



California State Teachers'
Retirement System
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August 12, 2016

Phoebe W. Brown, Secretary
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

**Re: PCAOB Rulemaking Docket Matter No. 034 – Release 2016-003 Reproposed Rule -
Auditor's Report - Expanded –Auditor Reporting**

Dear Ms. Brown and PCAOB Board members:

I am writing on behalf of the members of the California State Teachers' Retirement System (CalSTRS) in response to the Public Company Accounting Oversight Board's (PCAOB, Board) request for written comments to the reproposed rule, release 2016-003, on the Auditor's Report. Thank you for the opportunity to provide a long-term investor's perspective on this reproposal on what is required in the auditor's report that would be useful to investors. We view this as a critical project and strongly support the PCAOB's finalizing what builds on more than five years of Board outreach, in which many investors such as CalSTRS reinforce the need for the Board to make the auditor's report more relevant and informative. We encourage the PCAOB to adopt a final standard on an expanded auditor's report expeditiously with an effective date that allows for audits of financial statements for periods ending on or after December 2017.

CalSTRS' mission is to secure the financial future and sustain the trust of California's educators. We serve the investment and retirement interests of more than 896,000 plan participants.¹ CalSTRS is the largest educator only pension fund in the world. We have a global investment portfolio valued at approximately \$193.3 billion as of July 31, 2016, with approximately \$108.9 billion of the fund's assets being invested in the public equity markets, on both a domestic and an international basis.² With such a large part of our investment portfolio exposed to the risks and rewards of the public equity markets, CalSTRS is grateful for the work done by the PCAOB that helps to promote investors' protection. We appreciate the Board's continued efforts to further the public interest in the preparation of informative, accurate and independent audit reports.

¹ CalSTRS at a Glance, Fact Sheet: <http://www.calstrs.com/sites/main/files/file-attachments/calstrsataglance.pdf>

² CalSTRS Current Investment Portfolio for the period ending July 31, 2016. <http://www.calstrs.com/current-investment-portfolio>

Additionally, the long-term nature of CalSTRS' liabilities, the composition of its portfolio and the CalSTRS Board's fiduciary responsibility to its members makes the fund keenly interested in the rules and regulations that govern the securities market. We have a vested interest and rely on the quality and integrity of financial reporting and believe a robust auditor's report is integral to our capital allocation analysis done on behalf of our beneficiaries. We believe the proposed rule changes will provide four important attributes – *transparency, relevance, reliability and credibility*. Investors are the intended beneficiaries of public company audits, with shareholders' capital paying for the auditor's report.

Furthermore, CalSTRS reinforces the need for vigorous enforcement of auditing standards and appreciates the efforts of the enforcement actions by the Board. CalSTRS affirms the continued dialogue and work with the International Forum of Independent Audit Regulators (IFIAR) to stress enforcement.

CalSTRS emphasizes support for:

1. Additional improvements to the auditor's report regarding independence, auditor tenure, addressee and language.
2. The importance and criteria of Critical Audit Matters (CAMs), being entity-specific. CAM criteria should be determined as outlined in the proposal along with the auditor's consideration of a nonexclusive list of factors. Additionally, CAMS should include matters that involve especially challenging, subjective, or complex auditor judgment; such as the auditor's assessment of the risks of material misstatement, including assessed risks of material misstatement due to fraud and other significant risks specific to the issuer's industry.
3. The need for an enforcement mechanism to insure that CAMs do not degenerate into boilerplate. CalSTRS agrees with the requirement for a statement by the auditor in circumstances where there are no CAMs to report.
4. Alignment of the PCAOB's concept of CAMs to the International Auditing and Assurance Standards Board's (IAASB) concept of Key Audit Matters (KAMs), strengthening and improving consistent global audit standards.³ Leverage the insights gained from the IAASB, the European Union (EU) and the Financial Reporting Council in the United Kingdom (FRC) from expanded auditor reports.
5. Inclusion of a going concern supplementary paragraph in the auditor's report and requirement, the minimum period considered to be at least, but not limited to, twelve months from the reporting date.

Proposed Requirements in 2013 and this Release - Additional improvements to the Auditor's Report

Language

1. In 2014, CalSTRS responded to Release No. 2013-005, Docket Matter No. 034 to support the proposal requiring the auditor to communicate critical audit matters (CAMs) in the auditor's report. We continue to believe the proposed changes would improve the current auditor's reporting model that merely states a pass or fail opinion. CalSTRS agrees the auditor's report should include "That the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether due to error or fraud."

³ IAASB, *The New Auditor's Report: A Comparison between the ISAs and the US PCAOB Reproposal*, May 2016. https://www.ifac.org/system/files/publications/files/IAASB-Auditor-Reporting-Comparison-between-IAASB-Standards-and-PCAOB-Reproposal_0.pdf

Adding the language requirement "due to error or fraud" articulates the already existing responsibility of the auditor under PCAOB standards. From our perspective, this is an essential clarification and should be included in the basis for opinion and description of procedures performed.

Independence

CalSTRS believes the lack of auditor independence negatively impacts the auditor's objectivity. We are concerned where an audit firm receives significant fees for non-audit services. We agree that adding a statement by the auditor on their independence from the company and board of directors reinforces investors' understanding of the auditor's obligations to be independent and objective in expressing the audit opinion. However, we feel it is important for the auditor to expand and explain the policies and processes the auditor completes to ensure their independence of the issuer. For example, in the HSBC Holding plc report of the independent auditor, the audit firm explained the steps they took to ensure their independence of the issuer and its worldwide subsidiaries.⁴

Tenure

We support the disclosure of the tenure of the auditor with a statement containing the year the auditor began serving consecutively as the company's auditor, not only for informational purposes but also to advance the Audit Committee's fiduciary responsibility in determining the appropriate maximum length of tenure to ensure the independence of the auditor. CalSTRS Corporate Governance Principles support companies clearly articulating their policy on audit firm rotation.

Addressee

As a shareholder and provider of capital, we agree the audit report should be addressed to the company's shareholders and board of directors, permitting additional addresses.

Critical Audit Matters

2. CalSTRS supports the PCAOB's proposed rule requiring auditors to disclose CAMs. Specifically, CalSTRS maintains the need for the auditor's report to contain consideration and articulation of:
 - critical financial statement and audit risks,
 - the auditor's assessment of management's estimates and judgments,
 - discussion of unusual transactions, restatements and other significant changes in the financial statements,
 - the auditor's assessment of the quality of the issuer's accounting policies and practices including those that are uncommon to the industry,
 - audit issues and their resolution which the audit partner documents in a final audit memo to the Audit Committee, and
 - the auditor's responsibilities regarding "Other Information."

⁴ HSBC, *Value of the Network, HSBC Holdings plc Annual Report and Accounts 2015*, Report of the Independent Auditors, Page 323 Preparing to change auditors (steps taken to ensure the independence of the auditor), Richard Oldfield (Senior Statutory Auditor) for and on behalf of PricewaterhouseCoopers, LLP, 22 February 2016. http://www.hsbc.com/investor-relations/financial-and-regulatory-reports?WT.ac=HGHO_f3.5_On,

Further we would recommend clarifying, that when the auditor describes CAMs that involve significant accounting judgment or estimation by management, the auditor would be expected to include information about their assessment and insight providing whether these are conservative, average or aggressive rather than simply stating they conform to Generally Accepted Accounting Principles (GAAP). The Board should consider expanding the criteria of CAMs, ensuring the criteria is not narrowly defined by materiality within one given period, versus the cumulative effect and/or trends in issues, restatements and adjustments. We would support the auditor reporting prior period CAMs, along with steps taken toward resolution of these, to identify trends that may not be apparent with current listing of CAMs.

Enforcement

3. The auditing profession plays a critical role in ensuring the integrity and efficiency of the capital markets. The financial interests of CalSTRS beneficiaries are most effectively served where investors can justifiably expect reliable financial reporting to evaluate investment risks and returns. Only with rigorous independent audit and enforcement are these attributes possible in the capital markets.

The PCAOB and other audit regulators around the world must collaborate to develop enforcement mechanisms to protect the interests of investors to increase efficiency, relevancy, reliability and transparency in accurate and reliable financial reporting. Only with consistent and broad regulation and enforcement will the enhanced auditor's report provide genuine and insightful information for investors. Moreover, it is essential that issuers and auditors preserve CAMs from weakening into boilerplate discussions that provide little value to investors and other users of financial reporting.

Alignment of CAMs to Key Audit Matters (KAMs) – Global Standardization of the Auditor's Report

4. CalSTRS reinforces the need for global standardization of the auditor's report, requiring ordering of paragraphs and obligator subheadings to mirror the auditor's reporting model under IAASB's ISAs.⁵ Although the format would be structured, the content would be issuer-specific with flexibility to ensure the auditor is able to provide the "story" that is pertinent to the audit of that company. We advocate the use of the IAASB's definition of KAMs that requires auditors to select the most significant matters in the audit for discussion in the auditor's report.⁶

⁵ International Federation of Accountants (IFAC), IAASB, *International Standard on Auditing (ISA) 701, Communicating Key Audit Matters in the Independent Auditor's Report*
https://www.ifac.org/system/files/publications/files/ISA-701_2.pdf

The New Auditor's Report: Greater Transparency into the Financial Statement Audit, January 2015.
<https://www.ifac.org/system/files/uploads/IAASB/Auditor-Reporting-Fact-Sheet.pdf>

⁶ IAASB, *Determining and Communicating Key Audit Matters*, prepared by the Auditor Reporting Implementation Working Group, July 6, 2016. <http://www.ifac.org/system/files/publications/files/IAASB-KAM-Overview-Diagram.pdf>

Going Concern and Other Information

5. Although the Board is addressing these topics under separate initiatives with a different timeline, CalSTRS agrees with the IAASB's requirements regarding the communication of going concern and other information in the auditor's report.⁷

Benefits and Use by Investors

CalSTRS see many benefits and improved usage of the expanded auditor's report. We agree with the intended benefits of the enhanced auditor's report which include:

- Enhanced communication between auditors and investors, as well as those charged with corporate governance, Audit Committees
- Increased user confidence in audit reports and financial statements
- Increased transparency, audit quality and enhanced information value
- Increased attention by management and financial statement preparers to disclosures referencing the auditor's report
- Renewed auditor focus on matters to be reported that could result in an increase in professional skepticism
- Enhanced financial reporting in the public interest

As a long-term shareholder and owner of more than 7,000 domestic and global companies, CalSTRS believes mandatory CAM disclosures through the enhanced auditor's report will lead to additional information and insight when we consider ratification of the auditor during proxy voting. Currently our voting policy is based on limited information provided by the auditor and the issuer using the ratio of audit fees to non-audit fees as a voting guideline. We believe the enhanced auditor's report will provide additional insight into the audit process, and improve our ability to evaluate the quality of an audit. This additional information may provide additional insight to gauge the possibility of an audit failure or the risk of an earnings restatement. Investors may be able to gain additional information that heightens their ability to engage with corporate boards to potentially enhance the long-term value of the company as well as possibly lower the cost of capital for the company. Additionally, we believe that insights on CAMs may be relevant in analyzing and pricing risks in our valuation and allocation of capital.

Auditor's Responsibilities Regarding Other Information

We concur with the requirement that when issuing an auditor's report, the auditor will include a separate section explaining the auditor's responsibilities and use of other information during the audit.⁸

Broker Dealers and Emerging Growth Companies

CalSTRS believes all issuers, including broker dealers, investment companies and emerging growth companies, should be subject to the same audit standards and requirements of an expanded auditor's report.

⁷ IAASB, *Auditor Reporting on Going Concern*, January 30, 2015.

<http://www.ifac.org/system/files/publications/files/Auditor-Reporting-Toolkit-Going-Concern.pdf>

⁸ Reference example within HSBC, *Value of the Network, HSBC Holdings plc Annual Report and Accounts 2015*, Report of the Independent Auditors, Other Reporting, pages 325-326, Richard Oldfield (Senior Statutory Auditor) for and on behalf of PricewaterhouseCoopers, LLP, 22 February 2016

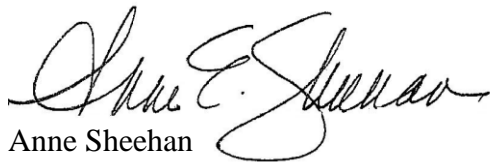
Alternative Dispute Resolution Clauses – Auditor Liability

CalSTRS principles outlines, “The external auditors should not receive indemnification from the company. Contracts with the external auditors should not require the company to use alternative dispute resolution.”⁹ We believe the auditor should disclose these types of clauses when this type of provision is included in the audit engagement agreement.

Lastly, we have included reference to a few audit reports that we believe capture the spirit of what an expanded auditor's reporting should include.¹⁰

We hope our summary perspective as a long-term investor provides insight to what we deem critical to the PCAOB's reproposal. We commend the PCAOB for taking steps to improve meaningful disclosures in the auditor's report for investors. If you would like to discuss this letter further, please feel free to contact me at my number above or Mary Hartman Morris at 916-414-7412, MMorris@CalSTRS.com.

Sincerely,



Anne Sheehan
Director of Corporate Governance
California State Teachers' Retirement System

⁹ CalSTRS Corporate Governance Principles, Section B. Auditors and Audit-Related Issues, #2, April 3, 2015. http://www.calstrs.com/sites/main/files/file-attachments/corporate_governance_principles_1.pdf

¹⁰ HSBC, *Value of the Network, HSBC Holdings plc Annual Report and Accounts 2015*, Report of the Independent Auditors, Page 323-335, Richard Oldfield (Senior Statutory Auditor) for and on behalf of PricewaterhouseCoopers, LLP, 22 February 2016. http://www.hsbc.com/investor-relations/financial-and-regulatory-reports?WT.ac=HGHO_f3.5_On, Downloads/hsbc-holdings-plc-annual-report-and-accounts-2015%20Annual Report and Accounts 2015 (502-page PDF)

National Grid plc Annual Report and Accounts 2015/16 Interactive version , Independent Auditor's report, Page 85—93, Michael Timar (Senior Statutory Auditor) for and on behalf of PricewaterhouseCoopers LLP, London, 18 May 2016. http://investors.nationalgrid.com/~media/Files/N/National-Grid-IR/reports/2016/NG_Interactive_16.pdf

Marks & Spencer Annual Report 2016, Page 78-85, Ian Waller (Senior statutory auditor) for and on behalf of Deloitte LLP, London, 24 May 2016. http://annualreport.marksandspencer.com/M&S_AnnualReport_2016.pdf