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May 29, 2012

Via Email
J. Gordon Seymour
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB No. 2012-001, Rulemaking Docket Matter No. 38

Dear Mr. Seymour,

The American Federation of State, County and Municipal Employees ("AFSCME") submits this letter in strong support of the Public Company Accounting Oversight Board's (the "Board's") Release No. 2012-011, "Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions" (the "Release"). AFSCME is the largest union in the AFL-CIO, representing 1.6 million state and local government, health care and child care workers. AFSCME members participate in over 150 public pension systems whose assets total over $1 trillion. In addition, the AFSCME Employees Pension Plan (the "Plan") is a long-term shareholder that manages $850 million in assets for its participants, who are staff of AFSCME and its affiliates.

AFSCME has a substantial track record of engagement with companies around the risks created by incentive compensation programs. We agree with the Board that poorly designed compensation plans can increase the risk of material misstatement, harming a company and its shareholders. Empirical evidence indicates that the desire to increase incentive compensation is a frequent motivation for financial statement fraud.[i] As well, there is support for the notion that certain compensation arrangements, such as large amounts of stock options, correlate to more large losses for shareholders.[ii] We therefore applaud the Board for issuing the Release to more specifically describe auditors' responsibilities for evaluating the impact of incentive compensation arrangements on the risk of financial misstatement.

The changes proposed in the Release do not represent a radical departure from current standards; instead, they clarify and provide more specificity. At present, Auditing Standard No. 12, "Identifying and Assessing Risks of Material Misstatement," states that the auditor "should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement." Understanding the "nature of the company" is one of the five elements in satisfying this requirement. (Auditing Standard No. 12, section 7)

Auditing Standard No. 12 already provides that an auditor, in obtaining an understanding of the nature of the company, should "[o]btain an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses." (Auditing Standard No. 12, section 11)

The changes proposed in the Release would replace that somewhat general language with more specific procedures, including reviewing employment agreements and proxy statement disclosure. (Release, page A3-1) Thus, we do not expect that the Release's greater specificity would result in a meaningful increase in audit costs. More specific guidance would, however, enhance the quality of the audit by assisting the auditor in identifying fraud risks; thus, on balance we favor the proposed change even if a modest increase in audit costs would result.

In addition, the amendments proposed in the Release would provide that the auditor should "inquir[e] of the chair of the compensation committee, or its equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers." (Release, page A3-1) Although we believe that communication between auditors and those involved in designing and implementing compensation arrangements would be useful in enhancing auditors' understanding of those arrangements, we are concerned that the language of this proposed change—"regarding the structuring"--may be too imprecise and may not serve the Board's objective. We urge the Board to clarify the information auditors should seek from board compensation committees and compensation consultants regarding executive compensation arrangements.

Criticism of the compensation-related amendments contained in the Release has focused on the possibility that auditors will begin dictating compensation practices, and

that companies with non-standard arrangements will risk not receiving a clean audit opinion. Those arguments fail to account for the fact that the Board's current standard already directs auditors to gain an understanding of executive compensation arrangements; we are aware of no reports of auditors demanding that companies abandon their existing practices. Those arguments also ignore the purpose of Auditing Standard No. 12—to require the auditor to assess the risk of material misstatement at a client in order to design appropriate audit procedures. More accurate assessments lead to better audits, benefiting investors such as the Plan.

We also support the measures outlined in the Release to more fully detail the measures auditors should take to identify and examine related party transactions. Related party transactions provide opportunities for insiders to extract personal benefit at the expense of investors. Although we recognize that related party transactions may have a legitimate business purpose, we agree with the Board that heightened scrutiny is necessary in the audit setting. Many high-profile corporate failures resulting in massive losses for investors, such as Enron, Adelphia and Hollinger, have involved the abuse of related party transactions. For example, at Enron, numerous related parties engaged in transactions with the company without any economic rationale, with the common objective of concealing the company's true financial condition. Once the truth came out, the company couldn't obtain financing and lost the confidence of counterparties, leading to bankruptcy. The related party transactions were used to conceal the problems, allowing them to become even larger (while benefiting insiders).[iii]

The Board's own inspections provide support for the notion that auditors may still not be probing these transactions sufficiently. One-quarter of the Board's settled disciplinary orders involve failures in this area.[iv] More specific standards and procedures will increase investor confidence in audits.

As with the compensation-related changes, the changes proposed in the Release on related party transactions build upon the auditor's existing duty to identify and analyze these transactions. We believe that requiring the auditor to understand the business rationale for related party transactions, in particular, will assist in identifying abuse. If Arthur Andersen's auditors had focused on and communicated with the board regarding the (non-existent) business rationale for the abusive related party transactions that Enron used to conceal its true financial condition, investor losses might have been significantly less. [v] Similarly, the Release's proposed changes to AU 316, "Consideration of Fraud in a Financial Statement Audit," do not introduce new responsibilities, but instead clarify how

auditors should think about (and apply professional skepticism when evaluating) the opportunities to engage in fraudulent financial reporting provided by related party transactions that are also significant unusual transactions for the company.[vi]

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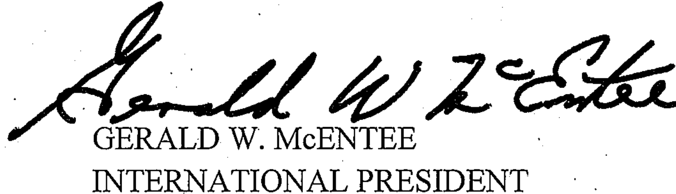
We appreciate the opportunity to share our views with the Board on these important issues. If you have any questions, or need additional information, please do not hesitate to contact Lisa Lindsley at (202) 429-1275.

Sincerely,



GERALD W. McENTEE
INTERNATIONAL PRESIDENT

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[i] See Mark S. Beasley et al., "Fraudulent Financial Reporting 1998-2007: An Analysis of Public Companies," at 3 (COSO 2010) available at http://coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.

[ii] See Wm. Gerard Sanders & Donald C. Hambrick, "Swinging for the Fences: The Effects of CEO Stock Options on Company Risk-Taking and Performance," Academy of Management Journal, at 30-31 (2007) available at http://journals.aomonline.org/InPress/pdf/done/291.pdf; see also Wm. Gerard Sanders, "Behavioral Responses of CEOs to Stock Ownership and Stock Option Pay," Academy of Management Journal, 477 (2001) (finding that stock option CEO pay was associated with greater acquisition activity) available at https://mywebspace.wisc.edu/czhang46/web/Executive%20compensation%20and%20risk%20taking/Sanders%202001.pdf.

[iii] Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., dated Feb. 1, 2002, available at http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf.

[iv] See Statement of Steven B. Harris, Board Member, Feb. 28, 2012 available at pcaobus.org/news/speech/pages/02282012_harrisstandard.aspx.

[v] See, e.g., Report of Investigation, Special Investigative Committee of the Board of Directors of Enron Corp., Feb. 1, 2002, at 24-25 (concluding that "Andersen did not

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fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal controls over the related-party transactions" and that Andersen allowed related-party transactions to proceed that should not have been approved) available at http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf.

[vi] See AU Section 316, "Consideration of Fraud in a Financial Statement Audit," paragraph .85 available at http://www.aicpa.org/research/standards/auditattest/downloadabledocuments/au-00316.pdf; Release, at A3-3.