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Written testimony to:
US Treasury Department
Advisory Committee on the Auditing Profession (ACAP)
Panel on General Sustainability

Chairman Levitt, Chairman Nicolaisen and Members of the Advisory Committee on the Auditing Profession:

I am pleased to be here today to represent CalPERS on the discussions before you on the sustainability of the auditing profession. Thank you for both the invitation to provide written testimony and your work on this important issue 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 $238 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. Public and investor confidence and stability are critical to the success and effective functioning of the capital markets. Auditing helps bring these attributes to the marketplace. CalPERS has great interest in five topical areas: auditor independence - potential auditor liability and risk; audit firm structure and ownership; transparency and governance of audit firms; auditors' responsibility for fraud detection; and choice in the audit market.

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

1. Auditor Independence – Potential Auditor Liability and Risk

CalPERS believes that in order to strengthen the external auditor's objective behavior when performing an audit of financial reporting, audit committees should ensure that contracts between public companies and their independent auditor do *not* limit the auditor's liability for consequential or other damages and should not mandate that the company use private alternative dispute resolution to prevent all access to the public court system. CalPERS does *not* believe that potential liability exposure is the root cause of auditor concentration, lack of competition or audit quality, but rather is more of a symptom. The ultimate failure of Arthur Andersen was not caused by its liability exposure, but rather the damage that was done to the firm's professional reputation due to deficiencies in the firm's quality control processes, criminal indictment and approval of aggressive accounting techniques.[2] CalPERS believes from an investor perspective, the real drivers of reputational risk have been the lack of audit quality control processes, the lack of transparency, and the lack of accountability to shareowners. Limiting the liability of auditors will not automatically encourage new audit firm entrants into the market for large public company audits and we do not believe this factor is conducive to robust investor protection and audit committee behavior that protects long-term shareowner value. Moreover, the number of companies audited by Big Four accounting firms continues to decline as public companies audited by Tier Two audit firms continues to rise, and for the first time in the five-an-a-half years since the passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), financial restatements declined among companies of all sizes. But the "tide is turning", SOX 404 is working. Investors are basing decisions on more accurate financial reports.[3]

In January 2008, the Government Accountability Office (GAO) released its audit marketplace findings in a report entitled "Audits of Public Companies, Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action." The GAO stated, "In light of limited evidence that the currently concentrated market for large public company audits has created significant adverse impact and the general lack of proposals that were clearly seen as effective in addressing the risks of concentration… without serious drawbacks, we found no compelling need to take action,"[4] including no compelling reason to

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[2] Iain Richards, Morley Fund Management, "*Bringing Audit Back from the Brink (Auditor liability and the need to overhaul a key investor protection framework)",* Accounting Business and the Public Interest, Vol. 3 No 1**,** February 2004.

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

[4] United States Government Accountability Office – Report to Congressional Addressees, "*Audits of Public Companies – Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*", page 6, GAO-08-163, January 2008.

artificially cap auditor liability. Accordingly, the GAO report contains no action recommendations at this time.

We do not find any convincing evidence that changing the law to shield auditors' from liability for failed audits would either increase audit competition or improve the quality of audits. Therefore, we urge the Advisory Committee to review all the underlying concerns and issues without simply moving towards artificially capping the liability of external public company auditors to the detriment of shareowners.

2. Public Company Audit Firm Structure & Ownership

CalPERS is currently reviewing its position on audit firm structure and ownership. While not a current policy at CalPERS, how an organization is structured could define its ability to react and fulfill its mission. Structure not only supports the effectiveness, efficiency and accountability for how an organization accomplishes its mission, but also influences the culture and ethical practices of an organization. State and Federal rules and regulations are important considerations when determining the legal structure of audit firms. Some have suggested that audit firms' structure considerations should include possible corporate structure, public company ownership and non-CPA ownership structures versus the employee (partnership) structure many audit firms have today. CalPERS believes such additional considerations or changes should be researched more fully to ensure these changes do not introduce additional problems into the equation such as increased conflicts of interest. One possible way to decrease this potential conflict of interest would be to introduce independent boards of directors to the audit firm structure.

Statutory audits were implemented as part of legislative reforms to assist in restoring investor confidence and encouraging capital development after the 1929 Stock Market Crash. 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 also believe that outside ownership has the potential to negatively impact the objectivity and independence of the audit firm. Opening up ownership and control of public company audit firms to non-auditors may create the potential for additional and significant conflicts of interest.

Many studies have developed a framework for assessing the factors that have the potential to decrease external auditor independence (also referred to as "independence risk") and those that might mitigate such risk. One study, Johnstone, Sutton and Warfield,[5] states that potential increases in audit firm independence risk may arise from direct investment, financial dependence, and interpersonal relationships. It is possible that factors such as these that may negatively impact the independence of the firms and should be addressed in determining whether outside capital would be helpful to audit firms, but harmful to investors by reducing the reliability of public company financial statements.

It is interesting to note that the Securities and Exchange Commission recently charged two PricewaterhouseCoopers (PwC) employees, who had access to confidential information about PwC's clients, with insider trading, "SEC Charges Two Former Accounting Firm Employees with Insider Trading." January 15, 2008 SEC Press Release.[6] If outside capital is allowed, then audit firms will also need to ensure a greater return on capital which may even further introduce potential conflict. Without increased audit firm transparency, additional scrutiny of audit firms' capital inflows and outflows and remuneration to partners, there may not be credible evidence that a need for additional audit firm capital from outside investors exists at this time.

3. <u>Transparency and Governance</u>

The European Union recently adopted reporting requirements (to be effective in June 2008) for public company auditors relating to issues such as a firm's legal structure and ownership, governance, and internal quality control system. CalPERS supports the role of the SEC in establishing similar reporting requirements for public company audit firms. We support the global movement towards adoption of one single set of high quality, globally accepted standards, but at a controlled pace to ensure unintended consequences are addressed. Similarly we believe this provides an impetus towards U.S. auditors adopting similar reporting requirements as required for public company auditors under the jurisdiction of the European Union.

Currently under consideration is CalPERS view on whether audit firms should disclose the firm's financial results. However, since Congress entrusted the public company auditor with the critical role of providing public trust in financial reporting; having audit firms disclose the firm's financial results may also consistent with this important function. We noted, the Financial Reporting

[5] Johnstone, K., Suton, M. and Warfield T. (2001) "*Antecedents and Consequences of Independence Risk*: Framework for Analysis" Accounting Horizons, 15(1): 1-18.

[6] Marc J. Fagel, Co-Acting Regional Director, SEC's San Francisco Regional Office, SEC Press Release, January 15, 2008 "*SEC Charges Two Former Accounting Firm Employees with Insider Trading*", www.sec.gov.

Council's final report of the market participants group regarding choice in the UK Audit market, Provisional recommendation 2, outlines that audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis. [7]

CalPERS recommends that required disclosure of key performance indicators to foster greater audit quality should be required of audit firms. These key performance indicators could include percent of training dollars spent on staff compared to the fees received for the audit, average experience of staff, partner time allocated to each audit, etc. Audit firms should also consider strengthening peer review as well as sharing key performance indicators during these reviews to facilitate and strengthen audit quality by both parties.

Another suggestion would be to ensure that Public Company Accounting Oversight Board (PCAOB) provides public access to all firm-specific inspection reports. Since audit committees are responsible for oversight of the public company auditor, these reports would provide insights for the benefit of public company audit committees on potential issues with audit firm quality and the continued use of the current auditor or in hiring a replacement auditor. Currently, the PCAOB inspection reports are not made public if potential defects in the firm's quality control systems are addressed to the PCAOB's satisfaction within one year from the date of inspection under the Sarbanes-Oxley Act. Also, allowing the investing public to view these types of important inspection reports should provide continued incentive for audit firms to continuously improve audit quality.

4. **Auditor responsibility for fraud detection and improving communication with investors**

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. It was poignantly captured in Chairman Levitt's October 15, 2007 remarks, "Investor confidence in that financial information does not merely fuel markets but makes them possible. We can't afford to break the trust and confidence of investors in our markets today… If there's a billion dollar error, investors must be able to rely on auditors to try to discover it... It includes telling investors the whole truth with respect to their findings… Likewise, a culture of audit quality requires individuals who are willing to and do call out of bounds."[8]

[7] Financial Reporting Council – FRC, October 2007, "*Choice in the UK Audit Market – Final Report of the Market Participants Group*."

[8] Arthur Levitt, Jr, Committee Co-chair, Oct 15, 2007 Transcripts, Open session, Monday, October 15, 2007.

As stated by former Commissioner Roel C.Campos "Given the over 91 million individual mutual fund investors in the U.S. alone that are relying on the capital markets to protect their retirement nest eggs, investors should and must require auditors to search for fraud and use professional skepticism in conducting a high quality audit."[9] Auditors must be willing to "referee and call out of bounds" when management and audit committees make poor, unsupported decisions, which negatively impacts the quality of a company's financial reporting and/or internal controls and causes financial harm to investors. Auditors must be willing to stand up to their clients if there is a dispute on the appropriate accounting treatment for a transaction.

The Safe Harbor

The Reform Act's most significant component, referred to as the safe harbor, protects that subset of soft information known as "forward-looking statements." Forward-looking statements include financial projections, future management plans and objectives statements of future economic performance, including certain statements required in SEC filings.

However, the safe harbor does not provide immunity for improper accounting practices. Ultimately, management is responsible for issuing financial statements that comply with U.S. GAAP. Failure to do so is still a basis for legal action by investors. Likewise, auditors are responsible for auditing financial statements in accordance with U.S. generally accepted auditing standards (GAAS). Thus, although the safe harbor protects auditors that participate in preparing forward-looking statements set forth in the MD&A and other investor targeted documents and SEC filings; it does not and should not immunize an auditor against a substandard audit.

Statements on Auditing Standards 99 – Consideration of Fraud in a Financial Statement Audit (SAS 99)

Auditors currently have an auditing standard that requires determination of whether an entity's financial statements are susceptible to material misstatement due to fraud. Additionally, SAS 99 was issued partly in response to large scale accounting scandals at Enron, WorldCom, Adelphia, Tyco and others. There are two primary objectives of SAS 99. The first objective is to ensure the engagement team will have an opportunity for the seasoned team members to share their experiences with the client on how a fraud might be perpetrated and concealed. The second objective is to set the proper ethical "tone at the top" for conducting the engagement. The brainstorming session is to be conducted in a

[9] SEC Commissioner Roel C.Campos, page 1, February 28, 2007 "Remarks Before the Mutual Fund Directors Forum First Annual Directors Institute", www.sec.gov,

manner that models the proper degree of professional skepticism and sets the culture for the entire engagement.

Similar to an earlier thought that I shared, "tone at the top" and professional skepticism is key to an independent auditor's judgment. SAS 99 also requires the auditor to gather information necessary to identify risks of material misstatement due to fraud. I am referencing SAS 99 as I believe investor sentiment and existing standards support that auditors must search for fraud. SAS 99 outlines procedures that should assist the auditor in the search to detect the existence of fraud. As a result, auditors must consider the requirements of SAS 99 as the minimum level of work required to detect fraud.

5. <u>Choice in the Audit Market - Competition – Use of Other tier Auditors</u>

CalPERS believes that audit committees should seek to appoint auditors from outside the Big Four. We believe audit committees should assess how best to achieve audit quality in choosing an auditor.

CalPERS currently utilize Macia Gini & O'Connell as its external auditor. There are many institutional investors that hire auditors outside the Big Four audit firms. I have included a table of many of these which provides the Advisory Committee support that quality audits are performed by auditors from different size audit firms.

Pension System	**Audit Firm**	**Number of Years**
CalPERS	Macias Gini & O'Connell	1
CalSTRS	Macias Gini & O'Connell	4
LACERA	Brown Armstrong	5
SDCERA	Brown Armstrong	3
LACERS	Brown Armstrong	3
Ohio PERS	Clifton Gunderson LLP	1
Pennsylvania State Employees Retirement System	Clifton Gunderson LLP	2
Pennsylvania School Employees' RS	Clifton Gunderson LLP	5
Colorado PERA	Clifton Gunderson LLP	4
State Retirement Agency of Maryland	Abrams, Foster, Nole & Williams, P.A/Clifton Gunderson LLP	3
Ohio Police and Fire Pension Fund	Clark, Schaefer, Hackett & Co.	4
KY Teachers Retirement System	Charles T Mitchell Company	5
Kentucky Retirement Systems	Mountjoy & Bressler, CPA's, LLP	5

Pension System	**Audit Firm**	**Number of Years**
Mississippi PERS	Home LLP	3
Arizona State Retirement System	Heinfeld and Meech	1
Illinois State Universities RS	BKD	6
Wyoming Retirement System	McGee, Hearne, & Piaz, LLP	7
Teachers' Retirement System of Oklahoma	Cole & Reed	2
North Dakota Public Employees Retirement System	Brady Martz & Assoc.	2
ND Retirement & Investment Office	Brady Martz & Assoc.	12
Washington Department of Retirement Systems	Peterson Sullivan PLLC	3
Washington State Investment Board	Peterson Sullivan PLLC	2
Public Employees Retirement Association of New Mexico	Moss Adams,	5
Public School Retirement System of Missouri	Williams, Keepers LLC	6
Louisiana State Employees Retirement System (LASERS)	Postlewaite and Netterville	9
Maine Public Employees Retirement System	Baker, Newman & Noyes, CPAs	3

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. 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 presented.

Sincerely,

Christianna Wood