

# TCF FINANCIAL CORPORATION

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May 9, 2012

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, D.C. 20006-2803.

Submitted by e-mail to: [comments@pcaobus.org](mailto:comments@pcaobus.org)

Re: PCAOB Rulemaking Docket Matter No. 038

Ladies/Gentlemen:

On behalf of TCF Financial Corporation, we are commenting on the Board's proposed changes to Auditing Standard No. 12 dated February 28, 2012 pertaining to executive compensation.<sup>1</sup>

## Background on TCF

TCF Financial Corporation (TCF) is a national bank holding company headquartered in Wayzata, Minnesota. TCF's national bank subsidiary, TCF National Bank (TCF Bank), has approximately 440 banking branches in 8 states and, through various subsidiaries, offers leasing, inventory finance and equipment finance services in all 50 states and Canada. Together, they employ approximately 7,000 people.

## Overview of Comments

The focus of our comments is the Board's proposed amendment to Auditing Standard No. 12 concerning executive compensation.<sup>2</sup>

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<sup>1</sup> PCAOB Release No. 2012-001 (February 28, 2012).

<sup>2</sup> PCAOB Release No. 2012-001 (February 28) at page A3-1 (Appendix 3). The definition of "executive officer" in the proposed amendments corresponds to the same term in SEC Rule 3b-7, which includes a registrant's president, any vice president of the registrant in charge of a principal business unit, division, or function (such as sales, administration or

The basis of the proposal is that: (1) incentives and pressures for executive officers to meet financial targets can result in risks of material misstatement to a company's financial statements, and (2) such incentives and pressures can result from executive compensation arrangements that are tied to company performance. Thus, the proposed standard would require the auditor, among other things, to "obtain an understanding of a company's financial relationships and transactions with its executive officers" and to "[obtain] an understanding of compensation arrangements with senior management other than executive officers" that is sufficient, in either case, to identify risks of material misstatement.

Our view, as set forth in more detail below, is that the proposed standard would not add incremental value to existing audit requirements. Instead, it could constitute an unwarranted check on management's prerogative to structure executive compensation in manner that is in the best interest of shareholders. It also has the potential to compromise auditor independence.

As to the first point, well-managed incentive compensation plans often are tied in some manner to company performance, and all participants in such programs therefore have financial motivation to enhance company performance. In practical terms, the proposal could steer management away from any performance-based plans that might be deemed unconventional, or it may inhibit performance-based plans altogether.

As to the second point, we are concerned that the proposed standard could inject auditors into the executive compensation design process, as management will not want to design plans that are deemed by auditors to present undue risk. This would undermine auditor independence.

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finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant.

### **The Proposed Standard Would Unnecessarily Influence the Design of Incentive Compensation Plans**

Performance-based incentive compensation plans are the norm for public companies. For example, many companies structure the incentive compensation programs for their executives so as to qualify for favorable tax treatment under Section 162(m) of the Internal Revenue Code.<sup>3</sup> Under Section 162(m), remuneration in excess of \$1,000,000 per year to covered employee of a publicly-held corporation is not tax-deductible unless paid pursuant to a qualified performance-based compensation plan.<sup>4</sup> "Qualified performance-based compensation" is compensation paid solely on account of the attainment of one or more pre-established, objective performance goals."<sup>5</sup>

For many public companies, performance-based incentive compensation is a significant portion of the executive's total compensation. Thus, it is fair to assume that under the proposed standards auditors would treat *all* incentive compensation plans as presenting risk of financial statement misstatements.

However, the risk of financial statement misstatement goes well beyond incentive compensation plans. High profile audit failures, such as Enron and WorldCom, were not because of the auditor's failure to understand the incentive compensation arrangements of those companies (largely stock options, which were commonplace at the time). The focus should instead be on the control environment of the company.

We recognize that auditing standards have always required auditors to have an understanding of executive compensation plans.<sup>6</sup> However, a possible

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<sup>3</sup> 26 U.S.C. 162(m).

<sup>4</sup> A "covered employee" is defined as any individual who, on the last day of the taxable year, is: (A) the chief executive officer of the corporation or is acting in such capacity; or (B) among the four highest compensated officers (other than the chief executive officer). 26 CFR 1.162-27.

<sup>5</sup> 26 CFR 1.162-27. Payment or vesting based solely on continued employment would not constitute a performance goal.

<sup>6</sup> See Audit Standard 12, paragraph 11, and AU Sec. 316.85. For example, AU Sec. 316.85 provides examples of fraud risk factors that could result in incentives and pressures to commit fraud, including available information that indicates that management's or the board of directors' personal financial situation is threatened by the entity's financial performance arising from (a) significant financial interests in the entity or (b) significant portions of their compensation

consequence of the proposal is that management will want to avoid performance-based plans or structure them in a way so as to convince auditors that the plans are low risk. Auditors would thus be in a position, intentionally or not, to second-guess management judgment on the structure of executive compensation in a way that is not necessarily in the company's or shareholders' best interest.

Our view is that the design of executive compensation plans should not be influenced by audit standards, but instead by shareholder preference. As evidenced by recent say-on-pay results, shareholders are focused on performance pay that reflects all elements of company performance. Instead, if an account is material to a company's reporting of financial performance, then the controls surrounding that account should be subjected to appropriate review by the auditors without regard to any possible management incentive to manipulate the account.

### **The Proposed Standard Could Compromise Auditor Independence**

We recognize that the PCAOB is not suggesting that auditors become involved in or influence executive compensation decisions, as any actual involvement by auditors in such decisions could present concerns over their independence.<sup>7</sup> Nonetheless, we have concern that auditor independence could in fact be compromised in this manner.

There is some basis for this concern based on public statements by PCAOB board members. For example, one board member stated that "it makes sense that auditors should consider the possible incentive to questionable accounting treatments created by compensation arrangements. Equity-based compensation

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(e.g., bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow; or (c) personal guarantees of debts of the entity.

<sup>7</sup> As the Board's release notes, the proposed amendments to the audit procedures in Auditing Standard No. 12 "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 associated with a company's financial relationships and transactions with its executive officers."

PCAOB Release No. 2012-001 (February 28) at page A4-44.

arrangements may also provide strong incentives for excessive risk-taking by executives. ... The Board's proposals would require auditors to focus on the potential opportunities and motivations for executive officers to exaggerate gains, or minimize losses, and to consider any effect compensation incentives might have on the reliability of the financial statements."<sup>8</sup>

Another PCAOB board member cited the "possibilities and perils of period-end window-dressing and other kinds of form-over-substance maneuvers intended to produce an accounting effect rather than to promote a business purpose," and further observed that as pay-for-performance has become the "business orthodoxy" the risk exists that accounting manipulation may occur to meet "compensation-triggering targets."<sup>9</sup>

Additionally, it would be unreasonable to assume that auditors will not express opinions or have discussions with board members or management that could influence (wittingly or not) their decisions regarding performance-based compensation plans. For example, an auditor might suggest that a particular performance measure that is sensitive to management's judgments or estimates could be changed so as to reduce or avoid the risk of material misstatements. It is also fair to assume that any suggestion by an auditor that an audit might be qualified in some manner relating to an executive compensation plan would spur the board or management to alter or discontinue to the plan.

## **Conclusion**

For the reasons set forth above, we ask that the Board not adopt the amendments to Auditing Standard No. 12 pertaining to executive officer compensation as proposed.

We appreciate the opportunity the comment on the proposal and welcome you to contact the undersigned should you have any questions.


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<sup>8</sup> Statement of Steven B. Harris, PCAOB Board Member, at PCAOB Open Board Meeting (Feb. 28, 2012), available at [http://pcaobus.org/News/Speech/Pages/02282012\\_HarrisStandard.aspx](http://pcaobus.org/News/Speech/Pages/02282012_HarrisStandard.aspx).

<sup>9</sup> Statement of Daniel L. Goelzer, PCAOB Board Member, at PCAOB Open Board Meeting (Feb. 28, 2012), available at [http://pcaobus.org/News/Speech/Pages/02282012\\_GoelzerStandard.aspx](http://pcaobus.org/News/Speech/Pages/02282012_GoelzerStandard.aspx).

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Very truly yours,

A handwritten signature in black ink, consisting of stylized, cursive letters that appear to be 'RLO'.