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Written testimony to:
Securities and Exchange Commission
Advisory Committee on Improvements to Financial Reporting
(CIFiR) -Panel regarding Materiality, Restatements and Professional Judgment

Chairman Pozen and members of the SEC Advisory Committee on Improvements to Financial Reporting:

I am pleased to be here today to represent CalPERS on the discussions before you on the Progress Report of the SEC Advisory Committee on Improvements to Financial Reporting. Specifically, I would like to address Chapter 3 Audit Process and Compliance, Financial Restatements, Materiality of errors and Professional Judgment.

Thank you for both the invitation to provide written testimony and your work on improving financial reporting as we believe the Advisory Committee's work is timely and critical to all investors.

CalPERS is the 4th largest retirement system[1] in the world and the largest public pension system in the U.S., managing approximately $240 billion in assets. CalPERS manages pension and health benefits for approximately 1.5 million California public employees, retirees and their families.

CalPERS has a significant financial interest in seeking improvement in the integrity of financial reporting. Auditors play a vital role in helping to ensure the integrity of financial reporting and it is the important role of auditors that brings standardization and discipline to corporate accounting, which in turn enhances investor confidence. Investor confidence is critical to the effective functioning of the capital markets. Such investor confidence can be driven by high quality financial reports resulting from the execution of sound auditing practices.

[1] Pensions & Investments, "P&I/Watson Wyatt world's 300 largest retirement plans", 2007 Databook, Page 28, December 24, 2007.

Restatements - Materiality

Investors need accurate and comparable data. CalPERS agrees that the increase in restatements is attributable to various causes. We also believe that companies, auditors and regulators strive to reduce the frequency and magnitude of errors that subject a company to restatement. CalPERS concurs with the evidence that companies subject to section 404 of the Sarbanes Oxley Act (SOX) have declined[2] and supports the value of SOX to investors. Strong internal controls and restatements that correct material accounting errors ensure that investors receive accurate, consistent and comparable data. Although restatements rose after the passage of SOX in 2002, the most recent data shows that restatements declined in 2007 for the first time since 2002. Based on the evidence, it is apparent that SOX is working as intended and suggests that accounting errors are being detected and corrected in a timely manner. However, investors are still unable to determine through current disclosure regulations whether these errors are fully remediated to reduce the likelihood of the same or similar errors from occurring again. Also, financial restatements associated with acquisitions, mergers, and discontinued operations are very important to investors when analyzing a companies' performance. As a result, improvements are necessary in the contents and timeliness of such disclosures

CalPERS supported the proposed auditing standard which provided the auditor guidance on evaluating whether the financial statements are consistent with prior years' financial statements retrospectively when financial statements reflect a change in accounting principle and therefore, will appear different from those previous years' financial statements on which the auditor previously reported. We also supported the Public Company Accounting Oversight Board's (PCAOB) efforts to revise its auditing standards in recognition of the Financial Accounting Standards Board's (FASB) revised accounting and disclosure requirements as outlined in Standards No. 154, Accounting Changes and Error Corrections.

CalPERS also supported the changes that require auditors to expand their report/opinion to address why there have been restatements and the reason for the misstatements. We also supported the position that auditor reporting requirements should apply to all restatements. This additional requirement is in line with the spirit of the Sarbanes-Oxley Act of 2002, Section 404 and would provide additional clarity on potential internal control weaknesses and/or issues.

CIFiR's developed proposal 3.1 that recommends guidance reinforcement on evaluating materiality of an error through the perspective of a reasonable investor is valuable. However, materiality should be defined with the end result in mind. Similar to the perspective that if an auditor believes a certain account has a high risk of material misstatement during the planning phase of the audit and the auditor then includes this perspective in their testing; we believe using the same materiality measures used in the

[2] Mark Grothe and others. "*The Tide is Turning*," Glass Lewis & Company Yellow Card Trend Alert, January 15, 2008

audit of the annual financial statements is beneficial in judging how an error affects the total mix of information available to a reasonable investor and their ability to properly value that company as an investment.

CalPERS does not support the evaluation of errors on a "sliding scale." A material transaction from a quantitative perspective should typically not be determined to be immaterial from a qualitative perspective. In addition, we do not believe multiple control deficiencies should be looked at in combination only if they are related to one another. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting. Although, CIFiR outlines qualitative factors as a guideline in determining this "sliding scale", CalPERS believes misstatements must be analyzed in light of all the surrounding facts and circumstances – the nature (classification vs. earnings impact), the effects on trends relating to key financial metrics and other factors to drive a similar conclusion by a prudent investor. Regardless of the decision on materiality and the need for a restatement, a detailed disclosure of these decisions should be contained in the company's/ auditor's report/opinion to address why there have been restatements and the reason for the misstatements. CalPERS agrees that education and outreach efforts by the SEC and PCAOB may be instrumental in ensuring a more consistent application of the definition of materiality.

Correction and Disclosure of Errors

CalPERS concurs with the viewpoints developed in Proposal 3.2 but provides caution that the enhanced guidance on how to correct, when to correct and disclosure should be further developed to prevent inconsistent application. We also firmly believe that all errors should be disclosed and corrected no later than the end of the reporting period in which the error is discovered. We are concerned that some material errors are not disclosed until corrected and therefore the lack of information during the "dark period" – period between the initial notification to the SEC and the time revised financial statements are filed with the SEC, may create uncertainty which in turn may adversely effect the company's stock prices or its ability to confirm compliance with loan covenants.

We strongly agree with CIFiR's proposed guidelines and recommendations by the Investors Technical Advisory Committee[3] that all companies which have a restatement should be required to disclose information on:

(1) the nature and magnitude of the error,
(2) the items in the financial statements impacted,
(3) the impact of the error on liquidity, results of operations, financial condition and cash flows,
(4) whether a material weakness in internal controls exists,

[3] Investors Technical Advisory Committee (ITAC), letter to Mr. Mike Cook, Chairman of the SEC Advisory Subcommittee on Audit Process and Compliance, December 13, 2007.

(5) the expected timetable for restatement of financial statements and remediation of internal controls and
(6) Management's response to the error, to the extent known, during the initial notification to the SEC and investors, the "dark period" and the filing of revised financial statements with the SEC. We concur that companies should update this disclosure on a periodic basis as part of the restatement process.

We are in agreement with the CIFiR that additional work should be performed to fully develop robust guidance regarding errors identified in interim periods. We support the position that the determination of materiality for an interim period error should be made based on the perspective of a reasonable investor, not whether an interim period is a discrete period, an integral part of an annual period, or some combination of both. Similarly, we recommend using the same materiality measures used in the audit of the annual financial statements in judging how an error affects the total mix of information available to a reasonable investor and their valuation assessment of an investment.

Professional Judgment

Professional judgment is developed with experience and sound foundations of technical skills sustained by continuing professional education and supported by an appropriate professional certification. CalPERS believes that professional skepticism is necessary for an auditor to apply their independent professional judgment to circumstances when conducting an audit. A similar degree of professional skepticism should apply to a company's internal accounting and auditing staff when applying professional accounting standards whether rules-based or principles-based.

The CIFiR believes that professional judgment if properly implemented should improve the quality of financial information available to investors, while reducing concerns about "financial engineering" or manipulation of financial data by companies. CalPERS acknowledges that the use of professional judgment is a byproduct of the markets moving towards a single set of globally accepted accounting standards. However, in the U.S. significant training is necessary to ensure investors, accountants, auditors, students and all users of financial reporting have the skills and experience necessary for any professional judgment foundation to be effective and trustworthy.

Framework & Categories of Judgments

CalPERS concurs that many different categories and levels of judgments exists. CalPERS also agrees that having a framework for auditing professionals can be useful and could provide guidelines for the application of professional judgment. By fostering more communication between decision-makers and ensuring all relevant information is obtained, professional judgment could be valued for what it is – judgment.

We do not agree with the position that establishing safe harbors for accountants and auditors will ensure accountants and auditors are candid and provide a thorough analysis. We are unaware of any evidence that shows providing safe harbors or immunizing accountants and auditors would improve or increase the effectiveness of professional judgment. Similar to CalPERS' testimony to the Advisory Committee on the Auditing Profession[4] we expressed our view that no evidence exists that shows how changing the law to shield auditors' from liability for failed audits would increase audit competition or improve the quality of audits; CalPERS does not believe establishing a safe harbor for professional judgment would improve investors' reliance on professional judgment nor would it protect investors on the quality of these judgments.

Developed Proposal – Judgment Framework for Accounting and Auditing Judgments

CalPERS supports CIFiR's developed proposal 3.4 that the SEC should adopt a judgment framework for accounting judgments and the PCAOB should adopt a similar framework with respect to auditing judgments with investors input. Both frameworks would assist investors and regulators in assessing whether accountants' and auditors' were reasonable and sound in their professional judgment formulation. We also believe that significant judgments should be disclosed to and discussed by management and the independent auditor with the audit committee of the Company's Board of Directors.

CalPERS' recent letter to the PCAOB [5] regarding criteria to increase reliance on inspections by non-U.S. oversight entities; supports the PCAOB's five broad principles designed to guide the Board in making a reliance determination to provide a sound basis for making a professional judgment. We believe that a similar framework could provide essential criteria, not a check the box approach to ensuring the professional judgment of both accountants and auditors. We support the view that a framework developed with input from investors, could serve as an approach to evaluate the process of making professional judgments.

The components shown in your Progress Report serve as a starting point for the development of a professional judgment framework. CalPERS reiterates its position that both documentation and transparency must be key components of any valid framework.

CalPERS concurs that professional judgment should be the outcome of a process in which a person or persons with the appropriate level of knowledge, experience and objectivity form an opinion based on the relevant facts and circumstances.

Closing

In closing, as I mentioned at the beginning of my testimony -- CalPERS has a significant financial interest in maintaining the integrity of financial reporting. Auditors play a vital role in ensuring the integrity of financial reporting. We support the work of CIFiR and its

[4] CalPERS testimony to the US Treasury Department – Advisory Committee on the Auditing Profession, February 4, 2008.
[5] PCAOB Release No. 2007-010, CalPERS comment letter regarding "Inspections of Foreign Registered Public Accounting Firms", March 5, 2008.

development of robust guidance on materiality, restatements and professional judgment. We believe this robust guidance is critical to the level of confidence that investors will have in financial reporting in the U.S. Please consider our testimony as you move forward with your recommendations.

Thank you for inviting me to share CalPERS' views with you today. I am happy to answer any questions you may have and would be happy to provide any further support of the ideas I have presented.

Sincerely,

Dennis A. Johnson