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HOW WILL YOU SPEND YOUR FUTURE?

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May 16, 2005

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. 018 and PCAOB Auditing Standard No. 2

Ladies and Gentlemen:

This letter is sent on behalf of the members of the California State Teachers' Retirement System (CalSTRS). CalSTRS is the third largest public pension system in the U.S., with over $125 billion in assets that are managed on behalf of 750,000 members and beneficiaries. Our domestic equity portfolio currently is comprised of $54 billion in investments; CalSTRS invests in over 2,800 stocks domestically. In terms of market value, the domestic equity portfolio represents the overwhelming majority of our trading on national securities exchanges. The long-term nature of CalSTRS' liabilities, and our responsibilities as a fiduciary to our members, has made us keenly interested in efforts to restore investor confidence in the capital markets and to improve transparency in financial reporting.

CalSTRS is pleased to provide comment on the Public Company Accounting Oversight Board's Release No. 2005-002, dated March 31, 2005, in which PCAOB proposed a new auditing standard relating to the elimination of a previously-disclosed material weakness in a reporting company's internal control over financial reporting.

In addition, we take this opportunity to comment upon lessons learned during the preparation of the first cycle of Annual Reports of Form 10-K of reporting companies that were subject to the internal control attestation requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") and Item 308 of Regulation S-K under the Securities Act of 1933.

The Proposed Auditing Standard

We applaud the PCAOB for its prompt recognition of the need for the proposed auditing standard. We believe that in certain instances, disclosure by a reporting company of a material weakness in its internal control over financial reporting will create uncertainty in the eyes of investors, and volatility in the company's securities. Under the current regulatory structure, such a company would be required by Item 308(c) of Regulation S-K to provide quarterly updates as to remediation efforts to the extent these efforts constituted material changes in the company's internal control over financial reporting. However, the investing community would have to wait until the company's next Annual Report on Form 10-K for third-party verification (provided by the company's auditors) of the elimination of the material weakness. This could unnecessarily prolong market uncertainty as to the current quality of the company's internal controls.

CalSTRS therefore supports the adoption of the proposed auditing standard. We have the following two observations in response to PCAOB's specific requests for comments, and several additional thoughts that we believe may be helpful as PCAOB formulates the definitive standard.

Responses to Specific Requests for Comment

- <u>We believe that companies should not be permitted to engage auditors to attest to the elimination of some previously-disclosed material weaknesses without disclosing the continuing existence of other previously-disclosed material weaknesses.</u>

We believe that if a reporting company identified more than one material weakness in its most recent annual report on Form 10-K and the auditor is engaged to express an opinion on some but not all of the material weaknesses that were identified in that report, the auditor should be required to specifically identify the previously-disclosed material weaknesses that remain unremediated. We believe that this will provide the most meaningful disclosure to readers in that it will set forth, in one location, a full update of the status of the company's current status in its efforts to eliminate its material weaknesses. We do not believe that this requirement would pose an undue burden on issuers, nor should it provide a disincentive to the utilization of the audit authorized by the proposed standard.

- <u>Auditors should be permitted to comment in interim reports on the elimination of material weaknesses identified after the immediately preceding audit of the company's internal control over financial reporting.</u>

As proposed, the standard would not permit the reporting company to engage its auditors to report upon the elimination of a material weakness discovered after the filing of the company's most recent audited financial statements. We believe that this disclosure may be useful to investors and beneficial to reporting companies, and see no reason to prohibit such an engagement. Without this modification, issuers may conclude that the discovery is material and thus disclosure is required in a current report on Form 8-K or a Quarterly Report on Form 10-Q pursuant to Rule 12b-20 (which requires disclosure of material information that is not otherwise called for by a specific line item of a form), yet be unable to disclose in the same or a subsequent 10-Q the successful remediation of the material weakness, forcing investors to wait until the filing of the 10-K to learn of the elimination of this material weakness.

We believe that our preceding comment should also apply to this situation - if a reporting company elects to utilize the standard to disclose the elimination of a material weakness that was discovered after the completion of the most recent audit, the disclosure must also identify any other material weaknesses that have been identified since the date of the last audit and remain unremediated. If this requirement is not imposed, we believe that reporting companies would be able to selectively disclose the good news regarding post-audit material weaknesses while withholding disclosure regarding corresponding potentially less favorable news. We also believe that a reasonable investor, when presented with information regarding the elimination of post-audit material weaknesses, would conclude that no other post-audit material weaknesses exist, leading to undue volatility in the reporting company's securities when the remaining disclosure is made in the company's next 10-K.

Additional Observations Regarding the Proposed Standard

- <u>We believe that PCAOB should retain the provisions of Paragraph 3 of the Auditing Standard to the effect that the promulgation of the Auditing Standard should not be read to imply that auditors should be retained in most or all instances to report in interim reports on the elimination of material weaknesses.</u>

We agree with PCAOB that while the proposed standard can provide disclosure that will be very useful to the markets in certain situations, there is no need for reporting companies to engage their auditors pursuant to the proposed standard with respect to every elimination of a post-audit material weakness. We also believe that it is entirely appropriate for a reporting company to elect to engage its auditor to report on the elimination of some, but not, all, post-audit material weaknesses that have been eliminated, for example in situations where there is heightened concern as to the presence of a particular material weakness, and recommend that PCAOB explicitly so state in the final version of the Auditing Standard. Our interest in greater transparency in financial reporting is balanced by our desire that unnecessary costs not be imposed on reporting companies.

- <u>Clarify that if the auditor is retained to provide an attestation under the Auditing Standard relating to a post-audit material weakness, then the reporting company should also be required to provide its evaluation of the elimination of that material weakness.</u>

Item 308(c) of Regulation S-K currently requires reporting companies to disclose material changes in internal controls in the prior quarter. There is no requirement for the company to provide any evaluation of the effectiveness of these changes. Under the proposed auditing standard, the auditor will attest to the effectiveness of management's assertion that the material weakness has been eliminated. Paragraphs 40 and 55 of the proposed standard require the auditor to obtain written attestations from management on the elimination of the material weakness and the effectiveness of the internal control(s) that are the subject of the engagement. However, there is no requirement that management's attestation be publicly disclosed. We do not see a justification for this difference from the annual attestations of internal controls required under Item 308 of Regulation S-K, and believe that the investing public will be just as interested in disclosure of management's views in the case of auditor attestation relating to a post-audit material weakness. We therefore recommend that the SEC amend Item 308(c) of Regulation S-K to include a requirement that management must disclose their attestation to such elimination in any engagement of the auditor pursuant to the proposed standard.

- Adjustments to AS No. 2 that are adopted in response to lessons learned during the 2004 10-K cycle for calendar year accelerated filers should also be included in the Auditing Standard relating to reports on elimination of material weaknesses.

We discuss below certain suggestions for modification to PCAOB's Auditing Standard No. 2 in light of lessons learned from the first cycle of Annual Reports that were subject to the requirements of Section 404 of the Act. We strongly urge PCAOB to evaluate the proposed standard in light of comments received on AS No. 2.

Lessons Learned Regarding Section 404 from the 2004 Annual Report Cycle for Calendar-Year Accelerated Filers

CalSTRS believes that the enactment of the Sarbanes-Oxley Act of 2002 was an important milestone for investors. We agree that accurate and reliable financial reporting lies at the heart of our financial market system and that investor confidence in such information is fundamental to the health of our markets. However, despite these salutary intentions, it has been widely reported that the cost of implementing Section 404 of the Act, whether measured in actual dollar expenditures or in time and effort expended on the part of reporting companies and their advisors, has far exceeded expectations. We have participated in several forums on the implementation of Section 404 and have been struck by the number of market participants that believe the benefits of this statutory provision far outweigh its costs; still there is wide agreement that the implementation of this section is in need of remediation.

Our interest in best protecting the value of our assets by promoting improved governance and financial reporting practices must be balanced against the need for regulatory burdens to be roughly commensurate with the benefits afforded. We believe that the quality of internal control over financial reporting has deteriorated markedly in recent years, and as an institutional investor we are deeply concerned about the systemic risks posed by this decline. However, we do not believe it is in investors' best interests to require reporting companies to expend millions of dollars annually on analyses of internal controls that may be overly formulaic and ill-suited to actually preventing fraudulent activities or inadvertent but material error in the preparation of financial statements.

We commend PCAOB, and the Securities and Exchange Commission, for their willingness to consider ways to improve the implementation, and reduce the cost, of the internal control reporting requirement for public companies, and in particular for jointly hosting the roundtable that was held to discuss this topic on April 13, 2005. To that end, we would like to make the following suggestions for PCAOB and the SEC to consider as they formulate guidance in this area.

- <u>The detail-oriented nature of the internal control disclosure process, and the sheer magnitude of the work required for the initial season, risks diverting management and the board from analyzing and addressing material issues facing their business.</u>

In general, we are concerned that the detail-oriented application of the internal control disclosure requirements risk so monopolizing the time of senior management, the Audit Committee and the Board of Directors of reporting companies that they will not be capable of devoting the time and resources necessary for them to develop and maintain the deep understanding of the business and risks of their companies necessary to be able to anticipate and prevent fraudulent activity. We recognize that, to some extent, the quantity of resources required to complete the attestation process for 2004 can be viewed as a deferred cost reflecting inadequate investment in internal control in prior years. We also recognize that costs should fall as repetition of the process occurs. However, costs incurred in 2004 were at a sufficiently high level that even if these predictions prove to be true, there is still ample room to streamline the process and increase its efficiency without compromising its results.

- <u>Auditors should be encouraged to utilize concepts of materiality and risk-based analysis in determining the scope of their testing of internal controls</u>

Although the SEC's definition of internal control makes clear that the goal of this standard is to provide reasonable, not absolute, assurances, we believe that the initial experience under Section 404 suggests that auditors and regulators may have been seeking assurance that borders on the absolute. In particular, we are aware of auditors imposing absurdly high coverage ratios in their evaluations of the effectiveness of internal controls, in some instances requiring 80% or even 90% of all internal controls to be individually tested. To the extent that these efforts can be ascribed to allegedly overly detailed or prescriptive provisions of AS No. 2, we strongly urge PCAOB and the SEC to modify this standard so as to make clear that internal control audits need not verge from the concept of reasonable assurance. It is important that such guidance (or specific amendments to AS No. 2) be in place such that reporting companies and their auditors can rely on it during the 2005 audit.

- <u>Reporting companies and their auditors should be encouraged to engage in free and open discussions regarding the preparation and audit of financial statements and the formulation of appropriate accounting treatments</u>

We have heard from a large number of sources that reporting companies are now unwilling to seek guidance from their auditors on interpretive questions under GAAP, or to circulate early drafts of financial statements to their auditors, for fear that incorrect positions taken at early stages of analysis will lead to material weakness determinations. Conversely, we also understand that auditors' shy away from meaningful discussions with clients about interpretive positions under GAAP during the course of a fiscal year for fear that frank and open discussions may compromise the auditor's independence with respect to the reporting issuer under current SEC rules and interpretations. We submit that there is no benefit to the market or to investors by chilling wide ranging discussions between auditors and their reporting company clients and encourage that the PCAOB and the SEC so clarify.

- <u>The issues with the implementation of Section 404's internal control reporting requirements are disproportionately harsh on small companies.</u>

While the bulk of our investments are in companies that fall on the large cap end of the capitalization scale, we are also significant investors in small cap companies. Because these companies can provide very attractive investment opportunities for our members, it is important to us that appropriate companies be encouraged to enter the public capital markets in the United States. We believe that the impact of Section 404 on small companies has been disproportionately harsh, and may have served to deter companies from going public in the United States. We are aware of colloquial evidence suggesting that companies that might otherwise be suitable candidates for initial public offerings are refraining from pursuing this option because they (and their sponsors) are unwilling to bear the expense of Section 404 compliance. Because we believe that this is a negative development for our capital markets, we strongly encourage both PCAOB and the SEC to consider steps that may be taken to provide some degree of relief for small companies while preserving the beneficial aspects of Section 404.

We understand that the Committee of Sponsoring Organizations is preparing a revised version of *Internal Control -- Integrated Framework* that is designed to apply to smaller companies. We support this development, and encourage PCAOB to provide guidance to the auditing profession so that this standard is appropriately utilized, along with greater exercise of judgment and risk-based analysis by auditors as discussed above, to ease the burdens imposed by Section 404 on smaller companies.

Further, since newly-public companies are required to comply with Section 404 in their first 10-K, we also understand that companies that are otherwise willing to pursue IPOs are in effect forced to time their transactions so as to become public early in their fiscal year, thus maximizing the available time to complete the work necessary to comply with Section 404. Given the volatility and unpredictability of the IPO markets in recent years, this sort of artificial timing constraint is counterproductive. As one means of addressing this issue, we suggest that PCAOB and the SEC consider permitting newly-public companies to delay Section 404 compliance until they file their second 10-K.

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Thank you for the opportunity to comment on these important issues. If you would like to discuss this letter, please feel free to contact me at the number set forth above.

Sincerely,

Jack Ehnes
Chief Executive Officer