HOW WILL YOU SPEND YOUR FUTURE?

California State Teachers'
Retirement System
100 Waterfront Place, MS-04
West Sacramento, CA 95605-2807

June 25, 2012

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

Subject: Docket 037: Concept Release on Auditor Independence and Audit Firm Rotation

The California State Teachers' Retirement System, with a portfolio valued at $146.8 billion as of May 31, 2012, is the largest teacher pension fund and second largest public pension fund in the United States. CalSTRS administers a hybrid retirement system, consisting of traditional defined benefit, cash balance and voluntary defined contribution plans, as well as disability and survivor benefits. CalSTRS serves California's 856,000 public school educators and their families from the state's 1,600 school districts, county offices of education and community college districts.

CalSTRS supports the PCAOB's efforts to strengthen auditor independence. The oversight provided by PCAOB to audit firms and, by extension, to Board Audit Committees demonstrates the commitment of an important market regulator dedicated to corporate governance and auditing best practices.

Introduction

CalSTRS operates in a highly accountable and transparent manner. While we are a direct fiduciary to our members and beneficiaries, our unique position as a public pension fund lends itself to broader stewardship and accountability. CalSTRS Corporate Governance Guidelines devote a substantial section to the review of audit firms and the services they provide to portfolio companies. CalSTRS website makes all CalSTRS Corporate Governance guidelines accessible to the public.

Independence of Auditor is Vital to Investors and the Capital Markets

Audited financial statements are vital pieces of information for any investor. These statements are particularly vital for public company investors where ownership and accountability are so widely dispersed, as they are in the US capital markets. While the majority of CalSTRS investments are centered in the US, no market can operate efficiently or confidently if the quality, comparability and reliability of the information audited financial statements provide is believed to be impaired by market participants. The independence of the auditor, while performing its duty to attest that the financial statements present fairly, in all material respects, the financial position of the company, is the cornerstone of investors' confidence and reliance in the company's statements.

Shareholders may want to reinforce the auditor's independence with a limit on auditing firms' non-audit services delivered to a company in the same year it provides the firm's audited financials to the public. (CalSTRS has established a limit of 30 percent on the non-audit services that a firm can provide while also performing an audit of the same company.) For public companies, these expenses are disclosed in the proxy statements and other filings, so monitoring this is straight-forward. Shareholders can judge for themselves whether they think the independence standard may be compromised by the existence of more profitable work being performed by the auditing firm.

Auditor Rotation as an Aid in the Independence of the Audit Firm

CalSTRS supports the rotation of audit firms as a tool to preserve an auditor's independence. We do not support mandatory rotation, but acknowledge the existence of instances where rotation is necessary. Knowledge and experience are crucial aspects of a quality audit. An arbitrary mandated tenure would likely be detrimental to the market and investors that such a rule would be designed to protect.

We believe that restatements or other evidence that oversight was lacking at the Board Audit Committee level and that the auditor's review of the statements was impaired are good reasons for rotating the auditor. If financial statements cannot be consistently filed with the market regulators in a timely fashion, this should raise concerns about the auditor's performance and the oversight of the Audit Committee.

The delay of these reports can have a material effect on the value of the public securities held in the market place, because in the absence of transparent reliable statements, market participants fear the worst. The auditor must realize that while the Audit Committee selects and hires the firm, it does so with investors' capital and on behalf of the investors in the firm. A primary reason for these financial reports is to satisfy the investors' needs for timely, accurate, transparent information.

CalSTRS Does Rotate its Auditors

CalSTRS has rotated its audit firms over the last several years. For CalSTRS, the intangible gain from rotation has outweighed the increased cost needed to produce the reliable financial statements our members, beneficiaries, fiduciaries and public expect from a large long-term institutional investor with a portfolio of $146.8bn (as of May 31, 2012.) CalSTRS multi-faceted investment approach and our administration of a complex benefit system we believe mimics the experience of large complex corporations.

The operational structure of CalSTRS is largely governed by the California Education Code. The *Education Code* requires the Teachers' Retirement Board to engage with an external audit firm to audit the system's financial statements. The board Audit and Risk Management

Committee (ARM) is responsible for the appointment, compensation and oversight of the independent certified public accounting firm engaged to audit CalSTRS financial statements.

As of 2009, CalSTRS prior external audit firm had held the contract for seven years. The award of their initial contract was the result of a competitive bidding process that began in 2003. Prior to the 2003 contract cycle, CalSTRS then external auditor held the contract for eight years. Prior to this eight year contract, the CalSTRS external auditor served for four years and subsequently merged with another firm.

CalSTRS Experience Rotating its Auditors

In 2009, CalSTRS conducted a competitive procurement process to solicit firms to serve as its external auditor for a period of eight years. The current auditor was not excluded from the competitive bidding process; it was one of two finalists interviewed by the ARM Committee for the new contract. In presenting the finalists to ARM, CalSTRS staff reviewed governmental requirements and accounting and auditing standards related to best practices for the rotation of independent certified accounting firms. Two specific practices reviewed were: the firms' five-year performance conducting financial statement audits and their partner rotation requirements.

The review also included:

- CalSTRS corporate governance policy supporting limiting external audit firms to seven consecutive years of audit service to portfolio companies.

- The American Institute of Certified Public Accountants 2003 brief on auditor partner rotation for "non-public " companies which concluded that in the non-public environment, the public is best served by not imposing regulations, such as mandatory partner rotation that has the potential to decrease competition due to limited choices and therefore increase costs.

- The Sarbanes-Oxley Act of 2002 (SOX) requirements for lead audit partner rotation after five years and the U.S. Securities and Exchange Commission's interpretation of SOX to extend the requirement to other audit partners after seven years for publically traded companies.

- The U.S. General Accounting Office mandated post-SOX survey to study the potential effects of required periodic rotation of public accounting firms auditing public company financial statements conclusion that mandatory audit firm rotation might not be the most efficient way to strengthen auditor independence and improve audit quality.

CalSTRS review of both sides of the auditor rotation argument found that there are no direct applicable laws, regulations, accounting and/or auditing standards, or Teachers' Retirement Board policies, which require CalSTRS to change an audit firm or audit partner.

The Teachers' Retirement Board Audit and Risk Management Committee's discussion on the two external audit contract finalists included the merits of auditor rotation to reinforce independence. The committee's decision-making focus revolved around the qualifications of the two external auditor firm finalists, their proposed partners and their staff ability to ensure and submit a high quality audit. The ARM Committee's final recommendation to the full board was to enter into a contract with the finalist representing a new firm.

CalSTRS new external auditor is engaged in a second audit cycle. There has been an increase in the financial costs to CalSTRS as a result of retaining the services of this new auditing firm. Annual audit fees are greater. The fee increase is probably attributable to contracting with a national versus regional firm. Internal costs, in the form of staff time, are greater as staff is working with a new audit team. But, as stated previously CalSTRS believes the intangible gains of audit rotation outweigh the financial costs.

The new external audit team provides a fresh perspective on the operations, risks, controls and financial results. The firm uses a different methodology leading to new insights, questions and conclusions. Auditors and/or staff may notice areas of weakness, which enables CalSTRS staff to proactively mitigate downstream risks.

It will be difficult to tell if the results of CalSTRS' experience represent a one-to-one correlation to independence. However, a deliberate change in approach, to some degree, is likely to contribute support to strengthen and preserve auditors' independence.

Sincerely,

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