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May 16, 2016

Ms. Kathleen K. Healy
Technical Director
International Auditing and Assurance Standards Board
529 5th Avenue
New York, New York 10017

Re: Overview on Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits

Dear Ms. Healy,

On behalf of the California Public Employees' Retirement System ("CalPERS"), thank you for the opportunity to provide our responses to the International Auditing and Assurance Standards Board's (IAASB) Overview on Enhancing Audit Quality in the Public Interest.

CalPERS is the largest public pension fund in the United States with approximately \$300 billion¹ in global assets. CalPERS' Investment Office mission is to manage its assets in a cost effective, transparent and risk-aware manner in order to generate returns to pay benefits to the funds' 1.7 million members, retirees and beneficiaries. As a significant institutional investor with a long-term investment horizon, we rely upon the integrity, stability and efficiency of capital markets.

Our engagements with companies, regulators, managers and stakeholders are guided by CalPERS Global Governance Principles (Principles). Our Principles state that:

Effective financial reporting depends on high quality accounting standards, with consistent application, rigorous, independent audit and enforcement of those standards.²

¹ See, [The CalPERS Comprehensive Annual Financial Report Fiscal Year Ended June 30, 2015](#)

² See, p. 33, [The CalPERS Global Governance Principles](#), dated March 14, 2016

We believe that financial reporting plays an integral role in the capital markets by providing transparent and relevant information about the economic performance and condition of businesses. Therefore, CalPERS is a strong advocate of standards that ensure the continual improvement and integrity of financial reporting.

Given how essential financial reporting is to the integrity of capital markets, the crucial role of the external audit is unquestionable. Robust audits help establish trust and confidence in financial markets and contribute to investor protection. Failure to deliver high-quality audits can result in adverse consequences for shareowners and stakeholders that use and rely on financial statements. Therefore, through independent review and opinions, the auditing profession plays a crucial role in promoting integrity and efficiency in financial markets.

As a long-term investor, we expect auditors to bring integrity, independence, professional competence and objectivity to the financial reporting process. We believe that the central role of the auditor should be to provide investors with an independent opinion as to whether the financial statements and disclosures therein are free of material misstatement, whether caused by error or fraud, are materially accurate, complete, and provide a true and fair view. Therefore, CalPERS supports improvements to audit standards that emphasize the significant role of auditors and their contribution to the quality and integrity of financial reporting.

Thank you for considering our comments above and in the appendix which follows. As a global investor, we support the comments submitted by the International Corporate Governance Network (ICGN) which addressed accounting and auditing issues from an international shareowner perspective. If you would like to discuss any of these points, please do not hesitate to contact me at (916) 795-9058 or James.Andrus@calpers.ca.gov.

Sincerely,

JAMES ANDRUS
Investment Manager, CalPERS
Global Governance

Cc: Anne Simpson, Investment Director

IAASB Overview on Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits

CalPERS commends the IAASB for taking up a review of audit standards around professional skepticism, quality control and group audits. Below we set out our responses to some of the specific questions asked in the Overview on Enhancing Audit Quality in the Public Interest:

G1. Table 1 describes what we believe are the most relevant public interest issues that should be addressed in the context of our projects on professional skepticism, quality control, and group audits. In that context:

(a) Are these public interest issues relevant to our work on these topics?

We agree that the following seven public interest issues are related to audit quality and are relevant to IAASB's project on professional skepticism, quality control and group audits:

- Guidance on the appropriate application of professional skepticism;
- Audit file improvements to enhance documentation around the auditors judgment;
- Ensuring International Standards on Auditing (ISAs) are fit for purpose;
- Encouraging proactive quality management at the firm and engagement level;
- Exploring the role transparency plays in audit quality;
- Providing better guidance on remediation of audit deficiencies or inspection findings; and
- Strengthening standards around communication among those involved in an audit.

(b) Are there other public interest issues relevant to these topics? If so, please describe them and how, in your view, they relate to the specific issues identified.

Audit standards should provide for enhanced reporting. We believe that enhanced reporting by external auditors is critical. Specifically, an integrated representation of operational, financial, environmental, social, and governance performance in terms of both financial and non-financial results would offer investors better information for assessing risk. Environmental, social and governance (ESG) performance can be integrated into an "Auditors Discussion and Analysis" that provides additional insight into the audit and company risks.

(c) Are there actions you think others need to take, in addition to those by the IAASB, to address the public interest issues identified in your previous answers? If so, what are they and please identify who you think should act.

The auditor should articulate to the Audit Committee all material risks and other matters arising from the audit that are significant to the oversight of the financial reporting process, including situations where the auditor is aware of disputes or concerns raised regarding accounting or auditing matters. The audit committee should then take appropriate action regarding each issue.

Along with the IAASB, regulators and enforcement entities also play a strong role in ensuring accounting and auditing standards are appropriately implemented. A coordinated effort with regulatory bodies and standard setters is critical to overall acceptance and consistent implementation of standards by the auditing profession. We encourage the IAASB to continue to its work with the International Forum of Independent Audit Regulators (IFIAR).

G2. To assist with the development of future work plans, are there other issues and actions (not specific to the topics of professional skepticism, quality control, and group audits) that you believe should be taken into account? If yes, what are they and how should they be prioritized?

Audit Scope

The IAASB should consider strengthening standards around the minimum scope of the audit and auditors assessment. As mentioned in our October 29, 2012 letter³ to the IAASB, the auditor's assessment should not be limited to just 12 months from the balance sheet. The CalPERS Investment Belief # 2 states that "a long time investment horizon is a responsibility and an advantage." So, we believe that there should be enhanced disclosure of reasonably foreseeable events beyond 12 months that would affect the auditor's assessment of an entity's ability to continue as a going concern. Additionally, shareowners who satisfy a reasonable shareholding threshold should have the opportunity to expand the scope of the forthcoming audit or discuss the results of the completed audit. We believe there should be transparency and advance notice when the audit is to be tendered in order to provide shareowners with an opportunity to engage with the company in relation to such process.

³ See, <https://www.ifac.org/system/files/publications/exposure-drafts/comments/2012%2010%2029%20Arnold%20Schilder%20IAASB.pdf>, dated October 29, 2012

Auditor Independence

To strengthen the auditor's objective and unbiased audit of financial reporting, we continue to emphasize the need for auditor independence as a direct link to audit quality. The validity of the audit assessment is undermined when shareowners lack confidence in the independence of the auditor's assurance. Therefore, audit disclosures should be strengthened, where possible, by independent assurance and attestation that the audit was carried out with regard to established standards of professional skepticism.

Sustainable Investing: Environmental, Social and Governance Factors

CalPERS expects fair, accurate and timely reporting on how companies employ and identify risks related to financial, human and physical capital, in order to generate sustainable economic returns. CalPERS Investment Beliefs # 4 and # 9 state that:

Long-term value creation requires effective management of three forms of capital: financial, physical and human; and

Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error.⁴

We seek good governance practices to ensure that CalPERS capital is deployed to produce sustainable long-term returns and meet pension obligations. In support of this long-term horizon, we believe the IAASB should give appropriate consideration to environment, social and governance issues, including the development of robust standards and practices to address both risk and opportunity arising from the effective management of three forms of capital: financial, physical and human.

For example, climate risk has been identified as a significant risk to investor's ability to generate long-term sustainable returns. In support of climate risk reporting, we advocate for clear and comprehensive mandatory disclosures that address material risk and opportunity posed by climate change. We support specific metrics as articulated in the Carbon Disclosure Project (CDP) and Sustainable Accounting Standards Board (SASB) materials. We also support the work of the Financial Stability Board's (FSB) Task Force on Climate-related financial disclosures. As an asset owner and long-term investor, it is important that we have comparable, material data from each portfolio company across industries. We believe this is possible through integrated reporting.

⁴ See, p. 6 and p. 10, [CalPERS Beliefs Our Views Guiding Us into the Future](#), dated May 2015

International Cooperation

CalPERS supports ongoing efforts to foster international collaboration among global audit standard-setters and oversight bodies. We believe international cooperation assists with strengthening audit quality and consistency globally. We view the establishment of a global framework as extremely important and support making steps towards mutual reliance and equivalence provisions.

Business Model

An additional issue that the IAASB should take into account is the current business model of the auditing profession. Currently, auditors must be skeptical of the very entities that pay them. The concern is that this business model deters auditors from challenging management assertions, asking difficult and probing questions, and being overly skeptical. Given the dynamic created by this business model, investors have reason to lack confidence in the quality of the audit assessment. We encourage the IAASB to consider reviewing the current business model and assessing whether alternative models can be implemented to strengthen investor confidence in the quality of audits.

G3. Are you aware of any published, planned or ongoing academic research that may be relevant to the three topics discussed in this consultation? If so, please provide us with relevant details.

The following publications and/or academic research are relevant to the topics of professional skepticism, quality control and group audits:

- Steven M. Glover and Douglas F. Prawitt (2013). *Enhancing Auditor Professional Skepticism*. Available at: <http://www.thecaq.org/docs/research/skepticismreport.pdf>.
- Mark W. Nelson, Chad A. Proell, and Amy E. Randel (2016) *Team-Oriented Leadership and Auditors' Willingness to Raise Audit Issues*. The Accounting Review In-Press.
- UC Davis Graduate School of Management (2013), CalPERS Sustainable Investment Research Initiative, Review of Evidence: Database of Academic Studies. Available at: <https://www.calpers.ca.gov/docs/governance/Archive/investments/siri-database-of-academic-studies.pdf>
- Sarowar Hossain, Gary S. Monroe, Mark Wilson and Christine Jubb (2016), The Effect of Networked Clients' Economic Importance on Audit Quality. *AUDITING: A Journal of Practice & Theory* In-Press.

PS1. Is your interpretation of the concept of professional skepticism consistent with how it is defined and referred to in the ISAs? If not, how could the concept be better described?

The ISA defines professional skepticism as, “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.”⁵ We believe that a “questioning mind” and “a critical assessment of audit evidence” by the auditor are essential to high-quality audits. We also believe that auditor integrity, independence, objectivity and professional competence are also important. However, our interpretation of the concept of professional skepticism is not totally consistent with how it is defined and referred to in the ISAs. We believe that there should be greater emphasis on independence.

The CalPERS Governance Principles highlight the importance of auditor independence stating that:

Auditors should provide independent assurance and attestation to the quality of financial statements to instill confidence in the providers of capital.⁶

Professional skepticism reflects an auditor’s sound judgment and is essential to audit quality. The professional skepticism standard encourages reasonable and balanced assurance on financial reporting matters to investors. We believe that approaching audits with professional skepticism best positions the auditor to ask relevant questions, challenge management assertions, and confidently opine on the quality of a company’s financial statements. We believe this process is bolstered when the auditor is truly independent. A recent accounting article, *The Effect of Networked Clients’ Economic Importance on Audit Quality*, highlights this issue.⁷ The researchers found that audit partner dependence on fees from other companies in a network reduces audit quality.

PS2. What do you believe are the drivers for, and impediments to, the appropriate application of professional skepticism? What role should we take to enhance those drivers and address those impediments? How should we prioritize the areas discussed in paragraph 37?

Professional skepticism is influenced by individual attitudes, ethics and competence. As a result, application of professional skepticism is generally demonstrated by thorough audit reports and documentation that clearly reflect the application of an auditor’s sound

⁵ See, paragraph 13 (l), <http://www.ifac.org/system/files/downloads/a008-2010-iaasb-handbook-isa-200.pdf>

⁶ See, p. 34, [The CalPERS Global Governance Principles](#), dated March 14, 2016

⁷ See, Sarowar Hossain, Gary S. Monroe, Mark Wilson and Christine Jubb (2016), *The Effect of Networked Clients’ Economic Importance on Audit Quality*. AUDITING: A Journal of Practice & Theory In-Press.

judgment throughout the audit. Additionally, audit documentation provides evidence that the audit complies with the ISAs.⁸

As stated in the ISA 230 handbook, “there may be no single way in which the auditor’s professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor’s exercise of professional skepticism in accordance with the ISAs. Such evidence may include specific procedures performed to corroborate management’s responses to the auditor’s inquiries.”⁹ So, we believe that there is a need for clarification in the ISAs about what constitutes sufficient evidence of the application of professional skepticism and how auditors should document the application of professional skepticism.

An additional impediment to the appropriate application of professional skepticism is the fact that auditors must be skeptical of the very entities that pay them. Consequently, auditors may be less motivated to challenge management assertions. This results in a disincentive for an auditor to be overly skeptical and creates a potential conflict of interest in the assessment. Given this, investors must rely on overall professionalism in the auditing profession and sufficient disclosures demonstrating independent assurance and attestation as to the quality of financial statements. We encourage strengthening performance and compensation metrics and incentives, where possible, to encourage consistent use and application of professional skepticism.

PS3. What actions should others take to address the factors that inhibit the application of professional skepticism and the actions needed to mitigate them (e.g., the International Accounting Education Standards Board, the International Ethics Board for Accountants, other international or national standards setters, those charged with governance (including audit committee members), firms, or professional accountancy organizations)?

Additional recommended actions to address factors that inhibit the application of professional skepticism include enhanced:

- Education;
- Ethics training;
- Leadership training;
- Regulatory focus and enforcement.

⁸ See, paragraph A7, <http://www.ifac.org/system/files/downloads/a011-2010-iaasb-handbook-isa-230.pdf>

⁹ See, paragraph A7, <http://www.ifac.org/system/files/downloads/a011-2010-iaasb-handbook-isa-230.pdf>

QC1. We support a broader revision of ISQC 1 to include the use of a quality management approach (QMA) as described in paragraphs 51–66.

- (a) Would use of a QMA help to improve audit quality? If so why, and if not, why? What challenges might there be in restructuring ISQC 1 to facilitate this approach?**
- (b) If ISQC 1 is restructured to require the firm’s use of a QMA, in light of the objective of a QMA and the possible elements described in paragraph 65, are there other elements that should be included? If so, what are they?**
- (c) In your view, how might a change to restructure ISQC 1 impact the ISAs, including those addressing quality control at the engagement level?**
- (d) If ISQC 1 is not restructured to require the firm’s use of a QMA, how can we address the call for improvements to the standard to deal with differences in the size and nature of a firm or the services it provides?**

We appreciate the IAASB providing additional guidance around International Standard on Quality Control (ISQC 1) and the key elements of quality control. We believe that the establishment and maintenance of an effective system of internal controls should be measured against internationally accepted standards of internal audit and tested periodically for its adequacy. The primary goal is to ensure companies adopt policies, operating procedures, internal controls, regulatory compliance programs, reporting, and decision-making protocols to effectively manage, evaluate, and mitigate risk.

The proposed Quality Management Approach (QMA) would emphasize the responsibility of firm leaders for a more proactive, scalable and robust response to managing quality risk. The QMA would also integrate a firm’s policies and procedures within its quality system through identification of relevant risks to quality and design of appropriate policies and procedures to address those risks.

We agree that enhanced accountability at the leadership level is needed. We believe companies have a role in establishing the appropriate “tone at the top,” including a culture that values protections which support transparency. Additionally, accountability of corporate boards matter. We view ratification votes, proxy access and majority voting as tools to hold audit committees accountable.

We appreciate that the proposed approach would emphasize the responsibility of firm leaders for a more proactive, scalable robust response to managing quality risk. We believe that focusing on firm leadership to produce higher quality audits should have a positive impact. For example, Nelson, Proell and Randall found that team oriented

leaders enhance the willingness of auditors to raise audit issues.¹⁰ Therefore, it is reasonable to assume that a heightened focus on firm leadership would yield audit quality benefits.

QC2. We are also thinking about revising our quality control standards to respond to specific issues about audit quality (see paragraphs 67–83).

- (a) Would the actions described in paragraphs 68–83 improve audit quality at the firm and engagement level? If not, why?**
- (b) Should we take other actions in the public interest to address the issues in paragraphs 67–83?**
- (c) Should we take action now to tackle other issues? If yes, please describe the actions, why they need priority attention, and the action we should take.**

We agree that the following actions described in paragraphs 68-83 could support improvements to overall audit quality:

- Firm level monitoring and remediation;
- Firm level quality control policies and procedures when operating as part of a network;
- Firm level transparency reporting;
- Engagement partner roles and responsibilities; and
- Engagement quality control reviews and reviewers.

The Audit Committee should require the auditor's opinion to include commentary on any management assertion that the system of internal financial controls is operating effectively and efficiently, that assets are safeguarded, and that financial information is reliable as of a specific date, based on a specific integrated framework of internal controls.

¹⁰ See, Mark W. Nelson, Chad A. Proell, and Amy E. Randel (2016) *Team-Oriented Leadership and Auditors' Willingness to Raise Audit Issues*. The Accounting Review In-Press.

GA1. We plan to revise ISA 600 (and other standards as appropriate) to respond to issues with group audits.

- (a) Should we increase the emphasis in ISA 600 on the need to apply all relevant ISAs in an audit of group financial statements? Will doing so help to achieve the flexibility that is needed to allow for ISA 600 to be more broadly applied and in a wide range of circumstances (see paragraphs 84–97)? If not, please explain why. What else could we do to address the issues set out in this consultation?**
- (b) Would the actions we are exploring in relation to ISA 600 improve the quality of group audits? If not, why?**
- (c) Should we further explore making reference to another auditor in an auditor's report? If yes, how does this impact the auditor's work effort?**
- (d) What else could the IAASB do to address the issues highlighted or other issues of which you are aware? Why do these actions need priority attention?**

We encourage consideration of practical matters affecting individual auditors, group auditors, and component auditors. We support clarifying roles and responsibilities, as well as, strengthening communication among those involved in an audit. We also support emphasis on audit firm accountability, access to reports and adequate documentation from auditors including focus on coordination of group audits and transparency of the audit.