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September 29, 2015

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. 041, Concept Release on Audit Quality Indicators, Release No. 2015-005

Dear Madam Secretary:

On behalf of the California Public Employees' Retirement System (CalPERS), thank you for the opportunity to provide our comments on the content and possible uses of potential "audit quality indicators" (AQIs) in response to the Public Company Accounting Oversight Board's (Board, PCAOB) Concept Release on AQIs (Concept Release). CalPERS agrees with the 2008 Final Report of the Advisory Committee on the Auditing Profession (ACAP) that:

> Requiring firms to disclose indicators of audit quality may enhance not only the quality of audits provided by such firms, but also the ability of smaller auditing firms to compete with larger auditing firms, auditor choice, shareholder decision-making related to ratification of auditor selection, and PCAOB oversight of registered auditing firms. [1]

CalPERS is the largest public defined benefit pension fund in the United States (US) with approximately $301 billion in global assets.[2] We believe that:

> Effective financial reporting depends on high quality accounting standards, as well as consistent application, rigorous independent audit and enforcement of those standards. CalPERS is a strong advocate of reform

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[1] Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury, page VIII:15, October 6, 2008. http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf

[2] CalPERS investment fund values, Facts at a Glance, August 3, 2015.

> that ensures the continual improvement and integrity of financial reporting.[3]

We support the Concept Release as part of the continual improvement and integrity of financial reporting. Currently, there are no agreed measures of audit quality. CalPERS favors the use of AQIs to inform discussions and improvements in audit quality and in turn improvements in the auditing process and financial reporting.

In February of 2014, the International Auditing and Assurance Standards Board (IAASB) published *A Framework for Audit Quality, Key Elements that Create an Environment for Audit Quality (*Audit Quality Framework*).* The Audit Quality Framework outlines basic concepts consistent with a quality audit. We support these concepts. Although the Audit Quality Framework does not create a system of AQIs, it lists factors that are reflected in the proposed AQIs that can contribute to audit quality at the engagement, firm and national levels. The PCAOB, on the other hand, has focused on concepts that can be quantified and has proposed specific AQIs. We appreciate this approach.

The Concept Release acknowledges the contemporaneous efforts of the IAASB and the United Kingdom's Financial Reporting Council (FRC) to raise audit quality by increasing audit transparency. Implementing a system including AQIs should have the added benefit of enhancing disclosures and transparency in a quantifiable way. CalPERS believes the use of concepts from the Audit Quality Framework, along with AQIs provides momentum towards improving audit quality in the U.S.

We agree with PCAOB staff that:

> The ability to better distinguish variations in measures that relate to audit quality may produce greater market differentiation among audits and stimulate competition in quality that may also have an effect on securities prices. This in turn could generally help investors given the public goods nature of securities prices.[4]

Most audit firms compete primarily on the basis of cost. AQIs may create the opportunity for audit firms to compete on audit quality as well as cost.

CalPERS Principles outline specific disclosures that audit committees should provide on an annual basis to shareowners. One disclosure requests:

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[3] CalPERS Global Governance Policy, Section 4. Integrity of Financial Reporting, Updated March 16, 2015. https://www.calpers.ca.gov/docs/policy-global-governance.pdf

[4] PCAOB Concept Release No. 2015-005, Rulemaking Docket Matter No. 041, July 1, 2015. http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf

> Rationale for recommending the appointment, reappointment or removal of the external auditor including information on tendering frequency, tenure, and any contractual obligations that acted to restrict the choice of external auditors.[5]

We believe the use of AQIs would provide audit committees additional decision points in their assessment of the external auditor. We continuously articulate the importance of the concepts of integrity, objectivity, independence, professional skepticism and accountability.[6] We believe the AQIs could embody these concepts in both a quantitative and qualitative manner and guide audit committees to better communicate the rationale for appointing or re-appointing the external auditor.

In his July 6th letter to the PCAOB, Robert Conway, retired Big Four audit partner, highlights the good job the PCAOB does in articulating the benefits of AQIs, but he also points out a problem with the existing audit firm business model.[7] Implementing AQIs may very well disrupt the existing model and bring about improvements.

CalPERS Principles highlight the importance of shareholder ratification of the independent auditor annually. AQIs would assist shareowners in the decision process in such annual ratification.

In its recent letter to the PCAOB, Comcast highlights, that for them:

> AQI metrics helped to provide greater transparency than previous processes into the nature of audit, specifically providing a basis for increased dialogue that reinforced our belief that we have been receiving high quality audits.[8]

Given the high degree of positive interest from most corners, it is clear that there is potential in the AQI project. Implementing AQIs could improve audit quality which would be great for audit firms, audit committees and shareowners. We support moving forward swiftly with the AQI project.

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[5] CalPERS Global Governance Principles, Updated March 2015.

[6] CalPERS letter to Phoebe Brown, Secretary, PCAOB on Rulemaking Docket Matter No. 034, *Auditor's Report on an Audit of Financial Statements*, May 2, 2014.
http://pcaobus.org/Rules/Rulemaking/Docket034/246b_CalPERS.pdf

[7] Robert Conway, Retired Audit Partner, letter to the PCAOB, July 6, 2015.
http://pcaobus.org/Rules/Rulemaking/Docket%20041/002_Conway.pdf

[8] Comcast comment Letter to the PCAOB's concept release on AQIs, August 31, 2015.
http://pcaobus.org/Rules/Rulemaking/Docket%20041/003_Comcast.pdf

We have attached our responses to certain questions included in the Concept Release to provide shareowner side input into the discussion. 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, Global Governance

Attachment

Concept Release on Audit Quality Indicators

1. Is increasing knowledge about, and use of, the audit quality indicators discussed in this release likely to provide insights about how to evaluate, and ultimately improve, audit quality? If so, why? If not, why not?

Yes. Currently, there are audit quality assessments, but investors have little insight into what is being analyzed. AQIs would create a more common language when discussing audit quality and eventually enhance transparency at the investor level.

2. Are the AQI project, and some number of the 28 specific indicators described below, likely to build a strong knowledge base to enhance discussions of audits among those involved in the financial reporting process or other users of AQIs?

Yes. Investors currently get very little information regarding audit quality. Audit reports are pass/fail. Audit committee reports are boilerplate. Audit committees are tasked with assessing audit quality, but there is little information provided regarding what audit committees actually review. The AQI project is a definite move forward.

3. Can the development of audit quality indicators, as described in this release, have unintended consequences, either positive or negative, for audit committees, audit firms, investors, or audit or other regulators? What are they? Can any negative consequences be alleviated? How?

There is the chance that once implemented firms begin to focus too keenly on AQIs and begin to overlook important things not included in AQIs. To prevent this, AQIs must be selected carefully. Some individual AQIs may include unintended consequences as well. For example, an AQI on timely reporting of internal weaknesses may lead to not reporting a weakness at all. We should not include AQIs where doing the right thing leads to an adverse AQI score. The issue can be the same, but the AQI must be focused on making the right things happen. We agree AQIs will enhance discussions within audit committees. Audit committees evaluate auditors. We do not know the metrics used for such evaluations, if any. AQIs will make it more likely that participants are speaking the same language.

4. What is the nature of the context that those using AQIs as a basis for analysis and discussion will generally require to be able to benefit from that use? Is the information required to build that context available? Is access to the necessary contextual information feasible?

We agree with the PCAOB that audit quality can be viewed from several perspectives; first, from a full compliance perspective with regards to auditing standards and applicable laws; secondly, in meeting the needs of a public company's shareowners and thirdly, in facilitating the timely and effective supply of information to the company's audit committee and public investors. We support the need for reporting AQIs under all three perspectives.

From a shareowner's perspective, we would be interested in disclosure of AQIs received for a specific audit - engagement, we believe audit committees would be able to ground their evaluations of audits in standards that flow from AQIs, and we would also benefit from aggregate information at a firm level. When compared, firms will try to improve relative to their competition.

5. Should any indicators be omitted from the list proposed in this release? Which indicators? Why?

The 28 potential indicators as categorized in the three groups provide quantitative and qualitative factors in assessing audit quality. One indicator that is not necessarily useful to shareowners is AQI # 12, "Allocation of Audit Hours to Phases of the Audit." This should be determined based on the auditor's and audit committee's risk assessment and discussion. Although this information could be informative, it would not necessarily be valuable without the full context of information and work of the audit committee and external auditor.

6. Should any indicators be added to the list? What are they? Why? How would they be quantified?

Although, somewhat qualitative, it would seem beneficial to add indicators with regards to:

- Training and inspection concerns as it relates to professional skepticism;
- Training dollars spent on staff compared to the fees received for the audit;
- Percentage of non-audit fees at the firm level in comparison to statutory audit fees;
- Percentage of annual contracts that have limited liability clauses at the firm level.

7. Which indicators are likely to be the most useful in evaluating audit quality and informing discussions of audit quality? Why? The least useful? Why?

We agree that many AQIs may be more useful initially and others more useful in later years. We agree reducing the AQIs might provide indicators that can be used prudently and effectively. There are reasons to support almost every indicator.

We believe these indicators would be most useful:

AQIs – 1, 2, 3, 4, 5, 6, 7 10, 13, 14, 15, 16, 17, 18, 19, 21, 22, 24, 25, 27

12. Are there one or more indicators among the 28 that are superior to other indicators on the list and cover the same subject or subjects, so that one or more indicators are unnecessary for that reason? Please identify the redundant indicators and explain.

We do not see any duplication in the AQIs and understand that different AQIs may cover the same ground. Although we identified AQIs that we believe would be more useful, it is very hard to easily weed out the other AQIs to an extent. Each seems to cover areas that would add value and improve audit quality. Each could be used in a particular context.

14. The indicators operate at the engagement level, the firm level, or in most cases both.

a.) How should "engagement level" be defined in the case of a global audit in which work is referred to one or more "other auditors" (whether or not the firm or firms involved are part of the engagement firm's global network)? Who should make that determination?

Engagement level is the issuer point of view. When there is more than one auditor and multiple sites, we suggest that engagement level approach analyze all participating in an audit on behalf of a particular issuer. The lead auditor should compile the information. For the firm audit, only the firm's information would be included.

b.) Would one or more of the indicators be more useful if it also operated at an audit firm's "office" or "regional" levels, not merely at "engagement" and "firm-wide" levels (so that, e.g., the percentage of an office's work devoted to a single large client would be known)? Which indicator or indicators?

In the Concept Release, the PCAOB highlighted that there are quality differences at the engagement team, office and regional levels within firms. It is important to understand these differences. A company could be using the worst team, from the worst office, in the worst region of a great firm. It would enhance overall audit quality if such a firm would address the issues and raise the quality level of each region, office and team. If problem teams, offices and regions can be identified early through AQIs, audit quality will improve over time because firms will more likely address the issues.

c.) Would one or more of the indicators be more useful if it also operated at the level of the audited company's industry or economic sector (so that, e.g., indicators for the audit of a particular bank could be compared with the average of indicators for all of an audit firm's banking clients)?

Certain AQIs would be more relevant for certain industries. Comparisons on the most relevant AQIs would be beneficial.

20. Could the collection and evaluation costs of AQIs be a greater economic burden for smaller audit firms than larger audit firms? Could this burden disadvantage smaller firms in competing for audit business if perceptions of quality are driven by the indicators?

Similar to CalPERS' strong belief that standards should apply to all listed issuers, we also believe the AQIs should apply to all audit firms. Within our letter, we cite the IAASB's Framework for Audit Quality. It is important to point out that this framework applies to all audit firms regardless of size, including audit firms that are part of a network or association.[1]

22. For what class or classes of users would AQIs be most valuable? Would some AQIs be more valuable than others to various classes of users?

We believe the AQIs will be helpful to audit committees, but investors will benefit from this information as well, especially if AQIs lead to increased disclosures.

28. Should engagement level AQI data be made public in whole or part? Should firm level AQI data be made public in whole or part?

Engagement level AQI data should be made available to the relevant audit committee. The audit committee should then communicate in its audit committee report its review of the AQI data. Firm level AQI data can be made available by firms by including such data in the annual reports produced by the firms. The difference would be that the firms would have to analyze the same factors that point to audit quality rather than choosing what they would like to highlight on an annual basis.

31. Would it be useful to phase in any ongoing AQI project? For example, should the project be voluntary for at least some period? If phasing is a good idea, what steps should the phasing involve? How should any phasing of the project be monitored?

AQIs could be adopted at the firm level first with firms revealing their assessments in their annual reports. Audit committees could then select what AQIs each is concerned with for a particular engagement, and those AQIs could be reviewed for that particular engagement.

[1] IAASB, A Framework for Audit Quality, Key Elements that Create an Environment for Audit Quality, February 18, 2014.

33. Should the Board consider steps to require audit firms to make engagement- and firm-level AQI data available to audit committees? To investors?

If the Board adopts a set of AQIs as a standard way to determine audit quality, audit committees will have to consider those AQIs when determining audit quality for a particular engagement. It would not be enough for an audit committee to focus on elements fully outside what has been set out as indicators of audit quality or not assess audit quality at all. Large firms already provide information on how they think they are doing by narrative or through an examination of factors. Adding AQI data would simply expand and make comparable a process that is taking place.

35. Should smaller audit firms be treated differently than large ones in designing an AQI project? What would small mean for this purpose? Having less than a certain number of auditors? Auditing 100 or fewer public companies per year and not being part of a global network of firms?

No, we believe AQIs should be required of all audit firms.

36. Should the size of the audited company set a limit on initial application of an AQI project? What would an appropriate size be? Should the fact that a public company is not a listed company affect the way AQIs apply to it?

No, CalPERS does not support differentiation in applying standards to different size audit firms. We believe the application of AQIs should be comparable for larger and smaller audit firms.

38. Would excluding certain types of audits from an AQI project distort the results of firm-wide public company audit comparisons, or suggest that only industry-based comparisons are valid?

Yes, we believe excluding certain types of audits would skew and or distort results of firm AQIs. Standards work best when applied to all. If exceptions are available, too many will work too hard to qualify for those exceptions. This will weaken having AQIs in the first place.

44. Would addition of a calculation of staffing leverage indicators that measures the ratio of partner and manager hours to total audit hours be helpful?

Yes, staffing leverage indicators would be helpful to both audit committees as well as investors.

51. Should training hours be computed on a per-person basis, by personnel class, or as an average by class? Should the size of the firm involved make a difference in this regard?

We believe that training hours should be computed on a per-person basis.

61. What other measures of independence, or independence issues, would be appropriate? Would information generated by this indicator be more meaningful if measurements were stratified by personnel level?

Independence is an underlying driver to the integrity of financial reporting. We view this AQI as one of the most important indicators of the credibility of the financial reporting process. All issues that show a lack of independence should be disclosed regardless of level. Our preference is to have an independent audit.

64. How should internal quality inspection findings be compared to or analyzed alongside PCAOB inspection results in applying indicators 18 and 19?

PCAOB inspection results identify deficiencies at the engagement level and provide for a more specific robust conversation with the audit committee. Such results should be used to verify the standards being applied in the internal reviews. Both are necessary.

65. What are the best methods for measuring magnitude of restatements for errors? Is one method superior to the others? Why?

One study, *Quantitative Measures of the Quality of Financial Reporting* tried to identify quantifiable metrics that can track the absolute and relative quality of financial reporting over time. The study used the metrics of the number of announced financial reporting restatements and market value losses from restatement as a percent of total market value of equity securities. The study found that 80% of the top ten market value losses in 2000 were from restatements on revenue recognition. The study stated that losses are most severe when companies make revenue recognition restatements. [2] We would support the magnitude of the restatement be measured in changes in value of the issuer.

[2] FEI Research Foundation, Quantitative Measures of the Quality of Financial Reporting, study with Min Wu, a Ph.D. candidate at New York University's Stern School of Business, 2001. http://www.thefreelibrary.com/Quantitative+Measures+Of+the+QUALITY+of+Financial+Reporting.-a076941314