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Office of the Secretary
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Re: Rulemaking Docket Matter No. 38; PCAOB Release No. 2013-004:
Proposed Auditing Standard, "Related Parties"; Proposed Amendments to Certain PCAOB
Auditing Standards Regarding Significant Unusual Transactions and Other Proposed
Amendments to PCAOB Auditing Standards

Dear Office of the Secretary:

This letter is in response to the PCAOB's request for comments on the above-cited Release. My comments and suggestions for modifying or clarifying specific paragraphs of the proposals follow:

Appendix 1 – Proposed Auditing Standard, Related Parties

Paragraph 1

I recommend that this introductory paragraph use language that more closely corresponds with the language used in paragraphs 2, 4, 10 and elsewhere. The words "related parties, and the" should be added as follows –

“... the auditor's evaluation of a company's identification of related parties, and the accounting for, and disclosure of relationships and transactions between the company and its related parties.

Paragraph 3, first Note

The following suggested revision deletes superfluous words without changing the meaning of the sentence:

Obtaining an understanding of the company's relationships and transactions with its related parties includes obtaining an understanding of the nature of the relationships ~~between the company and its related parties~~ and of the terms and business purposes (or the lack thereof) of the transactions ~~involving related parties~~.

Paragraph 3, second Note

I note that Appendix 3 (Other Proposed Amendments) adds the following sentence to the end of footnote 3 of paragraph 4 of Auditing Standard No. 12 (page A3-1) –

Also, proposed auditing standard, Related Parties, requires the auditor to perform procedures to obtain an understanding of the company's relationships and transactions with its related parties

that might reasonably be expected to affect the risks of material misstatement of the financial statements (emphasis added).

I therefore suggest the following revision to this second Note in order to conform to the language used in Appendix 3.

Performing the risk assessment procedures described in par. 4-9 of this standard in conjunction with the risk assessment procedures required by Auditing Standard No. 12 is intended to provide the auditor with a reasonable basis for identifying and assessing risks of material misstatement associated with the company's relationships ~~related parties and relationships~~ and transactions with its related parties.

Alternatively, the wording in footnote 3 should be changed so as to be consistent with the language used in this second Note to paragraph 3.

Paragraph 5(c)

A. Relationship(s)

The meaning of the term “relationship” used throughout the proposal, is not defined; however, its meaning is partly clarified in paragraph 5(c) and footnote 6 to paragraph 10 (see page A3-7). I recommend that “relationship(s)” be footnoted and explained as including –

- (a) the nature of the relationship (see paragraph 8),
- (b) the names of the parties (when aggregating similar transactions – see ASC 850-10-50-3), and
- (c) the ownership structure (“even though there are no transactions between the entities” – see ASC 850-10-50-6).

In addition, see AU 336 (“Using the Work of a Specialist”) page 10 of this letter for additional comments regarding the meaning of “relationship.”

B. Inquiry of Management

Identifying related parties and understanding and verifying the ownership structure of the company and its related parties, including the levels of direct and indirect control, and changes in those levels during the course of the year, may be one of the more difficult and complex aspects of an audit (especially audits of multinational entities when nominee shareholders may obscure the true beneficial owners of the related entities). However, the audit procedure outlined in paragraph 5(c) focuses solely on asking management about the “nature of any relationships, including ownership structure, between the company and its related parties.”

Two comments –

1. An outline of the steps necessary to verify the actual levels of ownership of the identified related parties should be added in an Appendix to this proposal.
2. Since inquiry of management is integral to the audit, auditors should be reminded to direct their inquiries specifically to those directors and officers who have certain responsibilities to the auditor under rule §240.13b2-2 (“Representations and conduct in connection with the preparation of required reports and documents”) of the Securities Exchange Act of 1934. This rule prohibits “officers and directors of an issuer, and persons acting under the direction of an officer or director, from taking any action to coerce, manipulate, mislead, or fraudulently influence the auditor of the issuer's financial statements if that person knew or should have known that such action, if successful, could result in rendering the financial statements materially misleading.” The SEC release (Release No. 34-47890, FR-71) defines “officers” which category may or may not include the same people as “management” as used in paragraph 5.

Regarding footnote 4, those signing the Management Representation letter would fall under the 1934 Act rule.

Paragraph 5(f)

I recommend that redundant words be removed as follows –

Any related party transactions that have not been authorized and approved in accordance with the company's established policies or procedures regarding ~~the authorization and approval of transactions with~~ related parties

Paragraph 6

The following revision is suggested to eliminate unneeded words –

~~The auditor should inquire of others within the company regarding their knowledge of the matters in par. 5 of this standard.~~ The auditor should identify others within the company to whom inquiries regarding matters in paragraph 5 should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding:

Paragraph 6, footnote 5

The meaning behind this footnote (and similar footnote 25A (page A2-9)), is not clear. Should the term “related parties” (after “(1)”) be read as “unknown and previously unknown related parties”?

Paragraph 7

Board of Directors.

Before inquiring of the audit committee, the auditor should first inquire whether the Board of Directors reviewed, authorized and approved the related party transaction.

Who is a Related Party?

Also, the auditor should determine that (a) members of the board of directors and audit committee, (b) management (paragraph 5), and (c) others (paragraph 6), know exactly how the auditor defines “related parties” under the applicable financial reporting framework. Auditors should not assume that members of these three groups have a technical understanding of the applicable reporting framework. For example, it may not be readily understood that directors (and audit committee members) and their immediate families and certain affiliates are considered related parties under US GAAP (ASC 850).

Paragraph 7(a)

I recognize the Board has taken a framework-neutral approach in this proposal; however, I suggest that the Board consider the language used in ASC 850-10-50-1 which states – “Financial statements shall include disclosures of material related party transactions (emphasis added).” Accordingly, I suggest the following revision –

The audit committee's understanding of the company's related parties and relationships and transactions with related parties that are ~~significant~~ material to the company

This change would eliminate the need to debate the meaning of “significant” when the term “material” has already been clarified in paragraph 2 of Auditing Standard No. 11 (“Consideration of Materiality in Planning and Performing an Audit”).

Paragraph 9

I propose the deletion of unessential language thus –

“If the auditor is using the work of another auditor, the auditor should communicate to the other auditor ~~relevant information about related parties, including~~ the names of the company’s related parties and the nature of the company’s relationships and transactions with those related parties.

Paragraph 11

I suggest adding the words “and audit procedures” and “assessed” to agree with the language used in paragraphs 2 and 8 of Auditing Standard No. 13. Therefore, the paragraph would read –

The auditor must design and implement audit responses and audit procedures that address the identified and assessed risks of material misstatement. This includes designing and performing audit procedures in a manner that addresses the assessed risks of material misstatement associated with related parties and relationships and transactions with related parties.

Paragraph 11, Note

This paragraph states in part –

“...that the auditor evaluate whether the business purpose (or the lack thereof) of the transactions indicates that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.”

To heighten the auditor’s awareness regarding the misappropriation of assets, I suggest adding an Appendix (e.g., captioned “Appendix B”) which would illustrate some of the many possible methods unconsolidated related parties may misappropriate assets to the detriment of shareholders and/or noncontrolling (minority) interests. For example, this Appendix would include (a) loans to the company by a related party bearing an above market rate of interest and conversely loans to a related party at a below market rate of interest; (b) investing in related parties at a price above fair value; (c) the sale of equity to a related party at a price below fair value; (d) the purchase of assets, goods or services by the company from a related party that may not be needed (or are in excess of anticipated needs), or at a price above fair value; and (e) the sale of assets, goods or services to a related party at prices below fair value.

Paragraph 12(b)

I suggest the elimination of the following unessential words –

Determine whether the transaction has been authorized and approved in accordance with the company’s established policies and procedures ~~regarding the authorization and approval of transactions with related parties~~

Paragraph 12(e)

Recognizing that this item allows audit procedures be scaled to the entity and the facts and circumstances, I recommend that an additional procedure be included in paragraph 12. This added audit step would require the auditor determine that material related party transactions that had been previously authorized and approved be revisited annually to establish that there were no changed circumstances that would require management (and/or the Board of Directors) to reauthorize and approve the related party transaction, or revise or terminate the transaction, and that such changed circumstances are properly accounted for and, if material, disclosed in the financial statements.

Paragraph 12, Note

The first sentence is not needed as its essence is captured in the second sentence. I propose that this Note be revised to read –

~~The applicable financial reporting framework may allow the aggregation of similar related party transactions for disclosure purposes. If the company has aggregated related party transactions for disclosure purposes in accordance with the applicable financial reporting framework, the auditor may perform the procedures....~~

Caption: Intercompany Transactions

Since the following paragraph deals exclusively with intercompany account balances, this caption should be revised to read “Intercompany Accounts and Transactions.”

Paragraph 13

Auditing Intercompany Transactions.

Audit procedures concerning intercompany transactions (as opposed to account balances) should be addressed in this proposal. While related party intercompany transactions are generally eliminated in consolidation, some intercompany transaction may not be fully eliminated. For example, transfer pricing transactions (ordinarily eliminated in consolidation) ordinarily result in net tax benefits. Accordingly, while arising from the direct result of related party transactions, the tax benefits (which may be entirely tax motivated) reflected in the financial statements are not eliminated in consolidation, nor are required to be disclosed (assuming materiality) and identified as a related party transaction (under US GAAP).

The proposed release should specifically discuss the auditor determining the business reason for intercompany transactions between related parties, or whether the intercompany transactions have “economic substance” notwithstanding the transactions may be eliminated in consolidation.

Intercompany transactions with related parties should heighten an auditors concern about the risks of material misstatements. Some examples –

- Business transactions that are not given accounting recognition and which may not be disclosed. For instance: (1) trademarks, patented technology, and computer software licensed to or made available to a related party; wherein no transaction is recorded in the financial statements, or (2) where a US parent company allows a foreign subsidiary to use equipment at no charge.
- Frequent normal business transactions between related parties, except that relatively small pricing variations in each individual transaction results in material benefits being transferred to one of the related parties.
- Intercompany transactions with related parties that either are not audited or are audited by others.

Paragraph 14, Note

This Note, referencing Appendix A, should be moved to paragraph 15 which deals with previously undisclosed related party transactions.

Paragraph 14, footnote 14

I recommend that this footnote be clarified as follows –

In evaluating whether a company has properly identified its related parties and relationships and transactions with related parties, the auditor (1) should assess the process used by the company (paragraph 4), and (2) perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

In addition, these required audit procedures should not be relegated to a footnote, but should be included directly in paragraph 14.

Paragraph 16(a), first sentence

Since the auditor has already determined that a previously undisclosed related party transaction has occurred, beyond the existence of something the auditor already knows, this audit step should outline the other information the auditor is inquiring management about.

In addition to “the possible existence of other transactions with the related party previously undisclosed to the auditor” (paragraph 16(a)), this audit procedure should require the auditor to inquire of management about the possible existence of transactions with other undisclosed related parties.

Paragraphs 14 to 16 and Appendix A

In performing the evaluations discussed in paragraphs 14 to 16, I suggest that the guidance in paragraph 10 of Auditing Standard No. 14, “Evaluating Audit Results”, be followed. Thus, the auditor should determine if previously undisclosed related parties or relationships and transactions with related parties identified during the audit are “clearly trivial or not, whether taken individually or in aggregate and whether judged by any criteria of size, nature, or circumstances. When there is any uncertainty about whether one or more items is clearly trivial, the matter is not considered trivial.”

Paragraph 19

This paragraph should be changed to agree with the suggestion in paragraph 1. Therefore, I suggest the following revision –

The auditor should communicate to the audit committee the auditor’s evaluation of the company’s identification of related parties, and the accounting for, and disclosure of its relationships and transactions with related parties.

Paragraph 19(b)

I suggest changing “authorized or approved” to “authorized and approved” to conform to paragraph 5(f) and other paragraphs of the proposal.

Appendix A

Question 7. Are the auditor's responsibilities for the examples of information and sources of information contained in Appendix A to the repropoed standard clear?

Yes, it is clear that the bulleted items in this Appendix are only examples (the word “examples” appearing seven times, along with the statement that they “are not intended to represent a comprehensive listing”), are (1) not prescriptive, and (2) allows auditors to use professional judgment in deciding the nature and extent of information they may examine and any additional auditing procedures that may be required.

Are there other examples that should be included in the repropoed standard?

No, however bullets 8 and 9 are similar and should be combined.

Appendix 2 – Significant Unusual Transactions

Section A

Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

Paragraph 14, first bullet (page A2-1)

The words “otherwise” and “particularly” do not add any meaning to this item, and the phrase “for the company” is implied in paragraph 14. I suggest that this first bullet be simplified as follows –

Controls over significant transactions that are outside the normal course of business ~~for the company~~ or that ~~otherwise~~ appear to be unusual due to their timing, size, or nature (“significant unusual transactions”), ~~particularly~~ including those that result in late or unusual journal entries

AS 9: Audit Planning

Paragraph 12 (page A2-1)

I suggest that superfluous words be deleted, such that the subparagraph would read as follows –

The nature and amount of assets, liabilities, and transactions executed at the location or business unit, ~~including~~, e.g., significant transactions that are outside the normal course of business for the company or that ~~otherwise~~ appear to be unusual due to their timing, size, or nature (“significant unusual transactions”) ~~executed at the location or business unit~~.

AS 12: Identifying and Assessing Risks of Material Misstatement

Paragraph 13 (page A2-2)

As mentioned above, I believe that the word “otherwise” should be deleted, and “for the company” is implied. Therefore, I suggest the following revision –

The methods the company uses to account for significant transactions that are outside the normal course of business ~~for the company~~ or that ~~otherwise~~ appear to be unusual due to their timing, size, or nature (“significant unusual transactions”)

AS 13: The Auditor’s Responses to the Risks of Material Misstatement

Paragraph 15.c. (page A2-4)

In line with the above suggestions, I put forward the following revision –

Evaluating whether the business purpose for significant transactions that are outside the normal course of business ~~for the company~~ or that ~~otherwise~~ appear to be unusual due to their timing, size, or nature (“significant unusual transactions”) indicates that the transactions....

AU 316: Consideration of Fraud in a Financial Statement Audit

Paragraph .85A.2 section a (page A2-4)

This replacement is confusing. I suggest using the terminology found elsewhere in this proposal, for example –

Related party transactions that are outside the normal course of business or appear to be unusual due to their timing, size or nature (“significant transactions with related parties”).

Paragraph .85A.2 section b (page A2-5)

If not deleted, this item should clarify the distinction between “significant” transactions and “significant unusual transactions”. Also, I suggest substituting the word “including” for “especially” in order to conform to the revision to Auditing Standard No. 5, paragraph 14 (page A2-1). Thus, this item would read –

~~Significant~~ or [H]ighly complex transactions or significant unusual transactions, ~~especially~~ including those close to period end, that pose difficult “substance-over-form” questions

AU 722: Interim Financial Information

Paragraph .55, App B, paragraph B1, tenth bullet (page A2-5)

I recognize this is just the reordering of the words now found in the original tenth bullet and note that the phrase “infrequent or significant unusual transactions” does not appear in US GAAP or PCAOB GAAS. However, the US financial reporting framework does use “unusual and infrequently

occurring [events].” I therefore suggest retention of the language auditors are familiar with and which is currently used (in ASC 225). The following wording is suggested –

Transactions that are unusual in nature or occur infrequently or are “significant unusual transactions” (i.e., outside the normal course of business or that appears to be unusual due to their timing, size or nature).

AU 316: Consideration of Fraud in a Financial Statement Audit

Paragraph 66, first Note (pages A2-6-7)

This Note implies that the auditor is responsible for the “identification of significant unusual transactions”; whereas replaced paragraph 66 stated “[d]uring the course of the audit, the auditor may become aware of significant transactions...” I suggest this note be revised to say “In deciding whether significant unusual transactions have been entered into to engage in fraud, the auditor should take into account information obtained from...”

Appendix 2 – Significant Unusual Transactions

Section B

AU 316: Consideration of Fraud in a Financial Statement Audit

Paragraph 66 (page A2-6)

I recommend deleting the words “for the company” and “otherwise” so as to be consistent with the suggested revisions mentioned above. This suggestion would revise the paragraph as follows –

Significant transactions that are outside the normal course of business ~~for the company~~ or that ~~otherwise~~ appear to be unusual due to their timing, size, or nature (“significant unusual transactions”) may be used to engage in fraudulent financial reporting or conceal misappropriation of assets.

Paragraph 67 (page A2-8)

First bullet

I suggest adding to the example the following underlined words: “... (e.g., the transaction involves (a) multiple entities within a consolidated group or unrelated third parties, or (b) multiple connected steps, or (c) unconsolidated related parties)”

Second bullet

To clarify this point, I suggest adding “unconsolidated” before the words “variable interest entities.”

Fourth bullet

I suggest adding to the end of this point the following underlined words: “...without assistance from the company or any related party”

Regarding the determination of “financial capability,” a cross-reference to footnote 24A would be helpful.

Paragraph 67 (page A2-9)

Fifth bullet

This paragraph distinguishes “commercial substance” (a guideline used only in connection with accounting for nonmonetary transactions) from “economic substance” (a doctrine governing all transactions). I suggest that this bullet be reworded such that “commercial substance” is understood to refer only to nonmonetary transactions.

In addition, I suggest adding the following underlined words to the parenthetical: “e.g., the transaction, or part of a linked transaction, is entered into shortly prior to period end and is unwound shortly after period end”

Seventh bullet

The proposal should emphasize that auditors should understand the quarterly and annual financial targets of the company; the consequences of achieving or not achieving such targets, and apply tailored audit procedures to the determination and measurement of these targets and their financial statement consequences.

Eighth bullet

Delete the unnecessary word “underlying” thus: “Management is placing more emphasis on the need for a particular accounting treatment than on the ~~underlying~~ economic substance of the transaction (e.g., accounting-motivated structured transaction)”

Paragraph .67A (page A2-10)

To eliminate unnecessary words without changing the meaning, I suggest the following revision –

~~The auditor must evaluate whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements. This includes~~ The auditor must evaluate ~~evaluating~~ whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework.

Appendix 3 – Other Proposed Amendments

Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Section III.A. of Appendix 4)

Paragraph 10A, first sentence (page A3-1)

I suggest that this paragraph be clarified by moving the parenthetical to a footnote and expanding the footnote to cover the basic components of many of today’s executive compensation plans. Doing this will remind auditor’s that “incentives and pressures” (discussed on pages 4, A4-74 and elsewhere in the release) may be embedded in these other components of compensation. The suggested footnote would read –

For example, executive compensation including both fixed and incentive plans (including plans using stock options and restricted stock), and executive benefits (including retirement plans, perquisites, tax gross-ups for the payment of taxes, and the reimbursement of expenses), deferred compensation and deferred savings plans, and any other arrangements.

Paragraph 10A, second sentence

It then follows that the procedures would be expanded beyond “compensation contracts” to include the reading and understanding of the immediately above-mentioned compensation plans for the benefit of the executive officers.

Paragraph 11, third bullet (top of page A3-2)

Recognizing that “senior management” is not defined in this proposal, and that such senior employees may overlap with executive officers, I believe that mentioning only incentive compensation and special bonuses may tend to unduly narrow the auditor’s focus and may result in their overlooking other potential risks of material misstatement. This paragraph should be expanded to mention the other forms of compensation discussed under Paragraph 10A, first sentence above.

Paragraph 10A specifically mentions the (obvious) method of gaining an understanding of executive compensation, i.e., by reading the employment and compensation contracts, etc. The final standard should similarly specify that auditor's should "obtain" an understanding of senior management compensation by "reading the employment and compensation contracts."

Paragraph 11, fifth bullet (page A3-2)

It is not clear why the proposed standard has limited this inquiry of the chair of the compensation committee to the structuring of only executive officers compensation. Auditors should also consider inquiring about the structuring of compensation to senior management mentioned in the third bullet.

AU 336, "Using the Work of a Specialist"

Footnote 6 of paragraph .10 (page A3-7) states –

The term *relationship* includes, but is not limited to, those situations meeting the definition of "related parties" contained in the financial reporting framework applicable to the company under audit.

This reference to the framework does not go deep enough. I recommend that this paragraph be clarified and expanded by describing those situations where there is a relationship with a party that is other than defined as a related party. I assume this sentence includes relationships with former owners, former directors or former management; while these parties are not defined as "related parties" under US GAAP, they may be able to negotiate agreements with the company with terms that may be more or less favorable than those from independent third parties.

I suggest this clarification track the language on page A2-9 (with the following suggested revisions): "The transaction occurs with a party that falls outside the definition of a related party (as defined by the accounting principles applicable to that company), with either party able to negotiate terms that may not be available for to other, ~~more clearly independent,~~ parties on an arm's-length basis"

AU 560, "Subsequent Events"

Paragraph .12b, Item (v) (page A3-7)

For clarity, I suggest changing "or" to "and" - thus this item would read - "Whether there have been any changes in the company's related parties ~~or~~ and whether there have been any significant new related party transactions."

* * * * *

I appreciate your consideration of these suggestions and comments and would be pleased to answer any questions the Board or the Staff may have about this letter.

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