

Proposed PCAOB Standards Require Auditors to Examine Executive Compensation Arrangements

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The recent PCAOB republished [auditing standards](#) on related parties and significant unusual transactions also include a modification to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, focused on executive compensation.

The amendment broadens the current standard that requires auditors to consider performing procedures to achieve an understanding of compensation arrangements with a company's senior management. The revised standard, which the PCAOB calls an "incremental expansion," mandate that the auditor perform procedures in order to understand the potential risks of material misstatements posed by incentives and pressures arising from a company's financial relationships and transactions with its executive officers, including executive compensation arrangements. Perks are specifically mentioned as being part of the arrangements to be examined.

In response to comments critical of the original proposal from February claiming that the performance of these procedures by the auditor could ultimately affect the design of compensation arrangements, the republished amendment clarify that the auditor's procedures in this area would be performed as part of the auditor's risk assessment process. It would not require the auditor to make any determination regarding the reasonableness of compensation arrangements or recommendations regarding those arrangements. However, the procedures are designed to increase the auditor's focus on incentives for and pressure on the company to achieve a particular financial position or operating result, given the role that a company's executive officers may play in the company's accounting decisions or financial reporting. For example, the auditor could consider whether the company's internal control over financial reporting is designed and operating to address risks that management might seek accounting results solely to boost certain executive officers' compensation.

The audit procedures would include reading employment contracts, proxy statements and filings with the SEC and other regulatory agencies. The auditor can also consider asking the compensation committee chair and the compensation consultant about the executive compensation structure as well as obtain an understanding of the policies and procedures for the authorization and approval of executive officer expense reimbursements.

The comment period ends on July 8th, and no comments have been received to date. If the republished standards are approved by the SEC, they would apply to audits of financial statements for fiscal years beginning on or after December 15, 2013.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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