via e-mail to: comments@pcaobus.org

May 14, 2012

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

Re: PCAOB Concept Release (No. 2012-001) on Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards (PCAOB Rulemaking Docket Matter No. 038)

Ladies and Gentlemen:

The Society of Corporate Secretaries and Governance Professionals (the "Society") appreciates the opportunity to provide comments on the Concept Release on Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards, PCAOB Release No. 2012-001, issued on February 28, 2012 (the "Concept Release") by the Public Company Accounting Oversight Board (the "PCAOB").

Founded in 1946, the Society is a professional membership association of more than 3,000 corporate secretaries, in-house counsel and other governance professionals who serve approximately 2,000 companies of almost every size and industry. Society members are responsible for supporting the work of corporate boards of directors and their committees and the executive managements of their companies regarding corporate governance and disclosure. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements.

The Society appreciates the PCAOB's efforts to improve the relevance and quality of public company audit reports to investors. However, we have several concerns with the proposed amendments. We have limited our comments to the amendments that cause us the most concern, namely the proposed amendments to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (the "Proposed Amendments") relating to executive compensation.[1]

[1] APPENDIX 3 –Other Proposed Amendments to PCAOB Auditing Standards Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Section III.A. of Appendix 4) Auditing

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We believe that the Proposed Amendments are unnecessary, would improperly involve the auditors in corporate governance matters and would create impediments in the relationship between a company's Board of Directors and its auditors. Current auditing standards, particularly AU Section 316, *Consideration of Fraud in a Financial Statement Audit* ("AU Section 316"), when combined with an adequate level of professional skepticism, provide sufficient guidance to auditors. Requiring auditors to become involved in executive compensation decisions that are appropriately reserved to the Board of Directors – and, in particular to its Compensation Committee – would upset well established concepts of corporate governance. It also would move the auditor away from its primary role of expressing an opinion on whether the financial statements fairly present the financial position of the company and whether its internal controls are adequate. Our detailed comments follow.

The Proposed Amendments Would Improperly Expand the Role of Auditors in the Executive Compensation Decision-Making Process

Corporate law in each state reserves decision-making authority, including over executive compensation matters, to the Board of Directors.[2] As part of this authority, the Board is responsible for overseeing the recruitment, retention, and compensation of the executive officers of the company. Typically, senior management determines, with Board oversight, the strategic direction of a company, and the Board (or, more likely, an independent Compensation Committee) approves company and individual performance targets for which to be compensated. In recent years, shareholders have demanded that the compensation packages directly link pay to

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Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows: a. Paragraph 10A is added after paragraph 10:

> 10A. The auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements). The procedures should be designed to identify risks of material misstatement and should include, but are not limited to (1) reading employment and compensation contracts and (2) reading proxy statements and other relevant company filings with the Securities and Exchange Commission and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers. Concept Release p. A3-1.

[2] *See, e.g.*, DEL CODE ANN. Tit 8 § 141(a) (2012) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."); MODEL BUS. CORP. ACT § 8.02(b) (2002) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.").

performance. Thus, the Board and/or the Compensation Committee are charged with approving the best way to align executive performance with the company's objectives.

Existing laws and regulations impose significant obligations to disclose executive compensation arrangements between a company and its executives. For example, Item 402 of Securities and Exchange Commission Regulation S-K requires discussion and analysis of "compensation awarded to, earned by, or paid to the named executive officers." Item 402 further requires a summary compensation table disclosing the detail of all elements of compensation. Item 601(a)(10) of Regulation S-K requires the public filing of contracts with directors and officers, including "any management contract or any compensatory plan, contract or arrangement." Other rules mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") governing compensation committee independence, pay ratios, and compensation clawbacks, are forthcoming. In addition to the comprehensive disclosure regimen, laws and regulations effectively mandate that executive compensation plans be approved by a shareholder vote[3], and further that shareholders have an advisory vote on pay at most publicly held companies. Besides these extensive disclosure obligations and shareholder approval requirements applicable to executive compensation, certain industries have extensive regulation over executive compensation matters. For example, financial services companies must comply with guidance issued by the federal banking agencies regarding incentive compensation arrangements and Section 956 of the Dodd-Frank Act. With this level of disclosure, regulation, and the shareholders' frequent opportunity to voice their concerns, investors and other users of financial statements are well equipped to judge the risks that executive compensation may pose for them.

Groups such as Institutional Shareholder Services and activist shareholders have also played a role in shaping executive compensation by raising concerns when they believe executive compensation is unreasonable or provides inappropriate incentives. While there may be occasions where inappropriate incentives lead to fraud such as improper revenue recognition, the larger and more important concern relates to the impact of properly authorized and recorded transactions that may reward short-term profits, but impede longer term strategic and other goals. We also note that these groups acknowledge that compensation decisions are legitimately made by the Board or its compensation committee and that they find the existing disclosure sufficient for their analytical purposes.

While the intended effect of proposed Paragraph 10A to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, may not be to fundamentally impact the traditional role of the Board with respect to executive compensation, we are concerned that the unintended consequence of the amendment will be to have precisely that impact. By specifically requiring auditors to assess the risk caused by executive compensation, the role of the auditor would be transformed from providing assurance as to the reliability and accuracy of financial

[3] *See* 26 U.S.C. § 162(m) (2012) (Internal Revenue Code).

statements to that of a judge of the appropriateness and business impact of the compensation system. We believe that this changed role is inappropriate.

Risk-taking is a corner stone of capitalism. Some decisions turn out better than others.[4] But at the end of the day, directors, who are elected by shareholders and charged with understanding the risks of the business, are in the best position to make executive compensation decisions. Warren Buffett has observed that the most important question to ask assessing a business' ability to succeed is whether the business model will work. This and most other business risks by their very nature are not susceptible to audit review. It is not coincidental that discussion and analysis of business risks, including executive compensation, are not addressed in financial statements themselves, but rather in other mandatory disclosures under Regulation S-K such as risk factors, executive compensation and management discussion and analysis.

We also believe the Proposed Amendments would create the following new problems:

- Requiring the auditor to substantively judge executive compensation would fundamentally change the relationship between the Board and the auditor. Section 301(2) of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") made clear that the audit committee is directly responsible for the appointment, compensation, and oversight of the work of the auditor. Under the Proposed Amendments, the auditor would be required in effect to express an opinion on the Board's business judgment, making the auditor both an overseer and servant of the board. The Proposed Amendments also seem to suggest that the auditor has an independent duty to the compensation committee. In fact, we would expect auditors to become obligated to attend compensation committee meetings. This needlessly complicates the auditor-company relationship. Moreover, the Proposed Amendments would complicate – and likely minimize or eliminate – the valuable role performed by independent compensation consultants to boards of directors and compensation committees.

- Auditor comments and/or advice regarding executive compensation would generate documentation and other records that could complicate any litigation or claims relating to the matters in question. Further, the records arising from auditor comments or advice would not be subject to attorney-client privilege or similar protections and could result in increased liability on the part of companies and their shareholders.

- The Proposed Amendments would appear to place the auditor in the role of advising the Board on substantive business decisions. This role seems inconsistent with the non-audit service prohibitions in Section 201 of the Sarbanes-Oxley Act and, in fact, not suited to the auditor's areas of expertise. Rather, this expanded role would entail analyzing executive compensation risk without the need to connect the risk with the rewards. Consequently, the auditor's advice may be skewed in favor of limiting compensation in a

[4] *See e.g., In re the Walt Disney Company Derivative Litigation* 907 A.2d 693 (Del. Ch. 2005).

> manner that may not be in the best interest of the shareholders. In fact, depending on the auditor, the risk assessment process could result in certain companies having uncompetitive compensation arrangements, and thereby, putting those companies at risk of losing talented executives.

We strongly believe that all decision-making risks associated with executive compensation should remain where they currently reside, at the Board or the Compensation Committee.

The Proposed Amendments Would Result in Inefficient Use of Company Resources

The Society strongly supports the PCAOB's mission to "further the public interest in the preparation of informative, accurate, and independent audit reports." However, the role of the auditor is not to be a guarantor of the reliability and accuracy of financial statements, but rather as the audit report states, "to obtain reasonable assurance about whether the financial statements are free of <u>material misstatement</u>, whether caused by error or fraud."[5] We believe that as additional tasks and responsibilities are assigned to the auditor, regardless of whether a specific task or responsibility is necessary for a particular audit, the auditor increasingly becomes enmeshed in the minutiae of a company's daily transactions rather than remaining focused on the larger, macro-view of the company's financial statements.

As each task is piled on, costs increase while, we fear, the results diminish. If an auditor merely read a company's executive compensation disclosures as part of its audit procedures because it had specifically identified a heightened risk in its audit planning process, then the cost to the specific company would likely be low. More importantly, the cost would not be borne by companies whose auditors have not identified significant audit risk associated with the executive compensation arrangements. Unfortunately, as we have seen in each case when auditors are required to perform specific procedures, the procedures will take on a life of their own. We would expect auditors to seek to demonstrate to the PCAOB (and potential plaintiffs) that they have met their obligations under Auditing Standard No. 12, to determine that a formal risk assessment of executive compensation arrangements would be necessary. Whether this risk assessment would be performed by a company's auditor (in spite of the prohibitions under Section 201 of the Sarbanes-Oxley Act) or if the auditor would require a third party to perform this risk assessment is unclear. But what is clear is that management and the Board would need to spend additional time and resources supporting and defending a company's executive compensation decisions to its auditors. We believe that management and the Board should focus their resources on the business and business risk, while auditors should continue to assess risks to the integrity of the financial statements.

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[5] AU Section 110, *Responsibilities and Functions of the Independent Auditor,* paragraph .02 (emphasis added).

Existing Auditing Standards Are Sufficient

Detecting fraud through the auditor's proper level of professional skepticism has long been a principle guiding financial statement audits. Since 1998, when the AICPA adopted Statement on Accounting Standards No. 82, *Consideration of Fraud in a Financial Statement Audit ("SAS No. 82"), the detection of fraud has been an increasing focus of auditors.* Since then, SAS No. 82 has been superseded by a more comprehensive framework to detect fraud with AICPA Statement on Accounting Standards No. 99, *Fraud Detection in a GAAS Audit ("SAS No. 99"), which has been adopted by the PCAOB p*ursuant to Rule 3200T as AU Section 316. Certain concepts of SAS No. 99, such as the requirement for audit teams to have "brainstorming sessions" on the potential for material misstatement due to fraud have also been incorporated into PCAOB Auditing Standard No. 12.

Fraud, by its very nature, is difficult to detect. Typically, the most significant fraud involves senior level management actively concealing or misleading the auditors. Fraud is also difficult to detect because the circumstances of fraud, including the position of the perpetrator, the accounts affected, and the concealment method, are case-specific. That said, the current auditing literature provides practical guidance to auditors to detect fraud. For example, Paragraph .07 of AU Section 316 alerts auditors to three conditions that usually exist when fraud occurs (incentive, circumstances, and rationalization). The guidance also provides examples of audit procedures rather than specific one-size-fits-all requirements. Ultimately, however, regardless of whether specific audit procedures are mandated or whether merely suggested, completing audit procedures will be a fruitless effort unless the auditor exercises professional skepticism.

The Society believes the PCAOB should not mandate specific audit procedures, but be more principles-based in order to improve fraud detection. A "questioning mind and a critical assessment of audit evidence"[6] will uncover more cases of fraud than requiring auditors to comply with the Proposed Amendments. While preventing fraudulent financial statements is in the best interests of all public companies, we strongly disagree that additional auditing procedures, applied broadly to all companies, is a cost-effective solution.

For all of these reasons, the Society does not support the proposed amendments set forth in the Concept Release.

[6] AU Section 316, *Consideration of Fraud in a Financial Statement Audit,* paragraph 13.

We thank the PCAOB for its efforts to improve the effectiveness of audits in detecting fraud, and we would be happy to provide you with further information to the extent you would find it useful.

Respectfully submitted,

The Society of Corporate Secretaries and Governance Professionals

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