



California State Teachers'
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Via email: IAASBcommunications@iaasb.org

Arnold Schilder, Chairman
Kathleen Healy, Technical Director
International Auditing and Assurance Standards Board
529 5th Avenue
New York, New York 10017

Re: Enhancing Audit Quality in the Public Interest, A Focus on Professional Skepticism, Quality Control and Group Audits

Dear Chairman Schilder and Ms. Healy:

I am writing on behalf of the members of the California State Teachers' Retirement System (CalSTRS) to the International Auditing and Assurance Standards Board (IAASB). Thank you for the opportunity to provide comment on "Enhancing Audit Quality" specifically on professional skepticism, quality control and group audits.

CalSTRS' mission is to secure the financial future and sustain the trust of California educators. We serve the investment and retirement interests of 896,000 teachers and their families. CalSTRS is the largest educator-only pension fund in the world with a global investment portfolio valued at approximately \$186.8 billion as of March 31, 2016.¹ The long-term nature of CalSTRS liabilities, its overall stewardship of the fund 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. As a long-term investor, CalSTRS relies on the integrity and efficiency of the capital markets.

CalSTRS supports this timely release with the December 2016 effective date of the New Auditor's Report.² The improved auditor's report provides more transparency that should from our perspective; provide additional value in assessing a company. Financial reporting

¹ CalSTRS at a Glance, March 31, 2016 <http://www.calstrs.com/glance>, CalSTRS Current Investment Portfolio, asset allocation mix and current market value as of March 31, 2016 <http://www.calstrs.com/current-investment-portfolio>.

² IAASB, New Auditor's Report, Effective for audits of financial statements for periods ending on or after December 15, 2016. <http://www.iaasb.org/new-auditors-report>

plays an integral role by providing transparent and relevant information about the economic performance and condition of businesses. The audit is critical in ensuring standardization and discipline in corporate accounting, where investors can rely on the integrity of financial reporting to evaluate investment risk and returns in capital allocation decisions. Therefore, this focus on skepticism, quality control and group audits are essential to the intent of the New Auditor's Report.

As investors, we rely on auditors to be the gate keepers of financial reporting integrity and audit quality. In being a gate keeper, auditors must be objective, and independent in both substance and appearance. Audit firms and Audit Committees must continue to practice robust policies regarding the provision of non-audit services and consultative services to avoid compromising auditor independence.

Important to our perspective, CalSTRS emphasizes that shareholders are the client of the auditor and the prime audience of the accounts. Investors rely on a vigorous external audit to strengthen the veracity and quality of financial reporting. Additionally, CalSTRS recognizes the important role of the IAASB in improving the auditor's report through enhanced reporting and communication between auditors and investors. Unfortunately, the financial crisis spotlighted some of the structural failures in the audit market that pose a threat to audit quality and the quality of financial reporting. We agree with the IAASB that, "the turbulent events of the recent global financial crisis have highlighted the critical importance of credible, high-quality financial reporting and the relevance of quality audits to support this."³

Holistic approach - Skepticism, Quality Control Approach and Group Audits

CalSTRS acknowledges, consistent with the IAASB, that audit oversight bodies have become more active and internationally cooperative. Publicly reported inspection reports are emphasizing where improvements to audit quality are needed. CalSTRS agrees that effective financial reporting depends on high quality accounting standards, as well as consistent application, rigorous independent audits and enforcement of both accounting and auditing standards. Professional skepticism is a key component of an audit and should be re-emphasized in auditing standards. Oversight bodies can also facilitate effective conversations to ensure auditors focus on the importance of professional skepticism.

CalSTRS supports and elevates the international cooperation through the International Forum of Independent Audit Regulators (IFIAR) and the role of the independent audit regulators from a total of 51 jurisdictions.⁴ We support the ongoing evolution of publicly posting

³ IAASB, A Framework for Audit Quality, Key Elements that Create and Environment for Audit Quality, Feedback Statement, Prepared by the Staff of the IAASB, February 2014.
<http://www.ifac.org/system/files/publications/files/Audit-Quality-Feedback-Statement.pdf>

⁴ International Forum of Independent Audit Regulators (IFIAR), About IFIAR, established on 15 September 2006, growing to 51 jurisdictions. <https://www.ifiar.org/About-Us.aspx>

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members' inspection and annual reports, though, noting only a limited number of independent audit regulators of the 51 member jurisdictions post on the IFIAR's website. These include Australia, Canada, Czech Republic, Dubai, France, Japan, Malaysia, The Netherlands, New Zealand, Norway, Poland, Switzerland, South Africa, United Kingdom, and the United States. CalSTRS believes a holistic approach is necessary and encourages other member jurisdictions to publicly post inspection reports, emphasizing where improvements to audit quality are needed.

In the following appendix to our letter we provide more aspects of the importance of audit firm governance and audit transparency reports, audit quality indicators (AQIs), key performance indicators (KPIs) as it relates to skepticism, quality control and group audits.

We hope our summary perspective as a long-term investor provides insight to the critical importance of enhancing audit quality for the benefit of investors and all stakeholders. Thank you for the opportunity to provide comment. We look forward to reviewing letters submitted along with the summary conclusions from this overview and invitation to comment.

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,

A handwritten signature in black ink, appearing to read "Anne E. Sheehan". The signature is fluid and cursive, with a large initial "A" and "S".

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

Appendix – CalSTRS’ Responses

G1. Table 1 describes what we believe are the most relevant public interest issues that should be addressed in the context of our projects on professional skepticism, quality control, and group audits. In that context:

- (a) Are these public interest issues relevant to our work on these topics?
- (b) Are there other public interest issues relevant to these topics? If so, please describe them and how, in your view, they relate to the specific issues identified.
- (c) Are there actions you think others need to take, in addition to those by the IAASB, to address the public interest issues identified in your previous answers? If so, what are they and please identify who you think should act.

CalSTRS is very supportive of IAASB’s efforts in improving audit quality as well as enhancing auditor reporting for the benefit of investors and other stakeholders. We believe Table 1 outlines many of the key public interest issues which are relevant and should be considered as it relates to Professional Skepticism, Quality Control and Group Audits. These include:

1. **Fostering an appropriately independent and challenging skeptical mindset of the auditor** – CalSTRS believes tone at the top, firm culture and ongoing training are important components to fostering an independent and challenging skeptical mindset. Also, each audit firm should develop a process to provide guidance internally to staff on inspection reports, quality issues and where the firm can develop best practices to handling key issues and the resolutions of these issues. We believe ongoing education, training and mentorship will expand auditor competencies to apply professional skepticism.
2. **Enhancing documentation of the auditor’s judgments** – The Enhanced Reporting model, New Auditor’s Report, although not an end-all will provide some basis for ensuring auditors are properly documenting the structure of the auditor’s judgments. Additionally, Key Audit Matters (KAMs) through ISA 701 provides a judgment-based decision-making framework which auditors will explicitly consider⁶:
 - Areas of higher risk of financial statements material misstatement
 - Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty
 - The effect on the audit of significant events or transactions that occurred during the period

Investors support the importance of KAMs and the intent to provide information on why the matter was determined to be a KAM; How it was addressed in the audit; and

⁶ E&Y Enhanced auditor’s reporting Assurance – Special edition, January 2016.
[http://www.ey.com/Publication/vwLUAssets/EY-enhanced-auditors-reporting/\\$FILE/EY-enhanced-auditors-reporting.pdf](http://www.ey.com/Publication/vwLUAssets/EY-enhanced-auditors-reporting/$FILE/EY-enhanced-auditors-reporting.pdf)

Reference to disclosure(s) in the Financial statements. Although not adopted, CalSTRS would have supported the requirement to provide a summary of KAMs for the last 2 years along with the current year's KAMs providing a history and how these were resolved, remediated and mitigated. CalSTRS agrees the enhanced auditor reporting with the use of robust KAMs is a significant enhancement and will add informative value to investors as well as guide auditors in documenting the structure of their judgments which should indirectly instill the process with increased skepticism.

3. **Keeping ISAs fit for purpose** – CalSTRS agrees that ISA 700 revised, the overarching standard for auditor reporting, including revisions to ISA 705, ISA 570 and ISA 720 may provide significant information to investors, only if auditors administer a robust interpretation and application of modifications to auditor's opinion, requirement and revised reporting on going concern and new reporting requirements on other information. CalSTRS is positive, yet circumspect and looks forward to reviewing the New Auditor's Report effective for audits of financial statements for periods ending on or after December 15, 2016.
4. **Encouraging proactive quality management at the firm and engagement level** - The diagram and the elements of a Quality Management Approach (QMA) outlined in paragraph 65 provides basic elements which are constructive and practical to establish a QMA framework. We agree robust risk assessment and governance frameworks are pivotal to establishing an effective QMA.
5. **Exploring transparency and its role in audit quality** – Transparency is fundamental to good governance and improvement in audit quality. CalSTRS supports the universal application of Audit Firm Transparency Reports (as outlined in paragraphs 72-75) to articulate firms' priorities and endeavors for audit quality, improving trust, confidence of investors and the leadership role that audit firms should exhibit in developing and sharing audit quality indicators. We support Audit Committees and Auditors develop audit quality indicators (AQIs), using in their assessment and improvement of audit quality as well as discussing in the Audit Committee Report and in the New Auditor's Report.
6. **Focusing more on firms (including networks) and their internal and external monitoring and remediation activities** - CalSTRS supports the use of The Audit Firm Governance Code by the Financial Reporting Council⁷ and enhancing transparency from the audit firms through Audit Transparency Reporting to provide clearer guidance about firms' leadership, principles, values and operations in improving audit quality.
7. **Reinforcing the need for robust communication and interactions during the audit** – Robust communication between the auditor, audit committee and investors is critical

⁷ Financial Reporting Council, Review of the UK Audit Firm Governance Code, December 2015.
[https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Review-of-the-UK-Audit-Firm-Governance-Code-Fe-\(1\)-File.pdf](https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Review-of-the-UK-Audit-Firm-Governance-Code-Fe-(1)-File.pdf)

to the overall audit process and ensuring investor confidence in the market and more specifically in the auditor's report. CalSTRS Principles⁸ state:

“The Audit Committee plays a critical role in providing oversight of the company's financial reporting processes, internal controls and independent auditors. The Audit Committee should be proactive in promoting auditor independence and audit quality.”

As referenced in the body of our letter, auditors must embrace the concept that shareholders are the clients of the auditor and should convey significant deficiencies in controls as well as opportunities for strengthening internal controls through KAMS and the enhanced auditor report. Audit Committees – those charged with governance, also need to recognize their fiduciary responsibilities to shareholders and provide robust reporting in the Audit Committee Report.

G2. To assist with the development of future work plans, are there other issues and actions (not specific to the topics of professional skepticism, quality control, and group audits) that you believe should be taken into account? If yes, what are they and how should they be prioritized?

Auditor Scope – Going Concern

CalSTRS is pleased that the New Auditor Report (enhanced auditor reporting) provides a description of the respective responsibilities of management and the auditor for going concern and a separate section when a material uncertainty exists as it relates to going concern, as well as new requirements to challenge adequacy of disclosures for “close calls” that may cast significant doubt on an entity's ability to continue as a going concern.⁹

Notwithstanding these requirements, investors may continue to be puzzled by the scope of an audit and what constitutes sufficient audit evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error in providing an opinion of true and fair view. The external, independent auditor is an expert who is well-positioned to challenge management's judgment on accounting elements, assessment of risks and whether an entity has the ability to continue as a going concern. CalSTRS believes there is still clear need for improvement by auditors surrounding this issue and recommend the IAASB continue in providing clarification on the scope and timing for going concern. The New Auditor's Report if utilized effectively by the auditor can provide insightful, comprehensible and distinct information that may advance strategic improvements.

⁸ California State Teachers' Retirement System Corporate Governance Principles, Section B, Auditors and Audit-Related Issues, page 8, April 3, 2015. http://www.calstrs.com/sites/main/files/file-attachments/corporate_governance_principles_1.pdf

⁹ IAASB, “The New Auditor's Report: Greater Transparency into the Financial Statement Audit,” January 2015. <https://www.ifac.org/system/files/publications/files/Auditor-Reporting-Fact-Sheet.pdf>

Auditor Independence

The lack of auditor independence negatively impacts the auditor's objectivity. CalSTRS continues to believe that auditor independence is an area of great gravity as supported and outlined in many of the audit firms' transparency reports with consulting revenues contributing more than mid to high level forty percent of its business.¹⁰ CalSTRS intention in highlighting that consulting services versus audit and enterprise risk services as the core revenue contributors is not to discourage this transparency but to continue the dialogue of the auditor's role and review of independence and its impact to audit quality. The rise of advisory services in audit firms was also highlighted by Public Company Accounting Oversight (PCAOB) Board Member Steven B. Harris in 2014¹¹ and again in 2015¹² and continues to be a concern of investors.

Integrated Financial Reporting

Integrated financial reporting incorporates corporate responsibility and sustainability into all aspects of business management that aims to build value over time. Business is increasingly complex and global in nature, requiring that financial reporting expand to capture environmental, social and governance (ESG) risks within companies' quarterly and annual financial reports. Investors demand an understanding of ESG risks along with relevant, comparable reporting to understand material financial risks that may impact the company's ability to generate a long-term risk adjusted return to its investors.

CalSTRS believes the role of the auditor, Audit Committee and those charged with governance, needs to be developed and defined to ensure the review and assurance of integrated reporting as it pertains to the overall financial health of an organization. The need for complete, comparable ESG financial reporting disclosures is a growing requirement, fundamental to CalSTRS capital allocation decisions as outlined in CalSTRS Investment Policy for Mitigating Environmental, Social and Governance Risks (ESG) and the CalSTRS 21 Risk Factors.¹³

¹⁰ <http://www2.deloitte.com/content/dam/Deloitte/us/Documents/regulatory/us-deloitte-llp-2015-transparency-report.pdf>

¹¹ PCAOB, "The Rise of Advisory Services in Audit Firms", Steven B. Harris, Board Member at Practicing Law Institute 12th Annual Directors' Institute on Corporate Governance, Nov. 2014.
http://pcaobus.org/News/Speech/Pages/11242014_Harris.aspx

¹² PCAOB, "Issues for the Academic Community to Consider" – concerns about the rise of advisory and consulting services at the largest accounting firms, at the PCAOB Academic Conference, April 2015.
http://pcaobus.org/News/Speech/Pages/04162015_Harris.aspx

¹³ CalSTRS, "Investment Policy for Mitigating Environmental, Social and Governance Risks (ESG)", June 2006.
<http://www.calstrs.com/general-information/calstrs-board-investment-policy-regarding-geopolitical-and-social-risks> http://www.calstrs.com/sites/main/files/file-attachments/calstrs_21_risk_factors.pdf

G3. Are you aware of any published, planned or ongoing academic research that may be relevant to the three topics discussed in this consultation? If so, please provide us with relevant details.

No additional research to provide.

PS1. Is your interpretation of the concept of professional skepticism consistent with how it is defined and referred to in the ISAs? If not, how could the concept be better described?

CalSTRS supports the IAASB in continuing to provide examples and definition of professional skepticism in an audit of financial statements. The ISAs define professional skepticism as “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.” They explicitly require the auditor to plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. We refer to the 2012 document issued by IAASB staff and IAASB Chairman on Professional Skepticism in Audit of Financial Statements.¹⁴ It is important to point out the ISAs require the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve any doubt about reliability or possible fraud. Objectivity based on knowledge, skill and ability is the intersection between attributes, mindset and action to promote an attitude of professional skepticism that includes a questioning mind, a critical assessment of the appropriateness and sufficiency of audit evidence.

PS2. What do you believe are the drivers for, and impediments to, the appropriate application of professional skepticism? What role should we take to enhance those drivers and address those impediments? How should we prioritize the areas discussed in paragraph 37?

Audit firm and audit team attributes are important drivers of audit quality. Audit quality is dependent on an auditor’s objectivity, independence and professional skepticism. There is an existing dichotomy with auditors believing an issuer is the client of the auditor versus the shareholder being the client. Audit Committees must reinforce their fiduciary duty to shareholders and assure auditors of the importance to challenge management in applying professional skepticism. Adequate communication between the auditor, Audit Committees and investors through the Audit Committee Report and the Auditor’s Report is an essential part of the audit process.

¹⁴ IAASB Staff Questions and Answers, “Professional Skepticism in an Audit of Financial Statements,” International Federation of Accountants, February 2012.
<http://www.ifac.org/system/files/publications/files/IAASB%20Professional%20Skepticism%20QandA-final.pdf>

Additionally, there are many other inherent impediments to the application of skepticism and include:

- Congenital bias, relationships
- Deadline and budget pressures
- Incentives that do not align with professional skepticism.

Some mitigating factors include accountability through the disclosure of the engagement partner's name in the audit report, training, continuing professional education (cpe), supervision, mentoring, planning, inspections and culture of the work environment and audit firm.

PS3. What actions should others take to address the factors that inhibit the application of professional skepticism and the actions needed to mitigate them (e.g., the International Accounting Education Standards Board, the International Ethics Board for Accountants, other international or national standards setters, those charged with governance (including audit committee members), firms, or professional accountancy organizations)?

Oversight bodies, audit inspections and peer to peer reviews are important opportunities to identify where issues may exist which are based on lack of professional skepticism or quality control issues. Audit firms must utilize these inspection reports as teaching tools and continuous education. We agree team level mitigating factors such as planning, brainstorming meetings, internal quality reviews, ethics training and compliance hotlines, partner rotations and peer to peer reviews may expand drivers to alleviate inhibiting factors which would contribute to a lack of professional skepticism, quality control or group audit issues. Again, tone at the top for the engagement team, avoiding groupthink or group pressures, job training and the comfort level and place to report issues are important components of mitigating the threat of poor auditor judgment and lack of professional skepticism.

Without out quality, ongoing training and cultural aspects of audit firm leadership and professional associations emphasizing and providing incentive and support, auditors may fail to strengthen and maintain the exercise of sufficient professional skepticism.

QC1. We support a broader revision of ISQC 1 to include the use of a quality management approach (QMA) as described in paragraphs 51–66.

(a) Would use of a QMA help to improve audit quality? If so why, and if not, why? What challenges might there be in restructuring ISQC 1 to facilitate this approach?

(b) If ISQC 1 is restructured to require the firm's use of a QMA, in light of the objective of a QMA and the possible elements described in paragraph 65, are there other elements that should be included? If so, what are they?

(c) In your view, how might a change to restructure ISQC 1 impact the ISAs, including those addressing quality control at the engagement level?

(d) If ISQC 1 is not restructured to require the firm's use of a QMA, how can we address the call for improvements to the standard to deal with differences in the size and nature of a firm or the services it provides?

CalSTRS supports the broader vision in the use of a quality management approach within quality control. The diagram outlined above paragraph 65 provides the continual improvement with the key components of firm culture, with the strategy that fosters quality with the nucleus of leadership responsibility and accountability. With any quality control, QMA, continual improvement and review of processes are necessary to ensure quality mechanisms do not become automatic and not meaningful. We believe it is important to have staff involved with leadership providing the support and interactive environment to develop different policies and procedures to address quality control risks.

We agree a firm's culture and strategy are at the core of an effective QMA whereas firms need to ensure an environment where issues can be elevated without retributions, but accepted as opportunities to improve and learn. Although the concept of scalability is discussed, we believe the components and underlying basis is applicable to firms of all sizes. We expect that smaller firms would not expect any less in their quality inspections and in addressing issues as well as identifying mitigating processes to ensure a QMA is effective and relevant.

QC2. We are also thinking about revising our quality control standards to respond to specific issues about audit quality (see paragraphs 67–83).

(a) Would the actions described in paragraphs 68–83 improve audit quality at the firm and engagement level? If not, why?

(b) Should we take other actions in the public interest to address the issues in paragraphs 67–83?

(c) Should we take action now to tackle other issues? If yes, please describe the actions, why they need priority attention, and the action we should take.

CalSTRS supports revising quality control standards to clearly set out:

- Robust roles and responsibilities for firm leadership and engagement partners;
- The basis for any reliance on a firm's system of quality control at the engagement level; and
- The basis, where applicable, for reliance by a firm on network-level policies and procedures

We suggest the QMA :

- Define processes – risks that may impact the quality of an audit
- Reiterate the need for competence and continuous training and or knowing when an individual does not have the expertise to tackle a specific portion of an audit
- Create repeatable processes of review, ensuring processes address documentation of supportable evidential matter
- Provide guidance on continuous improvement of a firms policies and procedures

- Ensure that quality review does not become so routine that auditors do not fully evaluate processes
- Develop an Improvement Team and rotate this responsibility
- Encourage different applications and audit approaches and quality control applications
- Develop key performance indicators (KPIs) based on audit inspections and quality issues
- Share KPIs in Audit Firms' Transparency Reports to be used as a tracking and improvement tool

CalSTRS agrees and reinforces the need for Engagement Quality Control Reviews and Engagement Quality Control Reviewers. We concur that an effective EQC review is an important engagement-level quality control. EQC reviews are also a key aspect of the monitoring component of a firm's system of quality control.

We support independent inspections of the EQC Reviewers' conclusions and recognize the importance of strengthening the requirements as well as communicating the results to the Audit Committee of an audit client. The Audit Committee should address whether the Quality Control systems in place are robust as well as describing the EQC findings and ways to improve.

GA1. We plan to revise ISA 600 (and other standards as appropriate) to respond to issues with group audits.

(a) Should we increase the emphasis in ISA 600 on the need to apply all relevant ISAs in an audit of group financial statements? Will doing so help to achieve the flexibility that is needed to allow for ISA 600 to be more broadly applied and in a wide range of circumstances (see paragraphs 84–97)? If not, please explain why. What else could we do to address the issues set out in this consultation?

(b) Would the actions we are exploring in relation to ISA 600 improve the quality of group audits?
If not, why?

(c) Should we further explore making reference to another auditor in an auditor's report? If yes, how does this impact the auditor's work effort?

(d) What else could the IAASB do to address the issues highlighted or other issues of which you are aware? Why do these actions need priority attention?

CalSTRS concedes that group audits may present complex challenges with the use of component auditors spotlighting issues of jurisdictions with different cultures, languages, laws and regulations.

Although a group financial statement review may utilize component auditors, it is important to investors to ensure communication and appropriate accountability. It is important that the lead group auditor is qualified and willing to accept full responsibility for the group audit opinion.

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CalSTRS believes the auditor's report should reference component auditors and their role in obtaining sufficient appropriate audit evidence to support a group audit opinion. We would also suggest the naming of the auditor in the audit report contain partners from the component auditors so investors fully appreciate the aggregate review.