of participants in the audit? If so, what are these implications? Do the implications change based on where or how the disclosure is made?

There are no liability implications brought on by merely disclosing the name of the engagement partner. Auditing firms such as KPMG state “the fact that an engagement partner has been named in a suit that seeks a material amount of monetary damages may make it more difficult for that individual to qualify for a mortgage from a lending institution,”[12] and Deloitte says “a personal signature requirement is certain to generate additional lawsuits and other proceedings against individual engagement partners, thereby raising litigation costs and the attendant burdens of litigation for the engagement partners and their firms.”[13]

Both have come out strongly against the engagement partner signature disclosure arguing that the signature requirement would increase liability. We disagree with this position. The fact is that neither an engagement partner’s signature nor the disclosure of an engagement partner’s name would increase liability. Liability is created when there is a problem with the audit, not when the auditor’s name is disclosed. As stated by the Certified Public Accounting firm, Piercy Bowler Taylor and Kern, in its August 14, 2015 comment letter to the PCAOB:

> Litigation risk and the attendant exposure to liability is inherently the same without regard to the placement of such disclosures, if any, whenever investors are damaged for reasons they can attribute to financial statement misstatements, and that in any litigation, the discovery process will readily result in the identification of all responsible parties. It is clearly not an issue.[14]

When there is a high quality audit there is no fear of liability. If the audit falls short, investors should have adequate recourse.

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[12] KPMG letter to the PCAOB, Release, 2009-005, Rulemaking Docket Matter #029, September 11, 2009. http://pcaobus.org/Rules/Rulemaking/Docket029/021_KPMG.pdf

[13] Deloitte letter to the PCAOB, Release 2009-005, Rulemaking Docket Matter #029, September 11, 2009. http://pcaobus.org/Rules/Rulemaking/Docket029/020_DT.pdf

[14] Piercy Bowler Taylor & Kern letter to the PCAOB, Release 2015-004, Docket Matter # 029, August 14, 2015. http://pcaobus.org/Rules/Rulemaking/Docket029/009d_PBTK.PDF

Each engagement partner will have insurance and will be indemnified by his/her firm. Given the signature does not create additional liability and there is protection for the engagement partner, the statement in the ACAP report in October of 2008 remains, in our view, correct:

> The signature requirement should not impose on any signing partner any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of an auditing firm.[15]

No additional liability would be imposed on an engagement partner by merely signing the audit opinion.

44. Should the disclosures be limited to whether the audit committee participated in the selection of the engagement partner, or should there be more detail regarding the audit committee's input?

There should be detail regarding the audit committee's input in the selection of the engagement partner. Investors want to know whether the audit committee actually participated in the selection.

53. Should current audit committee disclosure requirements be changed for smaller reporting companies or emerging growth companies? If so, which requirements and why? Would investors in smaller reporting companies or emerging growth companies find this information any more or less useful than similar disclosure requirements for other issuers? If so, how, and why?

No, we oppose different reporting requirements. We value transparency and see no gains from reducing transparency.

54. With respect to the additional disclosures discussed in this release, should any disclosure requirements, if adopted, apply to smaller reporting companies or emerging growth companies? If so, which requirements and why? If not, why not? Would different disclosure requirements impact the issuers (e.g., secondary market liquidity)?

[15] *Final Report, Advisory Committee on the Auditing Profession,* VII: 20 Oct. 6, 2008. http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf

All requirements should apply to all companies. At least one study clearly shows that small companies are punished for taking advantage of reduced transparency requirements.[16]

55. Should additional disclosures, such as those presented in Section VI, be required, or should they be voluntary as they are today? Should the Commission consider requiring specific disclosures, or requiring certain categories of disclosures? If so, which categories?

The Board should require additional disclosures and encourage additional voluntary disclosures. Given the primary disclosure requirements were put in place in 1999, prior to a major accounting and auditing scandal, and the 2008 financial crisis, it would appear that we should swiftly move to be in line with the better global disclosure requirements. Currently an audit committee can easily meet the minimum regulatory requirement without revealing substantive gaps in oversight. Although, we do not want to encourage boiler plate language, we support mandating specific disclosures, then leaving it to audit committees to tailor their "story" in a narrative type report.

57. Would the disclosures prompt the audit committee to change how it oversees the auditor? If so, how?

The additional disclosures will give the audit committee greater power. In one cycle, all audit committees will begin to have at least one meeting with the auditor without having management present. All audit committees will have some role in selecting or retaining the auditor and the engagement partner. Investors would be able to gain greater comfort because the information would be communicated that the audit committee is in fact reviewing financial reporting and internal auditing. When forced to report on such things, audit committees are more likely to make certain those things get done. We do believe that most companies are compliant, and most audit committees are doing great jobs, but better requirements will strengthen all companies.

59. Would the disclosures promote audit quality? If so, how?

Yes. The disclosures would empower audit committees. Investors will better understand the work of audit committees. The added information will provide greater comfort that the members of the audit committee take their roles as stewards seriously. In some cases, investors will get better information regarding difficult judgments.

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[16] Going Public after the Jobs Act", by Carlos Berajo, Loyola Law School, August 2014. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2423683

60. Would the disclosures discussed herein result in boiler plate information? If so, how could the requirements be crafted to avoid boiler plate disclosure?

The disclosures will not necessarily result in boiler plate responses. First, the audit report should be crafted to come from the chair of the audit committee. Second, comparable examples can be provided as training tools to change the mindsight of those historically writing the audit committee report to better communicate with investors. Third, there is some key information that even if it is boiler plate would still be valuable. Investors want to know if the audit committee meets in a substantive way with the auditor without management being present. Investors want to know that the audit committee members actually attend the meetings. Investors want to know how the audit committee participated in selecting the auditor and the engagement partner. Investors want to know specifically what the audit committee does, and a reference to the charter does not suffice. Currently, the investor is referred to the charter, but there is no statement that the audit committee complied with all of the duties included in the charter. We would like "bespoke" reports that communicate to us, but if the American way leads to boiler plate, that should not be a reason to fail to address important gaps.

66. The audit committee disclosure requirements may reference other documents, such as an audit committee charter. Should such documents be provided along with the required disclosures? If not, should information be provided to help locate the information referenced? Why or why not? Should information be hyperlinked? If so, are there any unintended consequences or implementation challenges that may result from information being presented in this manner?

Ideally, the audit committee can describe specifically what it does during the year in the body of the audit report. What happens currently is that there is a reference to the charter that insinuates that the committee actually complied with the charter during the year. In many cases, that may very well be true. In some cases, it is not. In the current reporting requirements, an investor would not know the answer and is left to assume that mentioning that a charter exists means that the audit committee complied with all duties included therein. There are more unintended consequences from audit committees not complying with their charter than what might occur if they are compelled to relate in a report what they did during the year.

73. Are there improvements that the Commission should consider to the reporting on the audit committee's oversight of the accounting and financial reporting process or internal audits? For instance, should the audit committee disclose how it interacts with the company's management?

Yes, the audit committee should disclose what it does and how it interacts with management. For example, in the Rolls Royce Report, the audit committee chair stated: “I joined management and KPMG, in a meeting with the Conduct Committee to hear first-hand and to participate in the debate.” It is intuitively obvious to the casual observer that such a statement creates more confidence in an audit committee than silence on the topic. Investors should know if audit committee members are left out of critical decisions when best practices would dictate that they be included.