May 31, 2012

Office of the Secretary
PCAOB
1666 K St NW
Washington, D.C. 20008

Re: PCAOB Release No.2012-001, Docket 038

Dear Secretary,

On behalf of more than 250,000 Public Citizen members and supporters, we are pleased to comment on proposed amendments to Auditing Standard No. 12 as it relates to the role of compensation agreements and the integrity of financial statements.

Generally, we applaud the PCAOB for proposing new compensation agreement items that auditors should inspect so as to understand better the risk that firms may be motivated to misstate financial results. Academic study and review by regulatory agencies support the common sense notion that compensation incentives can promote fraud and needless risk-taking that jeopardize the integrity of a firm. The Board proposes reasonable improvements to measures taken under Auditing Standard No. 12.

In addition to the Board's proposed new directions, we urge the Board to develop tools or resources such as a database or Fraud Center from which auditors can learn about compensation structures that have been associated with misstatements.

Compensation figures as a motivation for fraud across all companies. A review by Beasley and Carcello of all fraud enforcement actions taken by the Securities and Exchange Commission from 1997 to 2008 found that a manager's wish to increase compensation served as the most commonly cited motivation to falsify results.[1]

Compensation also figured at the center of the financial crash, which was caused in part by managers who obscured vital risk information, misleading shareholders, auditors, and prudential supervisors.[2] For example, firms that pay executives with stock options provide an assymetric

[1] See M. Beasley, J. Carcello, D. Hermanson, and T. Neal, "*Fraudulent Financial Reporting 1998-2007 An Analysis of U.S. Public Companies*," available at http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.

[2] The Federal Reserve found that "risk-taking incentives provided by incentive compensation arrangements in the financial services industry were a contributing factor to the financial crisis that began in 2007." Federal Reserve: Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking

incentive to produce financial results that may involve excessive risks. If those risks instead lead to losses, the manager does not suffer a loss of pay. Board member Steven Harris observed that certain stock-option plans proved to be "strong incentive for excessive risk-taking that was not understood by auditors.[3] The Financial Crisis Inquiry Report found that "massive losses" related to the subprime mortgage market stemmed from employee compensation systems.[4] Financial statements failed to enumerate these compensation-motivated risks. Studies by the Securities and Exchange Commission,[5] the U.S. Senate,[6] and scholars reached similar conclusion.[7] Tellingly, major firms that failed (or were rescued) during the financial crisis, such as Bear Stearns, Lehman Brothers, Washington Mutual, Wachovia, and Morgan Stanley, each received unqualified, clean audits sometimes as little as a few weeks before they collapsed. With that backdrop, it is clear that audit metrics should be altered.

We support the Board's rationale for enhanced auditing oversight of compensation schemes that contribute to frauds and misstatements. The preamble of the February 28 Release provides ample justification for robust new measures. The Board release observes,

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Organizations, October 2011, available at http://www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf

[3] Statement of Steven B. Harris, available at: http://pcaobus.org/News/Speech/Pages/02282012_HarrisStandard.aspx

[4] See, generally, The Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States,* (January 2011), available at: http://www.gpoaccess.gov/fcic/fcic.pdf.

[5] See, generally, *Restoring Trust, Report to The Hon. Jed S. Rakoff The United States District Court for the Southern District of New York On Corporate Governance for the Future of MCI* (pages 17-19) available at: http://www.sec.gov/spotlight/worldcom/wcomreport0803.pdf. That report describes how the need to maintain the company's stock price to avoid a margin call on stock owned by an executive officer at WorldCom Corporation allegedly provided an incentive to perpetrate fraudulent financial reporting.

[6] See Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions (January 2, 2003), available at: http://www.gpo.gov/fdsys/pkg/CPRT-107SPRT83559/pdf/CPRT-107SPRT83559.pdf. Certain regulatory agencies subsequently issued guidance describing internal controls and risk management procedures that may help financial institutions identify, manage, and address the heightened reputational and legal risks that may arise from elevated-risk complex structured finance transactions. See SEC Release No. 34-55043, *Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities* (January 5, 2007) available at: http://sec.gov/rules/policy/2007/34-55043.pdf.

[7] *See* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 247 (2010) (arguing that bank executive compensation packages insulate their recipients from company losses and lead executives to insufficiently weigh investment risks); Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173, 1173 (2010) (arguing that stock based executive compensation caused managers to take excessive risks that inflicted damage on creditors and society); Fredrick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation* (Emory Public Law, Research Paper 10-93, 2010), *available at* http://ssrn.com/abstract=1546229 ("[E]quity compensation tends to induce greater risk taking by aligning managers' risk preferences with those of equity holders.").

> "Incentives and pressures for executive officers to meet financial targets can result in risks of material misstatement to a company's financial statements. Such incentives and pressures can be created by a company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements)."[8]

The refinements in the Release intersect with SAS 99 and its injunction that auditors maintain "professional skepticism."

We believe the proposal provides adequate guidelines. The release notes that the proposed procedures "are not intended to call into question the policies and procedures of the company, but rather to assist the auditor in identifying and assessing risks." Shareholders should welcome improved procedures in an audit; misstatements harm shareholders. Andrew Liazos of the trade publication CFO.com stated, "It's not unreasonable for auditors to understand what financial performance triggers incentive-compensation payments. Such information might suggest areas susceptible to questionable accounting decisions and practices."[9]

When the PCAOB established compensation as an audit subject in Auditing Standard No. 12 it provided that "the auditor should consider performing . . . procedures and the extent to which the procedures should be performed [to] obtain an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses."

The proposed amendments to Accounting Standard 12 add valuable new instructions
To equip an auditor to assess compensation plans, we ask the Board to develop resources such as a best-practices depository regarding compensation plans associated with fraud. As a start, a compensation plan should be included in the depository if an officer subject to the plan was found guilty of fraud and compensation was a motivation for the fraud. We urge such a resource be developed within a year. In addition, the PCAOB may wish to commission a study that explores the intersection of specific compensation structures and fraud. We urge such a resource be developed within a year. The Beasley Carcello report agreed that "more study about the effect of compensation policies and processes on fraud risk and board oversight of that risk may be needed."[10]

In 2008, the Treasury Department's Advisory Committee on the Auditing Profession (ACAP) recommended that the PCAOB establish a National Fraud Center. The PCAOB should follow this recommendation. The National Fraud Center could be used to study frauds after they happen, modeled on the National Transportation Safety Agency's post-mortem after

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[8] At p. 2 http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2012-001_Related_Parties.pdf

[9] Andrew Liazos, "Will Auditors Influence How Executives are Paid?" CFO.com, March 13, 2012

[10] From the Beasley Carcello report: More study is needed to determine if there are leading practices that help to reduce the risk of senior management involvement in financial statement fraud. For example, emerging practices may exist related to the screening and selection of senior executive officers, how they are compensated to avoid excessive fraud risks, and how boards and others oversee senior management. Mechanisms for sharing of those practices with wider audiences may need to be considered. In addition, CPA firms may want to focus additional effort on assessing the integrity of top management and sharing with the profession those approaches that prove effective.

transportation accidents, to better inform the profession on why frauds occur, how they are perpetrated, and how they are concealed. A Fraud Center could examine the relation between compensation plans and fraud.[11]

In the proposed additions to paragraph 11 of AS 12, we ask that the language be clarified to better convey what we understand to be the Board's intent. Specifically, we suggest the following language: "The auditor should discuss the structure of the company's compensation plans for executive officers with the chair of the compensation committee, or its equivalent, and any compensation consultants engaged by either the compensation committee or the company."

Under Regulation SK, the SEC requires companies to disclose "the extent that risks arising from the registrant's compensation policies and practices for its employees are reasonably likely to have a material adverse effect on the registrant."[12] This 2009 SEC rule contains an important caveat, providing that firms must make this disclosure only with plans that are "reasonably likely to have a material adverse effect on the company." Consequently, the auditor should be attuned to whether the company's proxy disclosures accord with the auditor's conclusions about whether pay structure may promote material risk, and departures should factor in the overall audit opinion. In May, 2012, JP Morgan reported a loss from certain speculation overseen by the chief investment office in excess of $2 billion. Shortly after, the firm's chief investment officer left the firm. More than 94 percent of her $15 million pay package came from "incentive compensation." While JP Morgan did not disclose details of this package in its shareholder reports, it did assure investors generally regarding the intersection of compensation and risk: "The Compensation & Management Development Committee each year reviews with the Chief Risk Officer the risks that the Firm faces and elements of our organizational structure, management practices and compensation programs that would discourage unnecessary or excessive risk-taking."[13] We note that for the 2012 proxy season, no major bank made a disclosure stating that its compensation structure was "reasonably likely to have a material adverse effect." We are not in a position to evaluate the integrity of these non-disclosures. Given the role of pay in causing the financial crash, it would be unwise to assume that all pay structure problems have been resolved in the absence of strong evidence to support that conclusion.[14] Reports of Wall Street pay suggest that bonuses remain high, and therefore employees may face incentives to subordinate risk.

Governance studies suggest that discussions between the auditor and the compensation committee and consultants may not be sufficient to achieve the goals of identifying the potential for misstatements owing to pay structures. The Beasley Carcell study, for example, found little outward difference in governance structures between firms that commit frauds and non-fraud firms. More robust obligations for the compensation committee may be part of the solution,

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[11] http://aaapubs.org/doi/abs/10.2308/ciia.2010.4.2.A1

[12] Item 402, for Def 14a, available at: *http://taft.law.uc.edu/CCL/regS-K/SK402.html*

[13] (See p. 21-24 of proxy statement, here: http://files.shareholder.com/downloads/ONE/1876940586x0x556146/e8b56256-365c-45aa-bbdb-3aa82f0d07ea/JPMC_2012_proxy_statement.pdf)

[14] ISS Governance shows that no firms have disclosed a material risk, provided under 402(s).

which is outside the purview of the auditor and the PCAOB.[15] We nevertheless encourage the Board to explore additional methods to strengthen the role of the auditor in detecting the risk of material misstatement.

Finally, we applaud the PCAOB for its ambitious efforts to improve the vitality of audits, with measures such as mandatory audit rotation. We urge the Board to consider measures to increase the level of information that auditors provide shareholders. These critical reforms can make the audit more relevant to shareholders.

Your consideration is appreciated. If you have questions, please contact me at bnaylor@citizen.org, or at 202.580.5626.

Sincerely,

Bartlett Naylor
Financial Policy Advocate.

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[15] Conversations with the compensation committee regarding the intersection of compensation and risk of misstatements alone may prove of limited value. The Beasley Carcello study found "relatively few differences in board of director characteristics existed between firms engaging in fraud and similar firms not engaging in fraud. Also, in some instances, noted differences were in directions opposite of what might be expected. These results suggest the importance of research on governance processes and the interaction of various governance mechanisms." [15] Specifically, the study found that 88 percent of fraud firms maintained a compensation committee. Eighty-five percent of fraud firm compensation committee membership consisted of outside directors. Eighty-nine percent of fraud firms maintain outside chairs of the compensation committee. Virtually none of the compensation committee chairs had accounting or finance expertise. There appears to be no clear deficiency with fraud firm governance. Consequently, there may be only slight value in discussing problems with compensation with the chair or other outside directors of the compensation committee. Sadly, this may be central to the problem, not the solution. We hypothesize that managers intent on fraud will have taken measures to euthanize basic governance safeguards.