



31 May 2012

Our ref: ICAEW Rep 80/12

Your ref: PCAOB Rulemaking Docket Matter No. 038

Office of the Secretary,
PCAOB, 1666 K Street,
N.W., Washington, D.C. 20006-2803
USA

Dear Sir

**Proposed Auditing Standard - Related Parties
Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant
Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards**

ICAEW is pleased to respond to your request for comments on PCAOB Release No. 2012-001 of 28 February 2012 entitled *Proposed Auditing Standard - Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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**ICAEW REPRESENTATION****ICAEW RESPONSE TO THE PCAOB'S REQUEST FOR COMMENT ON ITS PROPOSED AUDITING STANDARD - RELATED PARTIES
PROPOSED AMENDMENTS TO CERTAIN PCAOB AUDITING STANDARDS REGARDING SIGNIFICANT UNUSUAL TRANSACTIONS AND OTHER PROPOSED AMENDMENTS TO PCAOB AUDITING STANDARDS**

Memorandum of comment submitted in May 2012 by ICAEW, in response to the PCAOB's consultation *Proposed Auditing Standard - Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* published on 28 February 2012

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the *PCAOB's Proposed Auditing Standard - Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* published on 28 February 2012 a copy of which is available from this [link](#).

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. The Audit and Assurance Faculty is a leading authority on external audit and other assurance activities and is recognised internationally as a source of expertise on audit issues. It is responsible for technical audit and assurance submissions on behalf of ICAEW as a whole. The faculty membership consists of nearly 8,000 members drawn from practising firms and organisations of all sizes from both the private and public sectors. Members receive a range of services including the monthly Audit & Beyond newsletter.

MAJOR POINTS

Exposure and engagement of standard-setters and preparers

5. We welcome the exposure of this standard and we support PCAOB's desire to improve the audit of related parties. Related party transactions, disclosures and the associated fraud risks are a difficult area for auditors and preparers of financial statements and the quality of disclosures depends substantially on the reporting requirements. We note that audits and auditors cannot compensate for poor quality, albeit compliant disclosures, nor can they compensate for a lack of clarity in the disclosure requirements. Enhancing auditor performance is only one part of the equation here. Standard-setters and preparers must also be engaged.

Identifying Related Parties and Internal Control

6. We are particularly concerned that the proposed standard can be read as laying the primary responsibility for identifying related parties at the auditor's door. The final standard should make it clearer than it does now that the responsibility for identifying related parties, assessing the associated risks and making the required disclosures rests firmly with preparers.
7. Internal controls over related parties are not always as good as they could or should be. We therefore urge the PCAOB to make it clear in the final standard that the quality of internal controls over the identification of related parties, transactions with them and related disclosures is critical. There are only fleeting mentions of internal control over financial reporting in the proposals despite the control implications of missing information. .

International Alignment, Changes to Existing Requirements, Changing Behaviour and Costs

8. ICAEW remains committed to the global convergence of auditing standards. We are saddened by the 'analysis' of differences between PCAOB, AICPA and IAASB requirements in this area. It consists of repeating verbatim the requirements of the various bodies with no attempt to

explain, let alone evaluate or justify the differences. We have noted in previous responses to the PCAOB our belief that it is appropriate for national standard-setters to challenge the IAASB. In order for this to happen, the PCAOB needs to demonstrate confidence in its positions by means of proper analyses of the differences between its standards and those of IAASB. This would enhance the quality of the PCAOB's and IAASB's standard-setting.

9. There is clearly an expectation underlying the proposals that more time will be spent on the audit of related parties and we are concerned that no attempt has been made to comment on the expected effect on audit costs. Costs are driven by auditor behaviour and both standard-setting and auditor application of standards would be further improved if the PCAOB were to make clearer the differences between extant requirements and its proposals, and the qualitative changes in behaviour its expects to see as a result of it proposals.
10. Appendix A4 of the release states that the requirements in paragraphs 3 and 18 of the proposed standard apply to intercompany transactions and paragraph 14 requires that procedures on intercompany account balances should be performed as of concurrent dates. It is unclear from these references whether the PCAOB has specific concerns regarding audit procedures currently performed on intercompany transactions that are eliminated within a consolidated group for which there is no disclosure requirement. We also note that the PCAOB did not ask any specific questions in this area.

Basis of Conclusions

11. A great deal of what appears in appendix 4 is useful in understanding the proposed standard. Many standard-setters now routinely publish their bases of conclusions and we encourage the PCAOB to consider doing the same with the contents of appendix 4. We made similar comments in our recent response to the PCAOB on communications with audit committees.

RESPONSES TO SPECIFIC QUESTIONS

1. **Is the framework neutral approach described in the introduction of the proposed standard appropriate? If not, why not?**
12. Yes, the framework neutral approach is appropriate.
2. **Is the objective of the proposed standard appropriate? If not, why not?**
13. PCAOB should consider carefully whether the objective of the standard should refer to the fraud risks associated with related parties. There is a risk that it will be perceived as weaker than international standards if it does not, regardless of the fact that the issue is dealt with elsewhere in PCAOB standards. Such an important point bears repetition.
3. **Does the proposed standard clearly articulate the auditor's responsibility for identifying related parties and obtaining an understanding of the company's relationships and transactions with related parties?**
14. We note above our concern about the need for the standard to make it clearer that the primary responsibility for identifying related parties lies with preparers of financial statements and not auditors.
4. **Are the procedures for identifying related parties and obtaining an understanding of relationships and transactions with related parties appropriate?**

15. The proposed standard emphasises procedural requirements at the expense of risk assessment, particularly fraud risk assessment. This is reminiscent of the 'old' IAASB standard prior to its most recent revision, which gave it a solid risk-based approach. While the procedures are not inappropriate, lengthy checklists of documents to be inspected as described in the appendices will likely result in a great deal more work, much of it without a great deal of benefit. A risk based approach would be better.
5. **Are the proposed requirements regarding the auditor's responsibility for information that comes to the auditor's attention that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist appropriate? If not, why not? Are there additional examples that should be included in Appendix A?**
16. The proposed requirements are not inappropriate but the PCAOB is giving out mixed messages to auditors and regulators with regard to appendices. The appendices are not intended to be comprehensive. They are already lengthy and they can always be supplemented. A question as to whether any other examples should be included seems to imply that they are in fact intended to be as comprehensive as possible, and we are concerned that they may be interpreted as requirements by PCAOB inspectors.
6. **Is paragraph 12 of the proposed standard appropriately aligned with the existing requirements regarding the identification and assessment of risks of material misstatement?**
17. Assessing and responding to risks of material misstatement should be the focus of the standard. Identifying related parties is part of that and paragraph 12 should appear immediately after the objective. Paragraphs 3 – 11 should follow this. If the objective cannot refer to fraud risks, paragraph 12 should do so at the very least.
7. **Are there other examples of fraud risks factors, in addition to dominant influence, that should be included in the proposed amendments to assist the auditor when determining whether a related party transaction is a fraud risk or other significant risk?**
18. More emphasis could be given to the importance of auditors understanding the business purpose of the transaction.
8. **Are there particular related party transactions that should be deemed a fraud risk or other significant risk?**
19. We have not identified any.
9. **Is paragraph 13 of the proposed standard appropriately aligned with the existing requirements regarding responding to the risks of material misstatement?**
20. We have not identified any misalignment although we do not understand why the paragraph requires two sentences: it appears that the two sentences could be combined by deleting the text, 'This includes designing and performing audit procedures in a manner that addresses the risk of material misstatement'.
10. **Are the procedures regarding related party transactions required to be disclosed in the financial statements, or that are a significant risk appropriate? Are there other specific procedures that should be required?**
21. The procedures appear appropriate. We have not identified any other specific procedures.
11. **Are the requirements in paragraph 16 of the proposed standard appropriate concerning the auditor's responsibilities regarding information that indicates that**

related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist?

12. Are the requirements in paragraph 17 appropriate regarding the identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor?

22. It is not clear how the documents listed in appendix A should be treated. Should auditors be proactively looking for additional matters within this list of documents, or does the appendix constitute guidance for auditors who have already found them? We are concerned about inefficiency and lack of focus that could result if auditors believe that they should perform all of the procedures in appendix A. It could become a checklist that is completed on all audits. The additional time auditors would need to obtain and understand employment and compensation contracts could be significant. Auditors may also need to engage specialists to understand these contracts and evaluate their impact on the fraud risk assessment. It is also unclear from the proposals what auditors would need to do if obtaining such information was impracticable because of privacy or confidentiality laws or regulations that prohibit disclosure of contract terms, for example.

13. Are the requirements in the proposed standard regarding the auditor's evaluation of the company's financial statement accounting and disclosure of related party transactions appropriate?

23. Yes.

14. Are the proposed requirements for substantiating management assertions that a related party transaction was consummated on terms equivalent to those prevailing in arm's-length transactions appropriate? If not, what other requirements are appropriate?

24. Yes, although the final standard should note that a qualified or adverse opinion will result in an inability to make appropriate SEC filings.

15. Are the requirements in the proposed standard for the auditor to communicate to the audit committee regarding relationships and transactions with related parties appropriate?

25. Yes.

16. Should the proposed standard change the auditor's responsibilities for the auditor's report regarding related party transactions? If so, how?

26. No.

17. Are the proposed amendments regarding the auditor's identification of significant unusual transactions appropriate? If not, why not?

18. Are the proposed amendments regarding the auditor's evaluation of significant unusual transactions appropriate? If not, why not?

27. The proposed amendments appear appropriate.

19. Are the proposed amendments to Auditing Standard No. 12 regarding a company's financial relationships and transactions with its executive officers appropriate? If not, why not?

Where transactions arise in entities that are not audited or are audited by another auditor, the same requirements should apply. 'Executive officers' is potentially a very wide group of people and examining their expense reimbursements is likely to be time consuming. Expense reviews should be focussed on detecting material misstatement. In recent years there have been many headlines regarding expense claims that were certainly evidence of poor corporate

governance, but they were generally immaterial to the financial statements. For this reason, the issue is primarily one for directors and the audit committee.

20. Are the other proposed amendments to PCAOB auditing standards appropriate? If not, why not?

28. It is difficult to answer this question without marked-up extracts from the relevant auditing standards. We encourage the PCAOB to include such extracts in future consultations, in line with good standard-setting practice.

21. Are the proposed standard and proposed amendments appropriate for audits of brokers and dealers? If not, why not?

22. Are there additional procedures specific to audits of brokers and dealers that should be included in the proposed standard and proposed amendments?

23. Should the auditor's communications to audit committees included in the proposed standard be applicable to audits of brokers and dealers? If not, provide examples and explanations for why the communication requirement should not be applicable for audits of brokers and dealers.

29. We do not comment on these questions

24. Is the Board's anticipated effective date appropriate?

25. Does the proposed effective date allow sufficient time for firms to incorporate the new requirements into their methodology, guidance and audit programs, and training for staff?

30. The proposed effective date is unrealistic. There will be no final standard before September 2012 at the very earliest and a year should be given for preparers to embed the necessary control mechanisms and for auditors to embed the requirements into their methodologies and conduct appropriate training.

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