## Discussion and Talking Points – PCAOB Roundtable – September 15, 2011

CalPERS is fundamentally a long-term, fiduciary investor, with a vested interest in the stability of the markets and the integrity of financial reporting. We believe financial reporting should provide users the information needed to make informed capital allocation decisions. CalPERS believes that independence and objectivity of the external auditor is necessary to maintain investor's confidence in the market. Auditors should serve as independent assurance of and attestation to high quality financial statements which instill confidence in the providers of capital to public companies. This is the basis for CalPERS policies and principles which underlies the integrity of financial reporting, the role of the auditor and audit committee.

There are many examples of why a change in the current auditor's reporting is needed and why an Auditor's Discussion and Analysis would add value to investors. One more recent example is Sino Forest (Toronto:TRE-CA). CalPERS holds 1.6 million shares which at our base cost was $9.9 million which is now worth $3.7 million. Sino-Forest is a leading commercial forest plantation operator in China. Its principal businesses include the ownership and management of plantation forests, the sale of standing timber and wood logs and the complementary manufacturing of downstream engineered-wood products. Canada's main securities regulator, the Ontario Securities Commission, suspended trading the 4th week in August in Sino-Forest's shares. The commission said Sino-Forest, as well as certain officers and directors, seem to have misrepresented the company's revenue, exaggerated its timber holdings and engaged in acts "they know or reasonably ought to know perpetuate a fraud." The OSC suspended trading in Sino-Forest on Aug. 26 and ordered the resignation of five executives including Chief Executive Officer Allen Chan before rescinding the order the same day. On 8/28 Sino-Forest announced the resignation of Allen Chan as Chairman and CEO. As of 8/31/11 Sino-Forest's auditor Ernst & Young in Toronto had not rescinded its unqualified opinion on the company's financial statements. Sino-Forest has established an independent committee of directors to examine and respond to the allegations in the Muddy Waters report and hired PricewaterhouseCoopers LLP to assist. Sino-Forest listed in Canada in 1994 through the reverse takeover of a dormant company on the Alberta Stock Exchange. Sino-Forest, based in Hong Kong and Mississauga, Ontario, eventually shifted to the Toronto exchange.

Also, as stated in the Investor Advisory Group Meeting on March 16th, 2011, Anne Simpson, Senior Portfolio Manager of CalPERS, "we lost something in the order of $70 billion because of the crisis and those companies at the heart of it all had clean accounts and auditors' reports." Every year the auditor report was the same with an unqualified opinion. The opinion was the same but the fees for the audit increased each year. For a fund like CalPERS the loss affects ordinary people's lives and the pensions they receive.

Another example, a study done in September 2009 "Investors', Auditors', and Lenders' Understanding of the message conveyed by the Standard Audit Report"[1] highlighted group differences within three patterns:

1. Type I communication gap – whether the user groups investors and lenders different from the auditor group;
2. Type II gap - The users group differ from each other; and
3. Type III gap – the user groups differ from each other as well as from the auditor group.

The purpose of the study was to evaluate the congruence or alternatively the communication gap between the three groups in their understanding of the objectives and limitations of the SAR and secondly, to evaluate the congruence in the interpretation of the technical language used in the SAR.

Findings were quite interesting – Overall participants rate the SAR as important in investing and lending decisions as well as for assessing whether financial statements are free from material fraud. Though the SAR provided relatively lower level of confidence that a company is well managed, a sound investment or that the company would meet its strategic goals – so no information on the governance, investment soundness or strategic risks. Overall the results

[1] Report prepared for the AICPA Auditing Standards Board (ASB) and International Auditing and Assurance Standards Board (IAASB) to better understand communications conveyed in the standard audit report. http://web.ifac.org/download/Study__3_AICPA_IAASB_Paper.pdf, Sept. 2009.

showed that the current Standard Auditor Report results in communication gap and expectations between users and the auditor and opportunistic interpretation of the technical terms in the SAR. I believe this study and many others support the need for improvement in the auditors' reporting.

**Questions from the Briefing Paper**

**Topic I: Auditor's Discussion and Analysis**

1. *What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

The current auditor's reporting model provides no more than this perspective of a current pass fail model and provides little insight into issues that may be simmering under the guise of boiler-plate language. CalPERS supports the need to improve communication of key financial reporting issues and the manner in which financial and other information is reported. Investors would benefit from an Auditor's Discussion and Analysis (AD&A) which would provide a view of the audit and financial statements through an independent source, the eyes of the auditor.

2. *What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?*

CalPERS supports the AD&A to include:

1. Key financial statement and audit risks the auditor has considered when conducting the audit, and the extent, if any, as to how the auditor addressed those risks;
2. The auditor's assessment of the key estimates and judgments made by management and how the auditor arrived at that assessment;
3. The quality of the accounting policies and practices adopted by management, including accounting applications and practices that are uncommon to the industry;

4. Unusual transactions and significant changes to accounting policies; (Top 4)
5. The methods and judgments made in valuing assets and liabilities (possibly sensitivity analyses, stress tests);
6. Identification of any matters in the annual report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of the audit;
7. Key audit issues and their resolution, which the audit partner documents in a final, summary audit memorandum;
8. Quality and effectiveness of the governance structure and risk management;
9. The completeness and reasonableness of the audit committee report;
10. The effectiveness of the company's internal controls over financial reporting;
11. Policies regarding the provision of non-audit services to avoid compromising auditor independence.

*3. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

CalPERS does not believe having inconsistent or competing information between the auditor and management is necessarily an issue. Shareowners are the owners of a company and obtaining both management's and the board's perspective along with an independent auditor's would provide a better understanding from different perspectives on the stewardship of the company.

*4. What are the potential benefits and shortcomings of implementing an AD&A?*

*Potential benefits include:*

- Greater objectivity,
- Increased transparency into the audit process and the significant judgments made in forming the auditor's opinion
- Better understanding of the auditor's opinion taken as a whole and how the auditor reached that opinion,
- Increased investor confidence,
- Improved perception of the integrity of reporting,
- Improved usefulness of the audited financial statements in making informed investment decisions, and

- Better information that informs shareowners with respect to their auditor ratification decision.

Potential shortcomings include:

- Currently with the issue of "don't bite the hand that feeds you" - Conflict perception on whom the auditor works for, company management versus shareowners based on remuneration and contracting of auditor.

**Discussion Topic II: <u>Required and Expanded Use of Emphasis Paragraphs</u>**

*5. What specific information should the required and expanded emphasis paragraphs include regarding the audit or the company's financial statements?*

As emphasis paragraphs are already permitted but not required, CalPERS does not believe this would be the optimum area for additional disclosure.

Currently Emphasis paragraphs are allowed and could be used to expand on significant:

- Issues in the financial statements, and how disclosed in the financials,
- Measurement uncertainty,
- Management judgments and estimates and
- Areas where in the opinion of the auditor, need additional clarification for a better understanding of the financial statements.

The issue is that most auditors do not use emphasis paragraphs.

*6. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

Providing this type of information in emphasis paragraphs may need additional disclosures on procedures the auditor performed relating to each of these matters.

*7. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

CalPERS believes information provided in an Auditor's Discussion and Analysis (AD&A) would provide more congruent disclosures.

**Discussion Topic III: <u>Auditor Assurance on Other Information Outside the Financial Statements</u>**

*8. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*

Currently the auditor's assurance is critical to investor's confidence in the integrity of financial reporting and its comparability based on US Generally Accepted Accounting Principles (GAAP). It has long been recognized that financial statements alone are not sufficient to communicate overall performance of an entity. In particular, MD&A has become a core element of the communication package for external reporting purposes. We utilize other information such as MD&A, earnings releases, etc. to obtain a better understanding of a company and its peers which assists in our overall investment allocation decisions.

The MD&A is a very important section of an annual report, especially to investors in our review of a company's fundamentals. MD&A proves a context within which the financial results and financial position can be interpreted. As underscored by the Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities by the IOSCO Technical Committee, an issuer should provide all information that would be material to an investor's investment decision, including disclosures in the MD&A. The MD&A requirements are intended to satisfy four principal objectives which benefit investors and other users of the MD&A:

1. Enables investors to see the company "through the eyes of management."
2. Improves financial disclosure overall and provides the context within which financial statements should be analyzed.

3. Provides information about the different components of earnings and cash flow and the extent to which they are recurring elements, thereby enabling investors to make a better prediction about the sustainability of earnings and cash flow in the future.
4. Provides information about the risks to a company's earnings and cash flow.

*9. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*

The MD&A is important to investors. Currently auditors as part of their engagement review the MD&A and consider whether such information or the manner of its presentation is materially inconsistent with the financial restatements or represents a material misstatement of fact. We believe the auditor could provide a statement based on their current responsibilities as it relates to MD&A within the Auditor's Discussion and Analysis AD&A. Although the auditor would not be providing assurance on future performance, CalPERS believes the auditor could through an AD&A provide a statement whether the MD&A is reasonable, whether assumptions and conclusions are rational based on the current financial performance.

CalPERS believes the AD&A is the first step for additional disclosure and the current review on the MD&A by the auditor could be addressed in the AD&A. We see the value of additional assurance but would need to understand the incremental cost benefit.

*10. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

CalPERS would support a fuller discussion of the MDA, specifically as a framework for integrated reporting is developed further. The International Integrated Reporting Committee released a request for comment on an integrated reporting framework on September 12th which should fuel this discussion on MD&A.

CalPERS would defer to the current attestation engagement procedures as issuers currently have the option to engage the auditor to attest on MD&A.

*11. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

Clearly from the discussion today, investors, like CalPERS would recommend the PCAOB focus on the Auditor's Discussion and Analysis(AD&A) and provide clarity within the AD&A on the responsibilities of the auditor on MD&A. We see the value of additional assurance but would need to understand what additional work will be performed and what additional assurance means to investors.

This would be a great opportunity to determine which issuers if any, currently request their external auditor firms to attest to the MD&A. If an issuer requested an attestation then the benefits and challenges should have been outlined to the audit committee and discussion of the benefits may be well articulated.

**Discussion Topic IV:**

**<u>Clarification of Language in the Standard Auditor's Report and Other Alternatives</u>**

Clarification to include: Reasonable Assurance, Auditor's Responsibility for Fraud; Auditor's Responsibility for Financial Statement Disclosures; Management's Responsibility for the Preparations of the Financial Statements; Auditor's Responsibility for Information Outside the Financial Statements and Auditor Independence.

*12. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

CalPERS supports providing additional clarification of each of the terms listed above. We agree that language should be further clarified as these terms are not necessarily fully articulated. CalPERS as a part of its testimony to the US Treasury Department Advisory Committee on the Auditing Profession (ACAP) in February 2008, provided comments on auditors' responsibility for detecting fraud and auditor independence.

Of critical importance to investors is the responsibility of auditors to detect fraud and improve the timely communication of these frauds to investors and shareowners. We believe the standard audit report should indicate the auditor's responsibility for detecting material fraud and the standard audit report should define that the auditor has a responsibility to obtain reasonable assurance (defined as a high, although not absolute, level of assurance) as to whether the financial statements are materially misstated, where caused by error or fraud. We also believe in defining the auditor's responsibility relating to fraud that "inherent limitations" be defined in detecting material misstatements resulting from fraud. In our opinion, there may not necessarily be inherent limitations, but rather time and cost limitations. In our view fraud detection would improve the quality of the audit and with time and effort may have detected many of the major frauds during the last few years. We believe that if during an audit it is found that the control environment is weak and presents opportunities for fraud, auditors should highlight this to the management and audit committee and offer to undertake extra work.

*13. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

The auditor should indicate its responsibility for auditing the financial statement disclosures (notes) as well as the primary financial statements. Additionally, the auditor's report should indicate that the auditor is independent of the company and that the auditor has observed the independence requirements of the SEC and PCAOB. We are not opposed to amending the audit report to indicate that management has the primary responsibility for the fairness of the financial statements, nor to clarifying the auditor's responsibility with respect to other information in documents containing audited financial statements.

CalPERS believes the key to maintaining investor confidence is the independence and competence of the auditor. CalPERS believes that when audit firms also perform non-audit consulting work for their audit clients, such non-audit services have the very real potential to impair the external auditor's objectivity, and adversely affect their independence and professional skepticism. We would support the auditor explicitly stating in the auditor's report a statement on their independence with respect to the company.

*14. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

This alternative would provide clarification that may be beneficial to investors to fully under the role of the auditor and the extent of the work the auditor is performing during the financial statement review. We do not necessarily see this as an expansion of the auditor's report and support the focus on the AD&A. We do not see that clarification will provide any incremental value when compared with an AD&A.

***B. <u>Other Alternatives</u>***

*15. What alternatives not mentioned in the concept release should the Board consider?*

CalPERS supports the expansion of the auditor's reporting through an Auditor's Discussion and Analysis. We do not have any other recommendations at this time.

*16. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

We support the focus on the AD&A.

*17. Which alternative is most appropriate and why?*

The focus of any changes in auditor reporting should be the value to investors. CalPERS supports that changes to the auditor report or changes that may include a new style of auditor report, such as the AD&A, should be cognizant of and related to any changes in integrated reporting and the general reporting framework.

Notes to self -

Page 236/262 IAG March meeting
integrity, objectivity, due professional care, and
public integrity

**For letter add information on integrated reporting to assurance piece**

CalPERS believes corporate reporting needs to integrate key financial and non-financial information. This is in order to identify risks related to the company's operational, financial, environmental, social, and governance status. Integrated reporting is necessary to understand risk management at a company and the drivers of value creation. CalPERS seeks financial and non-financial information that is relevant, timely, comparable, and of high quality. As the International Integrated Reporting Committee has commented "There is a need to develop more comprehensive and comprehensible information about an organization's total performance, prospective as well as retrospective, to meet the needs of the emerging, more sustainable, global economic model

CalPERS has a fiduciary duty of prudence, which requires that we take into account all of the information which identifies and mitigates risks and assists in identifying drivers of value creation. To fulfill this investors require comprehensive financial and non-financial disclosures by investee companies. In February 2010, CalPERS Board approved adoption of ICGN's