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SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 19b-4

Proposed Rules

By

Public Company Accounting Oversight Board

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In accordance with Rule 19b-4 under the
Securities Exchange Act of 1934



1. Text of the Proposed Rules

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") Auditing Standard No. 18, *Related Parties* ("Auditing Standard No. 18" or the "standard"), amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other amendments to PCAOB auditing standards (collectively, referred to as the "standard and amendments" or the "proposed rules").¹ The proposed rules are attached as Exhibit A to this rule filing. In addition, the Board is also requesting the SEC's approval, pursuant to Section 103(a)(3)(C) of the Act, of the application of the proposed rules to audits of emerging growth companies ("EGCs"), as that term is defined in Section 3(a)(80) of the Securities Exchange Act of 1934. Section 104 of the Jumpstart Our Business Startups Act provides that any additional rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the actions will promote efficiency, competition, and capital formation." See Exhibit 3.

(b) Auditing Standard No. 18 supersedes the Board's auditing standard, AU sec. 334, *Related Parties*, and AU sec. 9334, *Related Parties: Auditing Interpretations of Section 334*.

(c) Not applicable.

¹ The amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "amendments regarding significant unusual transactions") and other amendments to PCAOB auditing standards (the "other amendments") are collectively referred to herein as the "amendments."

2. Procedures of the Board

(a) The Board approved the proposed rules and authorized them for filing with the SEC, at its open meeting on June 10, 2014. No other action by the Board is necessary for the filing of the proposed rules.

(b) Questions regarding this rule filing may be directed to Greg Scates, Deputy Chief Auditor (202/207-9114, scatesg@pcaobus.org), Brian F. Degano, Associate Chief Auditor (202/207-9113, deganob@pcaobus.org), Nicholas Grillo, Associate Chief Auditor (202/207-9104, grillon@pcaobus.org), Karen Buck Burgess, Counsel to the Chief Auditor (202/591-4168, burgessk@pcaobus.org), or Gail A. Pierce, Assistant General Counsel (202/591-4378, pierceg@pcaobus.org).

3. Board's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rules

(a) Purpose

The Board developed the standard and amendments because, as described more fully below, the Board believes its existing requirements need to be strengthened to heighten the auditor's attention to areas that have been associated with risks of fraudulent financial reporting and that also may pose increased risks of error. The Board has concluded that its existing requirements in the critical areas² do not contain sufficient required procedures and are not sufficiently risk-based, which can lead to inadequate auditor effort in the critical areas. The auditor, serving in the role as a gatekeeper³ in the financial reporting system, should be alert to

² A company's related party transactions, significant unusual transactions, and financial relationships and transactions with its executive officers, are collectively referred to herein as "the critical areas" or "these critical areas."

³ According to the SEC:

the possibility that transactions in these critical areas pose increased risks and, thus, require heightened scrutiny during the audit.⁴ Increased auditor attention to these critical areas should, in the Board's view, increase the likelihood of the auditor identifying material misstatements.

The standard and amendments being adopted by the Board include: the standard; the amendments regarding significant unusual transactions; and other amendments. As described below, the standard and amendments address:

- Relationships and Transactions with Related Parties;
- Significant Unusual Transactions; and
- Financial Relationships and Transactions with Executive Officers.

Relationships and Transactions with Related Parties: The standard addresses the auditing of relationships and transactions between a company and its related parties. A company's related

The federal securities laws, to a significant extent, make independent auditors "gatekeepers" to the public securities markets. These laws require, or permit us to require, financial information filed with us to be certified (or audited) by independent public accountants. Without an opinion from an independent auditor, the company cannot satisfy the statutory and regulatory requirements for audited financial statements and cannot sell its securities to the public. The auditor is the only professional that a company must engage before making a public offering of securities and the only professional charged with the duty to act and report independently from management.

See SEC Securities Act Release No. 33-7870, *Proposed Rule: Revision of the Commission's Auditor Independence Requirements* (June 30, 2000) at Section II.A. See also, SEC Securities Act Release No. 33-7919, *Final Rule: Revision of the Commission's Auditor Independence Requirements* (November 21, 2000) at Section III.A.

⁴ See, e.g., SEC AAER No. 3427, *In the Matter of the Application of Wendy McNeeley, CPA*, at 10–12 (December 13, 2012), <http://www.sec.gov/litigation/opinions/2012/34-68431.pdf>. That opinion states, in part, that the SEC and courts have repeatedly held that related party transactions require heightened scrutiny by auditors. See also *McCurdy v. SEC*, 396 F3d 1258, 1261 (D.C. Cir. 2005) (citing *Howard v. SEC*, 376 F3d 1136, 1149 (D.C. Cir. 2004) noting that related-party transactions "are viewed with extreme skepticism in all areas of finance," aff'g *James Thomas McCurdy, CPA*, 57 S.E.C. 277 (2004)).

party transactions could pose increased risks of material misstatement, as their substance might differ materially from their form.⁵ Related party transactions also may involve difficult measurement and recognition issues that can lead to errors in financial statements. Such transactions potentially provide more of an opportunity for management to act in its own interests, rather than in the interests of the company and its investors. Moreover, in some instances, related party transactions have been used to engage in fraudulent financial reporting and to conceal misappropriation of assets – types of misstatements that are relevant to the auditor's consideration of fraud.⁶ The importance to investors of auditing related party transactions is reflected in Section 10A of the Securities Exchange Act of 1934 (the "Exchange Act"), which requires each audit of financial statements of an issuer to include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."⁷ The standard is designed to strengthen auditor performance requirements by setting forth specific procedures for the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. The standard supersedes the Board's existing standard, AU sec. 334, *Related Parties*, (the "existing standard"), which has not been

⁵ See also Exhibit 1.II.D for additional discussion of such risks.

⁶ See paragraph .06 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

⁷ See Section 10A(a)(2) of the Exchange Act, 15 U.S.C. §78j-1(a)(2), which was added to the Exchange Act by the Private Securities Litigation Reform Act, enacted by Congress in 1995.

substantively updated since it was issued in 1983.⁸

Significant Unusual Transactions: The amendments regarding significant unusual transactions recognize that a company's significant unusual transactions can create complex accounting and financial statement disclosure issues that could pose increased risks of material misstatement. In some instances, significant unusual transactions have been used to engage in fraudulent financial reporting. For example, significant unusual transactions, especially those close to period end that pose difficult "substance-over-form" questions, may be entered into to obscure a company's financial position or operating results.⁹ In such cases, management may place more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction. Existing audit requirements regarding significant unusual transactions are principally contained in AU sec. 316. The amendments regarding significant unusual transactions include specific procedures that are designed to improve the auditor's identification and evaluation of a company's significant unusual transactions and, in particular, to enhance the auditor's understanding of the business purpose (or the lack thereof) of such transactions.

Financial Relationships and Transactions with Executive Officers: The other amendments include, among other things, improved audit procedures addressing a company's

⁸ AU sec. 334 is one of the Board's interim auditing standards. Shortly after the Board's inception, the Board adopted the existing standards of the American Institute of Certified Public Accountants ("AICPA"), as in existence on April 16, 2003, on an initial, transitional basis. *See Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (April 18, 2003).

⁹ See, e.g., SEC AAER No. 1631, *In the Matter of Dynegy Inc., Respondent* (September 24, 2002), <http://www.sec.gov/litigation/admin/33-8134.htm>; and SEC AAER No. 2775, *In the Matter of Michael Lowther, CPA, Respondent* (January 28, 2008), <http://www.sec.gov/litigation/admin/2008/34-57210.pdf>.

financial relationships and transactions with its executive officers. A company's executive officers are in a unique position to influence a company's accounting and disclosures. A company's financial relationships and transactions with its executive officers (as one example, executive officer compensation) can create incentives and pressures for executive officers to meet financial targets, which can result in risks of material misstatement to a company's financial statements. The other amendments modify Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, to require the auditor to perform specific procedures, as part of the auditor's risk assessment process,¹⁰ to obtain an understanding of the company's financial relationships and transactions with its executive officers. However, these amendments do not require the auditor to make any determination regarding the reasonableness of compensation arrangements or recommendations regarding compensation arrangements.

The auditor's efforts regarding these critical areas are, in many ways, complementary. For example, the auditor's efforts to identify and evaluate a company's significant unusual transactions could identify information that indicates that a related party or relationship or transaction with a related party previously undisclosed to the auditor might exist. Likewise, obtaining an understanding of a company's financial relationships and transactions with its executive officers also could identify such information. The standard and amendments direct the auditor to consider the linkage between a company's relationships and transactions with its related parties, its significant unusual transactions, and its financial relationships and transactions

¹⁰ In 2010, the Board adopted eight standards on assessing and responding to risk in an audit (the "risk assessment standards"), which cover the entire audit process, from initial planning activities to evaluating audit evidence to forming the opinion to be expressed in the auditor's report. See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release 2010-004 (August 5, 2010).

with its executive officers. This complementary audit approach should help the auditor "connect the dots" between different aspects of the audit. Both the auditor and the investor benefit from a comprehensive and consistent examination of the critical areas, not only because of the risk of material misstatement due to fraud, but also because these transactions, due to their nature, could pose a risk of material misstatement due to error.

In addition, the standard imposes new requirements relating to the auditor's communications with the company's audit committee. These changes recognize that the new auditor performance requirements contained in the standard relate to areas of the audit that warrant discussion with the audit committee. The new communication requirements in the standard work in concert with the communication requirements in Auditing Standard No. 16, *Communications with Audit Committees*,¹¹ and require the auditor to include, as one of the auditor's required communications with the audit committee, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships with related parties. Additionally, the amendments regarding significant unusual transactions are intended to enhance the discussion between the auditor and the audit committee regarding the business purpose (or the lack thereof) of a company's significant unusual transactions required by Auditing Standard No. 16.¹² Similarly, requiring the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive

¹¹ See *Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU Sec. 380*, PCAOB Release No. 2012-004 (August 15, 2012).

¹² See paragraph 13.d. of Auditing Standard No. 16, as revised by the amendments regarding significant unusual transactions. As revised, the auditor is required to communicate to the audit committee the auditor's understanding of the business purpose (or the lack thereof) of significant unusual transactions.

officers is intended to improve the auditor's identification of fraud risks or other significant risks, which are also already required to be discussed with the audit committee pursuant to Auditing Standard No. 16.¹³

Recommendations to improve the requirements in the critical areas have been longstanding. The standard and amendments reflect public input, including discussions with the Board's Standing Advisory Group ("SAG")¹⁴ and comments received on a proposal in 2012¹⁵ and a reproposal in 2013.¹⁶ A wide range of commenters, including audit firms serving companies of

¹³ See paragraph 9 of Auditing Standard No. 16, which requires the auditor to discuss with the audit committee the significant risks identified during the auditor's risk assessment procedures.

¹⁴ The SAG discussed the topic of related parties at a number of its meetings prior to the issuance of the Board's proposal, including at meetings occurring on: September 8-9, 2004; June 21, 2007; and October 14-15, 2009. The SAG also discussed the proposal and reproposal on May 17, 2012 and May 15, 2013, respectively. See the SAG Meeting Archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>.

¹⁵ See *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (the "proposing release" or the "proposal"), PCAOB Release No. 2012–001 (February 28, 2012), http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2012-001_Related_Parties.pdf, which included: (i) an auditing standard, *Related Parties* ("proposed standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions; and (iii) other amendments to PCAOB auditing standards (collectively, these are referred to as the "proposed standard and amendments").

¹⁶ See *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (the "reproposing release" or the "reproposal"), PCAOB Release No. 2013–004 (May 7, 2013), http://pcaobus.org/Rules/Rulemaking/Docket038/Release%202013-004_Related%20Parties.pdf, which included: (i) an auditing standard, *Related Parties* ("reproposed standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions; and (iii) other proposed amendments to PCAOB auditing standards (collectively, these are referred to as the "reproposed standard and amendments").

all sizes, were supportive overall of the need to improve existing standards in these critical areas. During the standard-setting process, the Board considered various alternatives, including some proposed by commenters, in order to develop new requirements that would promote investor protection, but that also would provide opportunities for efficient implementation. After considering the comments received on the reproposal, the Board is adopting the standard and amendments substantially as repropoed.

In general, the Board's new performance requirements for auditors are designed to promote heightened scrutiny in the critical areas, with the goal of promoting the auditor's ability to identify, evaluate, and respond to risks of material misstatement. The new requirements represent a targeted approach, focusing on areas that have historically reflected increased risks of fraudulent financial reporting and that also may pose increased risks of error. The Board believes that the standard and amendments, which are aligned with the risk assessment standards, represent a cohesive audit approach that will contribute to audit effectiveness and provide opportunities for an efficient implementation. In the Board's view, the new requirements further the Board's overall mission of improving audit quality, protecting the interests of investors, and furthering the public interest in the preparation of informative, accurate, and independent audit reports.¹⁷

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

¹⁷ See Section 101 of the Act, Pub. L. 107-204, 116 Stat. 745. Under Section 101 of the Act, the mission of the PCAOB is "to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports...."

4. Board's Statement on Burden on Competition

Not applicable. The Board's consideration of the economic impacts of the standard and amendments are discussed in Exhibit 1.II.D.

5. Board's Statement on Comments on the Proposed Rules Change Received From Members, Participants or Others

The Board released the proposal for public comment on February 28, 2012. See Exhibit 2(a)(A). The Board received 37 written comment letters relating to the proposal. See Exhibits 2(a)(B) and 2(a)(C). The Board discussed the proposal with the SAG on May 17, 2012. See Exhibit 2(a)(D).

The Board released the reproposal for public comment on May 7, 2013. See Exhibit 2(a)(E). The Board received 24 written comment letters relating to the reproposal. See Exhibits 2(a)(F) and 2(a)(G). The Board discussed the reproposal with the SAG on May 15, 2013. See Exhibit 2(a)(H).

6. Extension of Time Period for Commission Action

The Board does not consent to an extension of the time period specified in Section 19(b)(2) of the Securities Exchange Act of 1934.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

Not applicable.

9. Exhibits

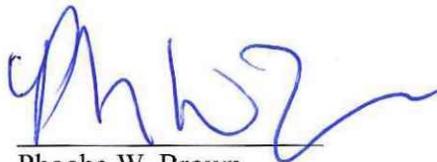
- Exhibit A – Text of the Proposed Rules.
- Exhibit 1 – Form of Notice of Proposed Rules for Publication in the Federal Register.
- Exhibit 2(a)(A) – PCAOB Release No. 2012-001 (Proposing Release).
- Exhibit 2(a)(B) – Alphabetical List of Commenters on the Proposal in PCAOB Release No. 2012-001.
- Exhibit 2(a)(C) – Written comments on the Proposal in PCAOB Release No. 2012-001.
- Exhibit 2(a)(D) – Transcript from SAG meeting on May 17, 2012.
- Exhibit 2(a)(E) – PCAOB Release No. 2013-004 (Reproposing Release).
- Exhibit 2(a)(F) – Alphabetical List of Commenters on the Reproposal in PCAOB Release No. 2013-004.
- Exhibit 2(a)(G) – Written comments on the Reproposal in PCAOB Release No. 2013-004.
- Exhibit 2(a)(H) – Transcript from SAG meeting on May 15, 2013.
- Exhibit 3 – PCAOB Release No. 2014-002 (Adopting Release).

10. Signatures

Pursuant to the requirements of the Act and the Securities Exchange Act of 1934, as amended, the Board has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

By:



Phoebe W. Brown
Secretary

July 10, 2014

EXHIBIT A – TEXT OF THE PROPOSED RULES

Below is Auditing Standard No. 18 and the amendments

Auditing Standard No. 18

Related Parties

Introduction

1. This standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.¹

Objective

2. The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.²

Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties

3. The auditor should 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 in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing*

¹ The auditor should look to the requirements of the U.S. Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties" and the financial statement disclosure requirements with respect to related parties.

² See, e.g., paragraphs 30-31 of Auditing Standard No. 14, *Evaluating Audit Results*. See also paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

Risks of Material Misstatement. The procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company's process (paragraph 4);
- b. Performing inquiries (paragraphs 5-7); and
- c. Communicating with the audit engagement team and other auditors (paragraphs 8-9).

Note: 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.

Note: Performing the risk assessment procedures described in paragraphs 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 related parties and relationships and transactions with related parties.

Obtaining an Understanding of the Company's Process

4. In conjunction with obtaining an understanding of internal control over financial reporting, the auditor should obtain an understanding of the company's process for:³

³ See, e.g., paragraph 18 of Auditing Standard No. 12, which requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures. See also paragraph 20 of Auditing Standard No. 12, which states that obtaining an understanding of internal control

- a. Identifying related parties and relationships and transactions with related parties;
- b. Authorizing and approving transactions with related parties; and
- c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

Performing Inquiries

5. The auditor should inquire of management regarding:⁴
 - a. The names of the company's related parties during the period under audit, including changes from the prior period;
 - b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);
 - c. The nature of any relationships, including ownership structure, between the company and its related parties;
 - d. The transactions entered into, modified, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;
 - e. The business purpose for entering into a transaction with a related party versus an unrelated party;

includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

⁴ See also AU sec. 333, *Management Representations*. Obtaining such representations from management complements the performance of procedures in paragraph 5 and is not a substitution for those inquiries.

- f. 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; and
 - g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.
6. The auditor should inquire of others within the company regarding their knowledge of the matters in paragraph 5 of this standard. The auditor should identify others within the company⁵ to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding:
- a. The company's related parties or relationships or transactions with related parties;
 - b. The company's controls over relationships or transactions with related parties; and
 - c. The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.⁶
7. The auditor should inquire of the audit committee,⁷ or its chair, regarding:

⁵ Examples of "others" within the company who may have such knowledge include: personnel in a position to initiate, process, or record transactions with related parties and those who supervise or monitor such personnel; internal auditors; in-house legal counsel; the chief compliance/ethics officer or person in equivalent position; and the human resources director or person in equivalent position.

⁶ For purposes of this standard, the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties.

⁷ The term "audit committee" has the same meaning as the term used in Auditing Standard No. 16, *Communications with Audit Committees*.

- a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
- b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

Communicating with the Audit Engagement Team and Other Auditors

8. The auditor should communicate to engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.⁸

9. 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.⁹ The auditor also should inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.

Identifying and Assessing Risks of Material Misstatement

⁸ This communication, which can be more effective when it occurs at an early stage of the audit, complements the discussion among engagement team members regarding risks of material misstatement in accordance with paragraph 49 of Auditing Standard No. 12. See also paragraph 5 of Auditing Standard No. 10, *Supervision of the Audit Engagement*, which establishes requirements regarding supervision of the engagement team members, including directing engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities.

⁹ See AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements.

10. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level.¹⁰ This includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties.

Note: In identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4-9 of this standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

Responding to the Risks of Material Misstatement

11. The auditor must design and implement audit responses that address the identified and assessed risks of material misstatement.¹¹ This includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.¹²

Note: The auditor also should look to the requirements in paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, for related

¹⁰ See paragraph 59 of Auditing Standard No. 12.

¹¹ See paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

¹² See generally, Auditing Standard No. 13 and paragraph 17 of Auditing Standard No. 15, *Audit Evidence*, which provides that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). For such related party transactions, AU sec. 316.67 requires 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.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk

12. For each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:
 - a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
 - b. 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;
 - c. Determine whether any exceptions to the company's established policies or procedures were granted;¹³

¹³ Information gathered while obtaining an understanding of the company also might assist the auditor in identifying agreements prohibiting or restricting related party transactions (for example, loans or advances to related parties).

- d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;¹⁴ and
- e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Note: 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 in paragraph 12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

Intercompany Accounts

- 13. The auditor should perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

Note: The procedures performed should address the risks of material misstatement associated with the company's intercompany accounts.

Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties

¹⁴ Examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.

14. The auditor should evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, taking into account the information gathered during the audit.¹⁵ As part of this evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

Note: Appendix A contains examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

15. If the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist.¹⁶ These procedures should extend beyond inquiry of management.

¹⁵ Information obtained from identifying and evaluating a company's significant unusual transactions and obtaining an understanding of a company's financial relationships and transactions with its executive officers could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

¹⁶ See paragraph 29 of Auditing Standard No. 15, which states that if audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has

16. If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:
- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
 - b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;¹⁷
 - c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
 - d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
 - e. Perform the procedures required by paragraph 12 of this standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk; and

doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

¹⁷ See AU sec. 333.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.

- f. Perform the following procedures, taking into account the information gathered from performing the procedures in a. through e. above:
- i. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
 - ii. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk;¹⁸ and
 - iii. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1.

Evaluating Financial Statement Accounting and Disclosures

17. The auditor must evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. This includes evaluating whether the financial statements contain the information regarding relationships and transactions with related

¹⁸ See paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.

parties essential for a fair presentation in conformity with the applicable financial reporting framework.¹⁹

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions

18. If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.²⁰

Note: Transactions with related parties might not be conducted on terms equivalent to those prevailing in arm's-length transactions (e.g., a company may receive services from a related party without cost). Except for routine transactions, it may not be possible for management to determine whether a particular transaction would have taken place, or what the terms and manner of settlement would have been, if the parties had not been related. Accordingly, it may be difficult for the auditor to obtain sufficient appropriate audit evidence to substantiate management's assertion that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. A preface to a

¹⁹ See paragraphs 30-31 of Auditing Standard No. 14.

²⁰ See paragraph .06.1. of AU sec. 333, which requires the auditor to obtain written representations from management if the financial statements include such an assertion. Representations from management alone are not sufficient appropriate audit evidence. See also paragraphs .35-.36 of AU sec. 508, *Reports on Audited Financial Statements*.

statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

Communications with the Audit Committee

19. The auditor should communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.²¹ The auditor also should communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and
- e. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

²¹ See Auditing Standard No. 16 regarding the timing of the communications to the audit committee.

APPENDIX A – Examples of Information and Sources of Information That May Be Gathered During the Audit That Could Indicate That Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor Might Exist

A1. This Appendix contains examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Specifically, paragraph A2. of this Appendix contains examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Similarly, paragraph A3. contains examples of sources that could contain such information. The examples contained in this Appendix are not intended to represent a comprehensive listing.

A2. The following are examples of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Buying or selling goods or services at prices that differ significantly from prevailing market prices;
- Sales transactions with unusual terms, including unusual rights of return or extended payment terms generally not offered;
- "Bill and hold" type transactions;
- Borrowing or lending on an interest-free basis or with no fixed repayment terms;
- Occupying premises or receiving other assets or rendering or receiving management services when no consideration is exchanged;
- Engaging in a nonmonetary transaction that lacks commercial substance;

- Sales without economic substance (e.g., funding the other party to the transaction to facilitate collection of the sales price, or entering into a transaction shortly prior to period end and unwinding that transaction shortly after period end);
- Loans to parties that, at the time of the loan transaction, do not have the ability to repay and possess insufficient or no collateral;
- Loans made without prior consideration of the ability of the party to repay;
- A subsequent repurchase of goods that indicates that at the time of sale an implicit obligation to repurchase may have existed that would have precluded revenue recognition or sales treatment;
- Advancing company funds that are used directly or indirectly to pay what would otherwise be an uncollectible loan or receivable;
- Sales at below market rates to an intermediary whose involvement serves no apparent business purpose and who, in turn, sells to the ultimate customer at a higher price, with the intermediary (and ultimately its principals) retaining the difference;
- Guarantees and guarantor relationships outside the normal course of business; or
- Transactions between two or more entities in which each party provides and receives the same or similar amounts of consideration (e.g., round-trip transactions).

A3. The following are examples of sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies;

- Disclosures contained on the company's website;
- Confirmation responses and responses to inquiries of the company's lawyers;
- Tax filings and related correspondence;
- Invoices and correspondence received from the company's professional advisors, for example, attorneys and consulting firms;
- Relevant internal auditors' reports;
- Conflicts-of-interest statements from management and others;
- Shareholder registers that identify the company's principal shareholders;
- Life insurance policies purchased by the company;
- Records of the company's investments, pension plans, and other trusts established for the benefit of employees, including the names of the officers and trustees of such investments, pension plans, and other trusts;
- Contracts or other agreements (including, for example, partnership agreements and side agreements or other arrangements) with management;
- Contracts and other agreements representing significant unusual transactions;
- Significant contracts renegotiated by the company during the period under audit;
- Records from a management, audit committee, or board of directors' whistleblower program;
- Expense reimbursement documentation for executive officers; or
- The company's organizational charts.

Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

A. Identifying Significant Unusual Transactions

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

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, as amended, is amended as follows:

In paragraph 14:

- The first bullet point is replaced with:

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 those that result in late or unusual journal entries;^{10A/} and

- Footnote 10A is added at the end of the first bullet:

^{10A/} See paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

Auditing Standard No. 9, Audit Planning

Auditing Standard No. 9, *Audit Planning*, as amended, is amended as follows:

In paragraph 12, subparagraph a. is replaced with:

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.^{14/}

Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

- a. In paragraph 13:
 - The fifth bullet point is replaced with:

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");^{7A/} and
 - Footnote 7A is added at the end of the fifth bullet:

^{7A/} See AU secs. 316.66-.67A.

- b. In paragraph 56.a.:
 - In item (6), delete the word "and" at the end of the item.
 - In item (7), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add Item (8):

(8) Whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties.^{31A/}
 - Add footnote 31A at the end of item (8):

^{31A/} See AU secs. 316.66-.67A.

- c. In paragraph 56.b.:

- In item (3), delete the word "and" at the end of the item.
 - In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add item (5):
 - (5) Whether the company has entered into any significant unusual transactions.
- d. In paragraph 56.c.:
- In item (3), delete the word "and" at the end of the item.
 - In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add item (5):
 - (5) Whether the company has entered into any significant unusual transactions.
- e. In paragraph 57, the third bullet point is replaced with:
Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements, a significant unusual transaction, or a significant related party transaction; and
- f. Paragraph 71.g., is replaced with:
Whether the risk involves significant unusual transactions.
- g. Paragraph 73A is added after paragraph 73:
73A. The auditor should obtain an understanding of the controls that management has established to identify, authorize and approve, and

account for and disclose significant unusual transactions in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18-40 and 72-73 of this standard.

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, as amended, is amended as follows:

- a. The second sentence of footnote 3 to paragraph 5.d. is replaced with:
See also paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and paragraphs .04 and .06 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.
- b. Paragraph 15.c. is replaced with:
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 may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets (AU secs. 316.66-.67A).

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. The first item in paragraph .85A.2, section a., under "Opportunities" is replaced with the following two items:
 - Related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business)
 - Significant transactions with related parties whose financial statements are not audited or are audited by another firm
- b. The fourth item in paragraph .85A.2, section a., under "Opportunities" is replaced with:
 - Significant or highly complex transactions or significant unusual transactions, especially those close to period end, that pose difficult "substance-over-form" questions
- c. The following item is added as the last item to paragraph .85A.2, section a., under "Opportunities":
 - Contractual arrangements lacking a business purpose

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

- a. In paragraph .55, Appendix B, paragraph B1., the tenth bullet is replaced with the following two bullets:
 - The occurrence of infrequent transactions
 - The occurrence of significant unusual transactions

B. Evaluating Significant Unusual Transactions

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material*

Misstatement, as amended, is amended as follows:

- a. Paragraph 11A is added after paragraph 11:

11A. *Responding to Risks Associated with Significant Unusual Transactions.*

Paragraph 71.g. of Auditing Standard No. 12 indicates that one of the factors to be evaluated in determining significant risks is whether the risk involves significant unusual transactions. Also, AU secs. 316.66-.67A establish requirements for performing procedures to respond to fraud risks regarding significant unusual transactions. Because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-.67A.

Auditing Standard No. 16, *Communications with Audit Committees*

Auditing Standard No. 16, *Communications with Audit Committees*, is amended as

follows:

- a. In paragraph 13.d., the phrase "rationale for" is replaced with the phrase "purpose (or the lack thereof) of."

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

a. Paragraph .66 is replaced with:

.66 Evaluating whether the business purpose for significant unusual transactions indicates that the transactions may have been entered into to engage in fraud. 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.

Note: The auditor's identification of significant unusual transactions should take into account information obtained from: (a) the risk assessment procedures required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial reporting) and (b) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

Note: The auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. See paragraphs 14-16 of Auditing Standard No. 18, *Related Parties*. Appendix A of Auditing Standard No. 18, *Related Parties*, includes examples of such information and examples of sources of such information.

b. Paragraph .66A is added after paragraph .66:

.66A The auditor should design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. The procedures should include:

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;^{fn 24A} and

- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

Note: Paragraph 11A of Auditing Standard No. 13 requires the auditor to take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures.

- c. Footnote 24A is added after subparagraph c. of paragraph .66A

^{fn 24A} Examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

- d. Paragraph .67 is replaced with:

.67 The auditor should evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. In making that evaluation, the auditor should evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);

- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor;^{fn 25A}
- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party of the company;
- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);
- 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 other, more clearly independent, parties on an arm's-length basis;
- The transaction enables the company to achieve certain financial targets;
- 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); and

- Management has discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Note: Paragraphs 20-23 of Auditing Standard No. 14, *Evaluating Audit Results*, provide requirements regarding the auditor's evaluation of whether identified misstatements might be indicative of fraud.

- e. Footnote 25 is deleted and footnote 25A is added at the end of the third bullet in paragraph .67:

^{fn 25A} Related parties or relationships or transactions with related parties previously undisclosed to the auditor includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties. Auditing Standard No. 18, *Related Parties*, requires the auditor to perform certain procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

- f. Paragraph .67A is added after paragraph 67:

.67A 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 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.^{fn 25B}

Note: The auditor considers management's disclosure regarding significant unusual transactions in other parts of the company's Securities and Exchange Commission filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

- g. Footnote 25B is added at the end of paragraph.67A:

^{fn 25B} See paragraphs 30-31 of Auditing Standard No. 14.

Other Amendments to PCAOB Auditing Standards

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

- a. The following sentence is added to the end of footnote 3 of paragraph 4:
Also, Auditing Standard No. 18, *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.
- b. In paragraph 10, the note following the final bullet is deleted.
- c. Paragraph 10A is added after paragraph 10:

10A. To assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's financial relationships and transactions with its **executive officers** (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the Securities and Exchange Commission and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.

d. In paragraph 11:

- The third bullet is replaced with:
Obtaining an understanding of compensation arrangements with senior management other than executive officers referred to in paragraph 10A, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses;
- In the fourth bullet, delete the period (.) and add a semicolon (;) at the end of the bullet.
- Add a fifth bullet:

Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and

- Add a sixth bullet:

Obtaining an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

- e. In Appendix A, paragraph A3A is added after paragraph A3:

A3A. Executive officer – For issuers, the president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policy-making functions for the company. (See Rule 3b-7 under the Exchange Act.) For brokers and dealers, the term "executive officer" includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions. (See Schedule A of Form BD.)

Auditing Standard No. 16, *Communications with Audit Committees*

Auditing Standard No. 16, *Communications with Audit Committees*, is amended as follows:

- a. The phrase "AU sec. 334, *Related Parties*" in footnote 25 is replaced with the phrase "Auditing Standard No. 18, *Related Parties*."
- b. The following bullet is inserted after the third bullet in Appendix B:
 - Auditing Standard No. 18, *Related Parties*, paragraphs 7 and 19.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows:

- a. The following bullet is added to the end of paragraph .09:
 - The predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions.^{fn 5A}
- b. Add the following footnote to the end of paragraph .09:

^{fn 5A} Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, describes significant unusual transactions.
- c. In paragraph .11, replace the fifth sentence with:

The predecessor auditor should ordinarily permit the successor auditor to review working papers, including documentation of planning, internal control, audit results, and other matters of continuing accounting and auditing significance, such as the working papers containing an analysis of balance sheet accounts, those relating to contingencies, related parties, and significant unusual transactions.

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. The heading before paragraph .79 is replaced with:

Communication about Possible Fraud to Management, the Audit Committee, the Securities and Exchange Commission, and Others^{fn 37}

- b. Paragraph .81A is added after paragraph .81:

.81A The auditor has a responsibility, under certain conditions, to disclose possible fraud to the Securities and Exchange Commission to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change and the fraud or related risk factors constitute a reportable event or are the source of a disagreement, as these terms are defined in Item 304 of Regulation S-K and Item 16F of Form 20-F. These requirements also include reports that may be required pursuant to Section 10A(b) of the Securities Exchange Act of 1934 relating to an illegal act that the auditor concludes has a material effect on the financial statements.

- c. For paragraph .82:

- Footnotes 39 and 41 are deleted.
- The paragraph is replaced with:

.82 The auditor also may have a duty to disclose the existence of possible fraud to parties outside the entity in the following circumstances:

- a. To a successor auditor when the successor makes inquiries in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors*.^{fn 40}
- b. In response to a subpoena.
- c. To a funding agency or other specified agency in accordance with requirements for the audits of companies that receive governmental financial assistance.

d. The following item is added to paragraph .85A.2, section b., under

"Opportunities":

- o The exertion of dominant influence by or over a related party

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), as amended, is amended as follows:

- a. Footnote 2 to paragraph .27 is replaced with:

Auditing Standard No. 18, *Related Parties*, establishes requirements regarding the auditor's evaluation of relationships and transactions between the company and its related parties.

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

- a. The third sentence of paragraph .03 is replaced with:
- For example, after the auditor performs the procedures described in Auditing Standard No. 18, *Related Parties*, the auditor should obtain a written representation that management has no knowledge of any relationships or transactions with related parties that have not been properly accounted for and adequately disclosed. The auditor should obtain this written representation even if the results of those procedures indicate that relationships and transactions with related parties have been properly accounted for and adequately disclosed.
- b. In paragraph .06:
- Subparagraph c. is replaced with:
Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
 - Subparagraph f. is replaced with:
Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.
 - Subparagraph l. is replaced with:
Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.^{fn9}
- c. Footnote 9 to paragraph .06 is replaced with:
- See paragraph 18 of Auditing Standard No. 18, *Related Parties*.

- d. The second sentence in paragraph 4 of Appendix A is replaced with:
Examples are fraud, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in Auditing Standard No. 18, *Related Parties*.
- e. In paragraph 6 of Appendix A:
- Item 2.a. is replaced with:
Financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
 - Item 11.d. is added:
Side agreements or other arrangements (either written or oral) that have not been disclosed to you.

AU sec. 334, "Related Parties"

SAS No. 45, Omnibus Statement on Auditing Standards — 1983 (AU sec. 334, "Related Parties"), as amended, is superseded.

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," as amended, is superseded.

AU sec. 336, "Using the Work of a Specialist"

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336, "Using the Work of a Specialist"), as amended, is amended as follows:

- a. Footnote 6 of paragraph .10 is replaced with:

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.

AU sec. 560, "Subsequent Events"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 560, "Subsequent Events" (AU sec. 560, "Subsequent Events"), as amended, is amended as follows:

- a. In paragraph .12b.:
 - Item (v) is added:

Whether there have been any changes in the company's related parties.
 - Item (vi) is added:

Whether there have been any significant new related party transactions.
 - Item (vii) is added:

Whether the company has entered into any significant unusual transactions.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

- a. In paragraph .24:
 - Subparagraph g. is replaced with:

Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
 - Subparagraph j. is replaced with:

Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.

- Subparagraph m. is replaced with:

Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

- b. The second sentence of paragraph C5 of paragraph .56 is replaced with:
Examples are *fraud*, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in Auditing Standard No. 18, *Related Parties*.
- c. Within paragraph C6 of paragraph .56, within the first illustrative representation letter (1.) for a review of interim financial information (statements):
- Item 2.a. is replaced with:
All financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
- d. Within paragraph C6 of paragraph .56, within the second illustrative representation letter (2.) for a review of interim financial information (statements):
- Item 2.a. is replaced with:
All financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
 - Item 12.d. is added:

Side agreements or other arrangements (either written or oral) that have not been disclosed to you.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-XXXXX; File No. PCAOB 2014-01)

[Date]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules Relating to Auditing Standard No. 18, *Related Parties*, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Amendments to PCAOB Auditing Standards

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on July 10, 2014, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "SEC" or the "Commission") the proposed rules described in items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rules

On June 10, 2014, the Board adopted Auditing Standard No. 18, *Related Parties* ("Auditing Standard No. 18" or the "standard"), amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other amendments to PCAOB auditing standards (collectively referred to as, the "standard and amendments" or the "proposed rules"). The amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "amendments regarding significant unusual transactions") and other amendments to PCAOB auditing standards (the "other amendments") are collectively referred to herein as the "amendments." The text of the proposed rules is set out below.

Auditing Standard No. 18

Related Parties

Introduction

1. This standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.¹

Objective

2. The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.²

Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties

3. The auditor should 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 in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. The procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company's process (paragraph 4);
- b. Performing inquiries (paragraphs 5-7); and

¹ The auditor should look to the requirements of the U.S. Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties" and the financial statement disclosure requirements with respect to related parties.

² See, e.g., paragraphs 30-31 of Auditing Standard No. 14, *Evaluating Audit Results*. See also paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

- c. Communicating with the audit engagement team and other auditors (paragraphs 8-9).

Note: 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.

Note: Performing the risk assessment procedures described in paragraphs 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 related parties and relationships and transactions with related parties.

Obtaining an Understanding of the Company's Process

4. In conjunction with obtaining an understanding of internal control over financial reporting, the auditor should obtain an understanding of the company's process for:³
 - a. Identifying related parties and relationships and transactions with related parties;
 - b. Authorizing and approving transactions with related parties; and
 - c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

³ See, e.g., paragraph 18 of Auditing Standard No. 12, which requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures. See also paragraph 20 of Auditing Standard No. 12, which states that obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

Performing Inquiries

5. The auditor should inquire of management regarding:⁴
- a. The names of the company's related parties during the period under audit, including changes from the prior period;
 - b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);
 - c. The nature of any relationships, including ownership structure, between the company and its related parties;
 - d. The transactions entered into, modified, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;
 - e. The business purpose for entering into a transaction with a related party versus an unrelated party;
 - f. 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; and
 - g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.
6. The auditor should inquire of others within the company regarding their knowledge of the matters in paragraph 5 of this standard. The auditor should identify others within the company⁵

⁴ See also AU sec. 333, *Management Representations*. Obtaining such representations from management complements the performance of procedures in paragraph 5 and is not a substitution for those inquiries.

⁵ Examples of "others" within the company who may have such knowledge include: personnel in a position to initiate, process, or record transactions with related parties and

to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding:

- a. The company's related parties or relationships or transactions with related parties;
 - b. The company's controls over relationships or transactions with related parties; and
 - c. The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.⁶
7. The auditor should inquire of the audit committee,⁷ or its chair, regarding:
- a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
 - b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

Communicating with the Audit Engagement Team and Other Auditors

8. The auditor should communicate to engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.⁸

those who supervise or monitor such personnel; internal auditors; in-house legal counsel; the chief compliance/ethics officer or person in equivalent position; and the human resources director or person in equivalent position.

⁶ For purposes of this standard, the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties.

⁷ The term "audit committee" has the same meaning as the term used in Auditing Standard No. 16, *Communications with Audit Committees*.

⁸ This communication, which can be more effective when it occurs at an early stage of the audit, complements the discussion among engagement team members regarding risks of

9. 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.⁹ The auditor also should inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.

Identifying and Assessing Risks of Material Misstatement

10. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level.¹⁰ This includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties.

Note: In identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the

material misstatement in accordance with paragraph 49 of Auditing Standard No. 12. See also paragraph 5 of Auditing Standard No. 10, *Supervision of the Audit Engagement*, which establishes requirements regarding supervision of the engagement team members, including directing engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities.

⁹ See AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements.

¹⁰ See paragraph 59 of Auditing Standard No. 12.

procedures in paragraphs 4-9 of this standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

Responding to the Risks of Material Misstatement

11. The auditor must design and implement audit responses that address the identified and assessed risks of material misstatement.¹¹ This includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.¹²

Note: The auditor also should look to the requirements in paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). For such related party transactions, AU sec. 316.67 requires 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.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk

12. For each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:

¹¹ See paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

¹² See generally, Auditing Standard No. 13 and paragraph 17 of Auditing Standard No. 15, *Audit Evidence*, which provides that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

- a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. 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;
- c. Determine whether any exceptions to the company's established policies or procedures were granted;¹³
- d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;¹⁴ and
- e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Note: 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 in paragraph 12 for only a selection of transactions from each

¹³ Information gathered while obtaining an understanding of the company also might assist the auditor in identifying agreements prohibiting or restricting related party transactions (for example, loans or advances to related parties).

¹⁴ Examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.

aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

Intercompany Accounts

13. The auditor should perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

Note: The procedures performed should address the risks of material misstatement associated with the company's intercompany accounts.

Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties

14. The auditor should evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, taking into account the information gathered during the audit.¹⁵ As part of this evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

Note: Appendix A contains examples of information and sources of information that may be gathered during the audit that could indicate that related parties or

¹⁵ Information obtained from identifying and evaluating a company's significant unusual transactions and obtaining an understanding of a company's financial relationships and transactions with its executive officers could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

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

15. If the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist.¹⁶ These procedures should extend beyond inquiry of management.

16. If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;¹⁷

¹⁶ See paragraph 29 of Auditing Standard No. 15, which states that if audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

¹⁷ See AU sec. 333.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.

- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of this standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk; and
- f. Perform the following procedures, taking into account the information gathered from performing the procedures in a. through e. above:
 - i. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
 - ii. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk;¹⁸ and
 - iii. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82, AU sec. 317, *Illegal Acts by*

¹⁸ See paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.

Clients, and Section 10A of the Securities Exchange Act of 1934, 15
U.S.C. §78j-1.

Evaluating Financial Statement Accounting and Disclosures

17. The auditor must evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. This includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.¹⁹

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions

18. If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.²⁰

Note: Transactions with related parties might not be conducted on terms equivalent to those prevailing in arm's-length transactions (e.g., a company may receive services from a related party without cost). Except for routine transactions, it may not be possible for management to determine whether a

¹⁹ See paragraphs 30-31 of Auditing Standard No. 14.

²⁰ See paragraph .06.1. of AU sec. 333, which requires the auditor to obtain written representations from management if the financial statements include such an assertion. Representations from management alone are not sufficient appropriate audit evidence. See also paragraphs .35-.36 of AU sec. 508, *Reports on Audited Financial Statements*.

particular transaction would have taken place, or what the terms and manner of settlement would have been, if the parties had not been related. Accordingly, it may be difficult for the auditor to obtain sufficient appropriate audit evidence to substantiate management's assertion that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. A preface to a statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

Communications with the Audit Committee

19. The auditor should communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.²¹ The auditor also should communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-

²¹ See Auditing Standard No. 16 regarding the timing of the communications to the audit committee.

length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and

- e. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

APPENDIX A – Examples of Information and Sources of Information That May Be Gathered During the Audit That Could Indicate That Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor Might Exist

A1. This Appendix contains examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Specifically, paragraph A2. of this Appendix contains examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Similarly, paragraph A3. contains examples of sources that could contain such information. The examples contained in this Appendix are not intended to represent a comprehensive listing.

A2. The following are examples of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Buying or selling goods or services at prices that differ significantly from prevailing market prices;
- Sales transactions with unusual terms, including unusual rights of return or extended payment terms generally not offered;
- "Bill and hold" type transactions;
- Borrowing or lending on an interest-free basis or with no fixed repayment terms;

- Occupying premises or receiving other assets or rendering or receiving management services when no consideration is exchanged;
- Engaging in a nonmonetary transaction that lacks commercial substance;
- Sales without economic substance (e.g., funding the other party to the transaction to facilitate collection of the sales price, or entering into a transaction shortly prior to period end and unwinding that transaction shortly after period end);
- Loans to parties that, at the time of the loan transaction, do not have the ability to repay and possess insufficient or no collateral;
- Loans made without prior consideration of the ability of the party to repay;
- A subsequent repurchase of goods that indicates that at the time of sale an implicit obligation to repurchase may have existed that would have precluded revenue recognition or sales treatment;
- Advancing company funds that are used directly or indirectly to pay what would otherwise be an uncollectible loan or receivable;
- Sales at below market rates to an intermediary whose involvement serves no apparent business purpose and who, in turn, sells to the ultimate customer at a higher price, with the intermediary (and ultimately its principals) retaining the difference;
- Guarantees and guarantor relationships outside the normal course of business; or
- Transactions between two or more entities in which each party provides and receives the same or similar amounts of consideration (e.g., round-trip transactions).

A3. The following are examples of sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies;
- Disclosures contained on the company's website;
- Confirmation responses and responses to inquiries of the company's lawyers;
- Tax filings and related correspondence;
- Invoices and correspondence received from the company's professional advisors, for example, attorneys and consulting firms;
- Relevant internal auditors' reports;
- Conflicts-of-interest statements from management and others;
- Shareholder registers that identify the company's principal shareholders;
- Life insurance policies purchased by the company;
- Records of the company's investments, pension plans, and other trusts established for the benefit of employees, including the names of the officers and trustees of such investments, pension plans, and other trusts;
- Contracts or other agreements (including, for example, partnership agreements and side agreements or other arrangements) with management;
- Contracts and other agreements representing significant unusual transactions;
- Significant contracts renegotiated by the company during the period under audit;
- Records from a management, audit committee, or board of directors' whistleblower program;
- Expense reimbursement documentation for executive officers; or
- The company's organizational charts.

Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

A. Identifying Significant Unusual Transactions

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

Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, as amended, is amended as follows:

In paragraph 14:

- The first bullet point is replaced with:

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 those that result in late or unusual journal entries;^{10A/} and

- Footnote 10A is added at the end of the first bullet:

^{10A/} See paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

Auditing Standard No. 9, Audit Planning

Auditing Standard No. 9, Audit Planning, as amended, is amended as follows:

In paragraph 12, subparagraph a. is replaced with:

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.^{14/}

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

- a. In paragraph 13:
 - The fifth bullet point is replaced with:

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");^{7A/} and
 - Footnote 7A is added at the end of the fifth bullet:

^{7A/} See AU secs. 316.66-.67A.
- b. In paragraph 56.a.:
 - In item (6), delete the word "and" at the end of the item.
 - In item (7), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add Item (8):

(8) Whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties.^{31A/}
 - Add footnote 31A at the end of item (8):

^{31A/} See AU secs. 316.66-.67A.
- c. In paragraph 56.b.:

- In item (3), delete the word "and" at the end of the item.
 - In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add item (5):
 - (5) Whether the company has entered into any significant unusual transactions.
- d. In paragraph 56.c.:
- In item (3), delete the word "and" at the end of the item.
 - In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add item (5):
 - (5) Whether the company has entered into any significant unusual transactions.
- e. In paragraph 57, the third bullet point is replaced with:
- Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements, a significant unusual transaction, or a significant related party transaction; and
- f. Paragraph 71.g., is replaced with:
- Whether the risk involves significant unusual transactions.
- g. Paragraph 73A is added after paragraph 73:
- 73A. The auditor should obtain an understanding of the controls that management has established to identify, authorize and approve, and account for and disclose significant unusual transactions in the financial

statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18-40 and 72-73 of this standard.

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material*

Misstatement, as amended, is amended as follows:

- a. The second sentence of footnote 3 to paragraph 5.d. is replaced with:

See also paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and paragraphs .04 and .06 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.
- b. Paragraph 15.c. is replaced with:

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 may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets (AU secs. 316.66-.67A).

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316,

"Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. The first item in paragraph .85A.2, section a., under "Opportunities" is replaced with the following two items:

- Related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business)
 - Significant transactions with related parties whose financial statements are not audited or are audited by another firm
- b. The fourth item in paragraph .85A.2, section a., under "Opportunities" is replaced with:
- Significant or highly complex transactions or significant unusual transactions, especially those close to period end, that pose difficult "substance-over-form" questions
- c. The following item is added as the last item to paragraph .85A.2, section a., under "Opportunities":
- Contractual arrangements lacking a business purpose

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

- a. In paragraph .55, Appendix B, paragraph B1., the tenth bullet is replaced with the following two bullets:
- The occurrence of infrequent transactions
 - The occurrence of significant unusual transactions

B. Evaluating Significant Unusual Transactions

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, as amended, is amended as follows:

- a. Paragraph 11A is added after paragraph 11:

11A. *Responding to Risks Associated with Significant Unusual Transactions.*

Paragraph 71.g. of Auditing Standard No. 12 indicates that one of the factors to be evaluated in determining significant risks is whether the risk involves significant unusual transactions. Also, AU secs. 316.66-.67A establish requirements for performing procedures to respond to fraud risks regarding significant unusual transactions. Because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-.67A.

Auditing Standard No. 16, *Communications with Audit Committees*

Auditing Standard No. 16, *Communications with Audit Committees*, is amended as follows:

- a. In paragraph 13.d., the phrase "rationale for" is replaced with the phrase "purpose (or the lack thereof) of."

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. Paragraph .66 is replaced with:

.66 Evaluating whether the business purpose for significant unusual transactions indicates that the transactions may have been entered into to

engage in fraud. 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.

Note: The auditor's identification of significant unusual transactions should take into account information obtained from: (a) the risk assessment procedures required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial reporting) and (b) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

Note: The auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. See paragraphs 14-16 of Auditing Standard No. 18, *Related Parties*. Appendix A of Auditing Standard

No. 18, *Related Parties*, includes examples of such information and examples of sources of such information.

b. Paragraph .66A is added after paragraph .66:

.66A The auditor should design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. The procedures should include:

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;^{fn 24A} and
- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

Note: Paragraph 11A of Auditing Standard No. 13 requires the auditor to take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures.

c. Footnote 24A is added after subparagraph c. of paragraph .66A

^{fn 24A} Examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

d. Paragraph .67 is replaced with:

.67 The auditor should evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. In making that evaluation, the auditor should evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);
- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor; ^{fn 25A}
- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party of the company;
- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent

arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);

- 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 other, more clearly independent, parties on an arm's-length basis;
- The transaction enables the company to achieve certain financial targets;
- 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); and
- Management has discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Note: Paragraphs 20-23 of Auditing Standard No. 14, *Evaluating Audit Results*, provide requirements regarding the auditor's evaluation of whether identified misstatements might be indicative of fraud.

- e. Footnote 25 is deleted and footnote 25A is added at the end of the third bullet in paragraph .67:

^{fn 25A} Related parties or relationships or transactions with related parties previously undisclosed to the auditor includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties. Auditing Standard No. 18, *Related Parties*, requires the auditor to perform certain procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

f. Paragraph .67A is added after paragraph 67:

.67A 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 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.^{fn 25B}

Note: The auditor considers management's disclosure regarding significant unusual transactions in other parts of the company's Securities and Exchange Commission filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

g. Footnote 25B is added at the end of paragraph.67A:

^{fn 25B} See paragraphs 30-31 of Auditing Standard No. 14.

Other Amendments to PCAOB Auditing Standards

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

- a. The following sentence is added to the end of footnote 3 of paragraph 4:

Also, Auditing Standard No. 18, *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.
- b. In paragraph 10, the note following the final bullet is deleted.
- c. Paragraph 10A is added after paragraph 10:
 - 10A. To assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the Securities and Exchange

Commission and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.

d. In paragraph 11:

- The third bullet is replaced with:

Obtaining an understanding of compensation arrangements with senior management other than executive officers referred to in paragraph 10A, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses;

- In the fourth bullet, delete the period (.) and add a semicolon (;) at the end of the bullet.

- Add a fifth bullet:

Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and

- Add a sixth bullet:

Obtaining an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

e. In Appendix A, paragraph A3A is added after paragraph A3:

A3A. Executive officer – For issuers, the president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a

company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policy-making functions for the company. (See Rule 3b-7 under the Exchange Act.) For brokers and dealers, the term "executive officer" includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions. (See Schedule A of Form BD.)

Auditing Standard No. 16, *Communications with Audit Committees*

Auditing Standard No. 16, *Communications with Audit Committees*, is amended as follows:

- a. The phrase "AU sec. 334, *Related Parties*" in footnote 25 is replaced with the phrase "Auditing Standard No. 18, *Related Parties*."
- b. The following bullet is inserted after the third bullet in Appendix B:
 - Auditing Standard No. 18, *Related Parties*, paragraphs 7 and 19.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows:

- a. The following bullet is added to the end of paragraph .09:
 - The predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions.^{fn 5A}
- b. Add the following footnote to the end of paragraph .09:

^{fn 5A} Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, describes significant unusual transactions.

- c. In paragraph .11, replace the fifth sentence with:

The predecessor auditor should ordinarily permit the successor auditor to review working papers, including documentation of planning, internal control, audit results, and other matters of continuing accounting and auditing significance, such as the working papers containing an analysis of balance sheet accounts, those relating to contingencies, related parties, and significant unusual transactions.

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. The heading before paragraph .79 is replaced with:

Communication about Possible Fraud to Management, the Audit Committee, the Securities and Exchange Commission, and Others ^{fn 37}

- b. Paragraph .81A is added after paragraph .81:

.81A The auditor has a responsibility, under certain conditions, to disclose possible fraud to the Securities and Exchange Commission to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change and the fraud or related risk factors constitute a reportable event or are the source of a disagreement, as these terms are defined in Item 304 of Regulation S-K and Item 16F of Form 20-F. These requirements also include reports that may be required

pursuant to Section 10A(b) of the Securities Exchange Act of 1934 relating to an illegal act that the auditor concludes has a material effect on the financial statements.

c. For paragraph .82:

- Footnotes 39 and 41 are deleted.
- The paragraph is replaced with:

.82 The auditor also may have a duty to disclose the existence of possible fraud to parties outside the entity in the following circumstances:

- a. To a successor auditor when the successor makes inquiries in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors*.^{fn 40}
- b. In response to a subpoena.
- c. To a funding agency or other specified agency in accordance with requirements for the audits of companies that receive governmental financial assistance.

d. The following item is added to paragraph .85A.2, section b., under "Opportunities":

- The exertion of dominant influence by or over a related party

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), as

amended, is amended as follows:

- a. Footnote 2 to paragraph .27 is replaced with:

Auditing Standard No. 18, *Related Parties*, establishes requirements regarding the auditor's evaluation of relationships and transactions between the company and its related parties.

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

- a. The third sentence of paragraph .03 is replaced with:

For example, after the auditor performs the procedures described in Auditing Standard No. 18, *Related Parties*, the auditor should obtain a written representation that management has no knowledge of any relationships or transactions with related parties that have not been properly accounted for and adequately disclosed. The auditor should obtain this written representation even if the results of those procedures indicate that relationships and transactions with related parties have been properly accounted for and adequately disclosed.

- b. In paragraph .06:

- Subparagraph c. is replaced with:

Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Subparagraph f. is replaced with:

Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.

- Subparagraph l. is replaced with:

Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.^{fn9}

c. Footnote 9 to paragraph .06 is replaced with:

See paragraph 18 of Auditing Standard No. 18, Related Parties.

d. The second sentence in paragraph 4 of Appendix A is replaced with:

Examples are fraud, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in Auditing Standard No. 18, *Related Parties*.

e. In paragraph 6 of Appendix A:

- Item 2.a. is replaced with:

Financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Item 11.d. is added:

Side agreements or other arrangements (either written or oral) that have not been disclosed to you.

AU sec. 334, "Related Parties"

SAS No. 45, Omnibus Statement on Auditing Standards — 1983 (AU sec. 334, "Related Parties"), as amended, is superseded.

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," as amended, is superseded.

AU sec. 336, "Using the Work of a Specialist"

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336, "Using the Work of a Specialist"), as amended, is amended as follows:

- a. Footnote 6 of paragraph .10 is replaced with:

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.

AU sec. 560, "Subsequent Events"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 560, "Subsequent Events" (AU sec. 560, "Subsequent Events"), as amended, is amended as follows:

- a. In paragraph .12b.:

- Item (v) is added:

Whether there have been any changes in the company's related parties.

- Item (vi) is added:

Whether there have been any significant new related party transactions.

- Item (vii) is added:

Whether the company has entered into any significant unusual transactions.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

- a. In paragraph .24:

- Subparagraph g. is replaced with:

Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Subparagraph j. is replaced with:
Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.
 - Subparagraph m. is replaced with:
Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.
- b. The second sentence of paragraph C5 of paragraph .56 is replaced with:
Examples are *fraud*, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in Auditing Standard No. 18, *Related Parties*.
- c. Within paragraph C6 of paragraph .56, within the first illustrative representation letter (1.) for a review of interim financial information (statements):
- Item 2.a. is replaced with:
All financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
- d. Within paragraph C6 of paragraph .56, within the second illustrative representation letter (2.) for a review of interim financial information (statements):
- Item 2.a. is replaced with:
All financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
 - Item 12.d. is added:

Side agreements or other arrangements (either written or oral) that have not been disclosed to you.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements. In addition, the Board is requesting that the Commission approve the proposed rules, pursuant to Section 103(a)(3)(C) of the Sarbanes-Oxley Act, for application to audits of emerging growth companies ("EGCs"), as that term is defined in Section 3(a)(80) of the Securities Exchange Act of 1934 (the "Exchange Act"). The Board's request is set forth in Section D below.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

(a) Purpose

Introduction

The Board is adopting a new auditing standard and amendments to its auditing standards to strengthen auditor performance requirements in three critical areas that historically have represented increased risks of material misstatement in company financial statements. Related party transactions; 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"); and a company's financial relationships and transactions with its

executive officers,²² have been contributing factors in numerous financial reporting frauds over the last several decades.²³ Prominent corporate scandals involving these critical areas served to undermine investor confidence and resulted in significant losses for investors, as well as the loss of many jobs.²⁴ These critical areas have continued to be contributing factors in more recent cases.²⁵ As discussed below, the Board's oversight activities indicate that there are continuing weaknesses in auditors' scrutiny of these areas.

The Board developed the standard and amendments because, as described more fully below, the Board believes its existing requirements need to be strengthened to heighten the auditor's attention to areas that have been associated with risks of fraudulent financial reporting

²² A company's related party transactions, significant unusual transactions, and financial relationships and transactions with its executive officers, are collectively referred to herein as "the critical areas" or "these critical areas."

²³ Such prominent corporate scandals include Enron Corporation, Tyco International, Ltd., Refco, Inc., and WorldCom, Inc. For a more detailed discussion of such financial reporting frauds, see: (i) *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (the "proposing release" or the "proposal"), PCAOB Release No. 2012–001 (February 28, 2012) at 9-11, http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2012-001_Related_Parties.pdf and (ii) *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (the "reproposing release" or the "reproposal"), PCAOB Release No. 2013–004 (May 7, 2013) at 2, http://pcaobus.org/Rules/Rulemaking/Docket038/Release%202013-004_Related%20Parties.pdf.

²⁴ In one such example, Enron Corporation was the nation's largest natural gas and electric marketer, with reported annual revenue of more than \$150 billion. When it filed for bankruptcy on December 2, 2001, its stock price had dropped, in less than a year, from more than \$80 per share to less than \$1. See *SEC Settles Civil Fraud Charges Filed Against Richard A. Causey, Former Enron Chief Accounting Officer; Causey Barred From Acting as an Officer or Director of a Public Company* (U.S. Securities and Exchange Commission ("SEC" or "Commission") Litigation Release No. 19996, February 9, 2007).

²⁵ See, e.g., SEC Accounting and Auditing Enforcement Release ("AAER") No. 3447, *SEC v. Keyuan Petrochemicals, Inc. and Aichun Li* (February 28, 2013), and SEC AAER No. 3385, *SEC v. China Natural Gas, Inc. and Qinan Ji* (May 14, 2012).

and that also may pose increased risks of error. The Board has concluded that its existing requirements in these critical areas do not contain sufficient required procedures and are not sufficiently risk-based, which can lead to inadequate auditor effort in the critical areas. The auditor, serving in the role as a gatekeeper²⁶ in the financial reporting system, should be alert to the possibility that transactions in these critical areas pose increased risks and, thus, require heightened scrutiny during the audit.²⁷ Increased auditor attention to these critical areas should, in the Board's view, increase the likelihood of the auditor identifying material misstatements.

The standard and amendments being adopted by the Board include: the standard; amendments regarding significant unusual transactions; and other amendments. As described below, the standard and amendments address:

- Relationships and Transactions with Related Parties;

²⁶ According to the SEC:

The federal securities laws, to a significant extent, make independent auditors "gatekeepers" to the public securities markets. These laws require, or permit us to require, financial information filed with us to be certified (or audited) by independent public accountants. Without an opinion from an independent auditor, the company cannot satisfy the statutory and regulatory requirements for audited financial statements and cannot sell its securities to the public. The auditor is the only professional that a company must engage before making a public offering of securities and the only professional charged with the duty to act and report independently from management.

See SEC Securities Act Release No. 33-7870, *Proposed Rule: Revision of the Commission's Auditor Independence Requirements* (June 30, 2000) at Section II.A. See also, SEC Securities Act Release No. 33-7919, *Final Rule: Revision of the Commission's Auditor Independence Requirements* (November 21, 2000) at Section III.A.

²⁷ See, e.g., SEC AAER No. 3427, *In the Matter of the Application of Wendy McNeeley, CPA*, at 10–12 (December 13, 2012), <http://www.sec.gov/litigation/opinions/2012/34-68431.pdf>. That opinion states, in part, that the SEC and courts have repeatedly held that related party transactions require heightened scrutiny by auditors. See also *McCurdy v. SEC*, 396 F3d 1258, 1261 (D.C. Cir. 2005) (citing *Howard v. SEC*, 376 F3d 1136, 1149 (D.C. Cir. 2004) noting that related-party transactions "are viewed with extreme skepticism in all areas of finance," aff'g *James Thomas McCurdy, CPA*, 57 S.E.C. 277 (2004)).

- Significant Unusual Transactions; and
- Financial Relationships and Transactions with Executive Officers.

Relationships and Transactions with Related Parties: The standard addresses the auditing of relationships and transactions between a company and its related parties. A company's related party transactions could pose increased risks of material misstatement, as their substance might differ materially from their form.²⁸ Related party transactions also may involve difficult measurement and recognition issues that can lead to errors in financial statements. Such transactions potentially provide more of an opportunity for management to act in its own interests, rather than in the interests of the company and its investors. Moreover, in some instances, related party transactions have been used to engage in fraudulent financial reporting and to conceal misappropriation of assets – types of misstatements that are relevant to the auditor's consideration of fraud.²⁹ The importance to investors of auditing related party transactions is reflected in Section 10A of the Securities Exchange Act of 1934 (the "Exchange Act"), which requires each audit of financial statements of an issuer to include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."³⁰ The standard is designed to strengthen auditor performance requirements by setting forth specific procedures for the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. The standard supersedes the Board's existing

²⁸ See also Section D for additional discussion of such risks.

²⁹ See paragraph .06 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

³⁰ See Section 10A(a)(2) of the Exchange Act, 15 U.S.C. §78j-1(a)(2), which was added to the Exchange Act by the Private Securities Litigation Reform Act, enacted by Congress in 1995.

standard, AU sec. 334, *Related Parties*, (the "existing standard"), which has not been substantively updated since it was issued in 1983.³¹

Significant Unusual Transactions: The amendments regarding significant unusual transactions recognize that a company's significant unusual transactions can create complex accounting and financial statement disclosure issues that could pose increased risks of material misstatement. In some instances, significant unusual transactions have been used to engage in fraudulent financial reporting. For example, significant unusual transactions, especially those close to period end that pose difficult "substance-over-form" questions, may be entered into to obscure a company's financial position or operating results.³² In such cases, management may place more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction. Existing audit requirements regarding significant unusual transactions are principally contained in AU sec. 316. The amendments regarding significant unusual transactions include specific procedures that are designed to improve the auditor's identification and evaluation of a company's significant unusual transactions and, in particular, to enhance the auditor's understanding of the business purpose (or the lack thereof) of such transactions.

Financial Relationships and Transactions with Executive Officers: The other amendments include, among other things, improved audit procedures addressing a company's

³¹ AU sec. 334 is one of the Board's interim auditing standards. Shortly after the Board's inception, the Board adopted the existing standards of the American Institute of Certified Public Accountants ("AICPA"), as in existence on April 16, 2003, on an initial, transitional basis. *See Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (April 18, 2003).

³² See, e.g., SEC AAER No. 1631, *In the Matter of Dynegy Inc., Respondent* (September 24, 2002), <http://www.sec.gov/litigation/admin/33-8134.htm>; and SEC AAER No. 2775, *In the Matter of Michael Lowther, CPA, Respondent* (January 28, 2008), <http://www.sec.gov/litigation/admin/2008/34-57210.pdf>.

financial relationships and transactions with its executive officers. A company's executive officers are in a unique position to influence a company's accounting and disclosures. A company's financial relationships and transactions with its executive officers (as one example, executive officer compensation) can create incentives and pressures for executive officers to meet financial targets, which can result in risks of material misstatement to a company's financial statements. The other amendments modify Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, to require the auditor to perform specific procedures, as part of the auditor's risk assessment process,³³ to obtain an understanding of the company's financial relationships and transactions with its executive officers. However, these amendments do not require the auditor to make any determination regarding the reasonableness of compensation arrangements or recommendations regarding compensation arrangements.

The auditor's efforts regarding these critical areas are, in many ways, complementary. For example, the auditor's efforts to identify and evaluate a company's significant unusual transactions could identify information that indicates that a related party or relationship or transaction with a related party previously undisclosed to the auditor might exist. Likewise, obtaining an understanding of a company's financial relationships and transactions with its executive officers also could identify such information. The standard and amendments direct the auditor to consider the linkage between a company's relationships and transactions with its related parties, its significant unusual transactions, and its financial relationships and transactions with its executive officers. This complementary audit approach should help the auditor "connect

³³ In 2010, the Board adopted eight standards on assessing and responding to risk in an audit (the "risk assessment standards"), which cover the entire audit process, from initial planning activities to evaluating audit evidence to forming the opinion to be expressed in the auditor's report. See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release 2010-004 (August 5, 2010).

the dots" between different aspects of the audit. Both the auditor and the investor benefit from a comprehensive and consistent examination of the critical areas, not only because of the risk of material misstatement due to fraud, but also because these transactions, due to their nature, could pose a risk of material misstatement due to error.

In addition, the standard imposes new requirements relating to the auditor's communications with the company's audit committee. These changes recognize that the new auditor performance requirements contained in the standard relate to areas of the audit that warrant discussion with the audit committee. The new communication requirements in the standard work in concert with the communication requirements in Auditing Standard No. 16, *Communications with Audit Committees*,³⁴ and require the auditor to include, as one of the auditor's required communications with the audit committee, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships with related parties. Additionally, the amendments regarding significant unusual transactions are intended to enhance the discussion between the auditor and the audit committee regarding the business purpose (or the lack thereof) of a company's significant unusual transactions required by Auditing Standard No. 16.³⁵ Similarly, requiring the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers is intended to improve the auditor's identification of fraud risks or other significant risks, which are also already required to be discussed with the audit committee pursuant to Auditing

³⁴ See *Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU Sec. 380*, PCAOB Release No. 2012-004 (August 15, 2012).

³⁵ See paragraph 13.d. of Auditing Standard No. 16, as revised by certain amendments regarding significant unusual transactions. As revised, the auditor is required to communicate to the audit committee the auditor's understanding of the business purpose (or the lack thereof) of significant unusual transactions.

Standard No. 16.³⁶

As discussed below, recommendations to improve the requirements in the critical areas have been longstanding. The standard and amendments reflect public input, including discussions with the Board's Standing Advisory Group ("SAG")³⁷ and comments received on a proposal in 2012³⁸ and a reproposal in 2013.³⁹ A wide range of commenters, including audit firms serving companies of all sizes, were supportive overall of the need to improve existing standards in these critical areas. During the standard-setting process, the Board considered various alternatives, including some proposed by commenters, in order to develop new requirements that would promote investor protection, but that also would provide opportunities for efficient implementation. After considering the comments received on the reproposal, the Board is adopting the standard and amendments substantially as repropose.

In general, the Board's new performance requirements for auditors are designed to promote heightened scrutiny in the critical areas, with the goal of promoting the auditor's ability

³⁶ See paragraph 9 of Auditing Standard No. 16, which requires the auditor to discuss with the audit committee the significant risks identified during the auditor's risk assessment procedures.

³⁷ The SAG discussed the topic of related parties at a number of its meetings prior to the issuance of the Board's proposal, including at meetings occurring on: September 8-9, 2004; June 21, 2007; and October 14-15, 2009. The SAG also discussed the proposal and reproposal on May 17, 2012 and May 15, 2013, respectively. See the SAG Meeting Archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>.

³⁸ See the proposing release, which included: (i) an auditing standard, *Related Parties* ("proposed standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions; and (iii) other amendments to PCAOB auditing standards (collectively, these are referred to as the "proposed standard and amendments").

³⁹ See the reproposeing release, which included: (i) an auditing standard, *Related Parties* ("reproposeing standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions; and (iii) other proposed amendments to PCAOB auditing standards (collectively, these are referred to as the "reproposeing standard and amendments").

to identify, evaluate, and respond to risks of material misstatement. The new requirements represent a targeted approach, focusing on areas that have historically reflected increased risks of fraudulent financial reporting and that also may pose increased risks of error. The Board believes that the standard and amendments, which are aligned with the risk assessment standards, represent a cohesive audit approach that will contribute to audit effectiveness and provide opportunities for an efficient implementation. In the Board's view, the new requirements further the Board's overall mission of improving audit quality, protecting the interests of investors, and furthering the public interest in the preparation of informative, accurate, and independent audit reports.⁴⁰

Background and Need for Improvement

As described more fully in the Board's proposing and reproposing releases, the Board developed the standard and amendments against the backdrop of several decades of financial reporting frauds involving companies' relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers.⁴¹

In considering the need for improvement, the Board noted that some of its existing requirements in these critical areas had not been updated to address significant developments since their issuance. For example, the existing standard addressing the auditing of related parties,

⁴⁰ See Section 101 of the Sarbanes–Oxley Act of 2002 ("Sarbanes–Oxley" or the "Act"), Pub. L. 107-204, 116 Stat. 745. Under Section 101 of the Act, the mission of the PCAOB is "to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports...."

⁴¹ See also Section D, which further elaborates on the Board's consideration of the need, the alternatives considered, and the Board's existing requirements and current audit practices, in connection with the Board's consideration of the economic impacts of the standard and amendments.

AU sec. 334, had remained largely unchanged for many years, despite prominent corporate scandals.⁴² The Board observed that the existing standard provided guidance and examples of procedures the auditor could perform, in lieu of specific required procedures. This could result in inadequate audit effort in an area that could pose increased risks of material misstatement. Additionally, the nature and extent of audit procedures addressing a company's related party transactions could vary widely. AU sec. 334 also does not reflect the risk-based approach taken in the Board's risk assessment standards, adopted in 2010, which provide an overall framework for the audit, based on the auditor's assessment of, and response to, risks of material misstatement.⁴³

The Board's view was also informed by a number of prominent reports and studies that supported the need to improve its existing requirements in the critical areas to better address issues pertinent to fraudulent financial reporting. These included studies by the audit profession that predated the establishment of the Board, and that suggested improvements to certain auditing standards adopted by the Board on an interim basis in 2003. For example, the Report of the Quality Control Inquiry Committee (the "QCIC Report") of the AICPA's SEC Practice Section recommended, after studying more than 200 cases involving audit failures, that "required audit procedures be broadened to help ensure the auditor gains a more complete understanding of

⁴² Audit procedures regarding a company's related parties have remained largely unchanged since the issuance of AU sec. 335, *Related Party Transactions*, in July 1975. In 1983, AU sec. 335 was replaced with AU sec. 334, but the nature and extent of the auditor's responsibilities and procedures pertaining to related parties in AU sec. 335 were carried over into AU sec. 334. AU sec. 334 removed guidance relating to accounting considerations and disclosure standards for related parties (in response to the issuance of Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, which is now contained in FASB Accounting Standards Codification Topic 850, *Related Party Disclosures*), along with other related technical changes.

⁴³ See PCAOB Release 2010-004 (August 5, 2010).

related-party transactions, including the business aspects of the transactions."⁴⁴

The Board also considered the results of its oversight activities. For example, the Board has observed that the facts underlying a significant percentage of the Board's settled disciplinary actions to date have involved auditors' failures to perform sufficient procedures regarding related party transactions.⁴⁵ Many of these cases involve smaller audit firms. Likewise, the Board's inspection program has identified a range of deficiencies in auditing related party transactions, particularly with respect to audits of smaller public companies that were conducted by smaller domestic audit firms.⁴⁶ The audit deficiencies cited included failures to test for undisclosed

⁴⁴ See AICPA SEC Practice Section, Memo To Managing Partners of SECPS Member Firms, "Recommendations for the Profession Based on Lessons Learned from Litigation" (October 2002), which includes the QCIC Report as an attachment.

⁴⁵ See, e.g., *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of P. Parikh & Associates, Ashok B. Rajagiri, CA, Sandeep P. Parikh, CA, and Sundeep P S G Nair, CA, Respondents*, PCAOB Release No. 105-2013-002 (April 24, 2013); *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Jaspers + Hall, PC, Thomas M. Jaspers, CPA, and Patrick A. Hall, CPA, Respondents*, PCAOB Release No. 105-2008-002 (October 21, 2008); *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Williams & Webster, P.S., Kevin J. Williams, CPA, and John G. Webster, CPA, Respondents*, PCAOB Release No. 105-2007-1 (June 12, 2007); and *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA, Respondents*, PCAOB Release No. 105-2005-022 (November 22, 2005).

⁴⁶ See *Report on 2007-2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies*, PCAOB Release No. 2013-001 (February 25, 2013) at 29, http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf, which states, in part:

Inspections staff have observed deficiencies related to firms' failures to test for undisclosed related parties or transactions with undisclosed related parties. Some of those firms failed to identify and address the lack of disclosure of related party transactions in the financial statements. Inspections staff have also identified deficiencies relating to the firms' failure to obtain an understanding of the nature and business purpose of transactions with related parties and to evaluate whether the accounting for those transactions reflects their economic substance.

related parties and failures to address risks posed by known related party transactions, including failures to obtain an understanding of the business purpose of such transactions. The types of audit deficiencies observed by the Board indicate that audit practice is inconsistent under the existing framework, which suggests that this is a challenging area warranting additional auditor effort and focus.

Significantly, the need for heightened scrutiny of related party transactions has been highlighted by SEC enforcement actions. For example, in a 2012 opinion issued by the SEC involving a company's transactions with its executive officers, the SEC stated "although in an ordinary arms-length transaction, one may assume that parties will act in their own economic interest, this assumption breaks down when the parties are related."⁴⁷ Additionally, a study performed by the SEC of five years of enforcement actions that was required by Section 704 of the Act examined 227 enforcement matters and found that 23 of those cases included the failure to disclose related party transactions.⁴⁸

SEC enforcement cases also have highlighted the role played by executive officers in fraudulent financial reporting by public companies. For example, a study examining SEC AAERs from 1998 to 2007 noted that the most commonly cited motivations for fraud included

See also Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms, PCAOB Release No. 2007-010, at 7 (October 22, 2007), http://pcaobus.org/Inspections/Documents/2007_10-22_4010_Report.pdf.

⁴⁷ See SEC, *In the Matter of the Application of Wendy McNeeley, CPA, AAER No. 3427*, at 15 (December 13, 2012), <http://www.sec.gov/litigation/opinions/2012/34-68431.pdf>. As previously noted, that opinion states, in part, that the SEC and courts have repeatedly held that related party transactions require heightened scrutiny by auditors and notes the importance of the auditor understanding the business purpose of material related party transactions.

⁴⁸ Section 704 of the Act directed the SEC to study enforcement actions over the five years preceding its enactment "to identify areas of issuer financial reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management." See *Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002* (January 24, 2003) at 6.

the need to: (i) meet external earnings expectations of analysts and others; (ii) meet internally set financial targets or make the company look better; (iii) conceal the company's deteriorating financial condition; (iv) increase the stock price; (v) bolster financial position for pending equity or debt financing; (vi) increase management compensation through achievement of bonus targets and through enhanced stock appreciation; and (vii) cover up assets misappropriated for personal gain.⁴⁹ That study indicated that the chief executive officer and/or chief financial officer were named in 89 percent of the cases involving fraudulent financial reporting brought by the SEC during that period.

The Board further considered that other standard-setters already have taken action to update their standards in related areas. For example, in July 2008, the International Auditing and Assurance Standards Board ("IAASB") took action to update and revise its auditing standard on related parties with the issuance of International Standard on Auditing No. 550, *Related Parties*. The IAASB emphasized that its new standard was warranted given the public focus on the accounting and auditing of related party relationships and transactions after recent major corporate scandals.⁵⁰ The Auditing Standards Board ("ASB") of the AICPA also revised its auditing standard on related parties with the issuance of AU-C Section 550, *Related Parties*, contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification*, in October 2011.

⁴⁹ See Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson, and Terry L. Neal, *Fraudulent Financial Reporting 1998–2007: An Analysis of U.S. Public Companies*, Committee of Sponsoring Organizations of the Treadway Commission (May 2010) at 3, http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.

⁵⁰ See IAASB Exposure Draft, *Related Parties* (December 2005). In addition, the IAASB staff issued guidance in August 2010 addressing the auditing of significant unusual or highly complex transactions. See IAASB Staff Questions and Answers, *Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions* (August 2010).

These considerations, particularly the magnitude and number of financial fraud cases over the last several decades involving companies' relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers, strongly indicate the need to strengthen existing auditing standards addressing these critical areas to promote audit quality and investor protection.

The Board's Proposals and Development of the Board's Approach

The following discussion highlights a number of key decisions made by the Board as it developed the standard and amendments, beginning with its proposal in 2012.⁵¹

The Board's Proposals: The Board issued its proposal on February 28, 2012.⁵² The Board received 37 comment letters on the proposed standard and amendments and discussed the proposed standard and amendments with the SAG on May 17, 2012.⁵³

In general, commenters were supportive of the Board's standard-setting efforts to enhance the auditor's efforts in the critical areas addressed by the proposal. However, commenters suggested several areas in which the proposed standard and amendments could be clarified or improved, including with respect to the other proposed amendments regarding a company's financial relationships and transactions with its executive officers.

In response to comments received, the Board made a number of revisions to its proposal

⁵¹ Prior to proposing the standard and amendments, the Board considered a number of alternatives. Section D contains a more detailed discussion of alternatives considered by the Board, including alternatives considered before the Board determined to issue the proposed standard and amendments in 2012.

⁵² See the proposing release.

⁵³ The comment period was extended from May 15, 2012 until May 31, 2012 to accommodate the discussion and comments received in connection with the SAG meeting. The transcript of the SAG's discussion of the proposed standard and amendments is available at http://pcaobus.org/Rules/Rulemaking/Docket038/2012-05-17_Transcript-Related_Parties.pdf.

and issued a reproposal for comment on May 7, 2013.⁵⁴ The Board's reproposing release discussed the Board's consideration of comments received and the reasons for making the changes in the reproposed standard and amendments. Additionally, the Board sought comment, and empirical data, on the potential economic implications of the reproposed standard and amendments, as well as on issues pertinent to the application of the reproposed standard and amendments to audits of brokers and dealers. Further, as a result of the enactment of the Jumpstart Our Business Startups Act (the "JOBS Act"), the Board also sought comment in its reproposal on issues pertinent to the applicability of the reproposed standard and amendments to audits of emerging growth companies ("EGCs").⁵⁵

The Board received 24 comment letters on the reproposed standard and amendments and discussed the reproposed standard and amendments with the SAG on May 15, 2013.⁵⁶ In general, commenters were supportive overall of the Board's efforts to improve existing standards in these critical areas. Notably, virtually all of those who commented on the reproposed amendments regarding a company's financial relationships and transactions with its executive officers indicated that the reproposed amendments sufficiently clarified an issue raised during the initial proposal, i.e., that the requirement for the auditor to obtain an understanding of the company's financial relationships and transactions with its executive officers does not require the auditor to assess the appropriateness of the compensation of the company's executive officers. Those who commented on the applicability of the standard were generally supportive of applying the

⁵⁴ See the reproposing release.

⁵⁵ Pub. L. No. 112-106 (April 5, 2012). See Section 103(a)(3)(C) of the Act (15 U.S.C. §7213(a)(3)(C)), as added by Section 104 of the JOBS Act.

⁵⁶ The transcript of the SAG's discussion of the reproposed standard and amendments is available at http://pcaobus.org/Rules/Rulemaking/Docket038/2013-05-15_SAG%20Transcript-Related_Parties.pdf.

standard and amendments to companies of all sizes, as well as to audits of brokers and dealers and audits of EGCs.

In response to the Board's request for input and empirical data regarding economic considerations, commenters provided their views regarding whether the standard and amendments would improve audit quality, as well as their views regarding potential costs and implementation issues. However, commenters did not provide empirical data.⁵⁷

As noted above, after consideration of the comments received, the Board is adopting the standard and amendments substantially as repropoed, with some clarifications and revisions in response to certain comments received. Section C contains a detailed discussion of comments received by the Board during the repropoal process, including the Board's response to significant comments received on the repropoed standard and amendments. Additionally, to assist the auditor in implementing the standard and amendments, Section C includes discussion and examples from the Board's propoing and repropoing releases modified to address the standard and amendments being adopted by the Board.

The Board's Overall Approach: The following discussion describes the Board's overall approach to developing the standard and amendments, and highlights some of the alternatives and policy choices made as the Board moved from its proposal to its repropoal and then to the adoption of the standard and amendments. In general, in developing the standard and amendments, the Board determined to develop an approach that would promote the auditor's heightened scrutiny of the critical areas but that would, at the same time, also provide opportunity for efficient implementation. Key considerations included:

- *Aligning with the Risk Assessment Standards:* The Board initially proposed to

⁵⁷ Section D discusses the Board's consideration of the economic impacts regarding the standard and amendments in greater detail.

align the auditor's efforts with the risk assessment standards, which require the auditor to consider the risks of material misstatement, whether due to error or fraud, throughout the audit. In the Board's view, this overall risk assessment approach promotes a cohesive audit, with opportunities to integrate audit effort where appropriate, and, at the same time, positions the auditor to identify areas in which there may be increased risks of material misstatement in company financial statements. In response to comments on its proposal, the Board took steps in its reproposal to more closely align the repropose standard and amendments with its risk assessment standards. Commenters who addressed this aspect of the reproposal generally agreed that the revisions improved the alignment with the risk assessment standards. This approach is retained in the standard and amendments being adopted by the Board.

- *Addressing Complementary Audit Areas:* The proposed standard and amendments were intended to highlight: (i) linkages between the standard and amendments and (ii) the opportunity for complementary audit work, which could improve audit effectiveness and offer opportunities for efficient implementation. For example, the auditor's work in identifying and evaluating significant unusual transactions could assist the auditor in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor by management. In its reproposal, the Board made revisions to improve the linkage between the repropose standard and amendments. This approach is retained in the standard and amendments being adopted by the Board.

- *Using Existing Concepts and Procedures:* The Board included some existing auditing concepts and procedures in its proposed standard and amendments. This was intended to permit audit firms to build on existing methodologies and training. This approach could minimize the costs of implementing the standard and amendments. In its reproposal, the Board sought comment on such issues. Several auditing firms who commented indicated that they would be able to update their methodologies and train staff to apply the standard and amendments in a short period, suggesting that the implementation of the standard would not be unduly burdensome. This approach is retained in the standard and amendments being adopted by the Board.
- *Providing Opportunity for a Scaled Approach:* The proposed standard was intended to provide for a scaled approach, establishing basic required procedures intended to assist the auditor in identifying red flags that indicate potential risks of material misstatement. The basic procedures were supplemented by more in-depth procedures that are commensurate with the facts and circumstances of the company under audit. Such facts and circumstances may include the size or complexity of the transaction, the nature of the company's relationships or transactions with its related parties, and the related risk of material misstatements in the financial statements. In response to a request for comments arising out of the Board's reproposal, many commenters agreed that the repropounded standard and amendments provide for a scaled approach. This approach is retained in the standard and amendments being adopted by the Board.

Additionally, commenters raised a variety of issues for consideration by the Board during the standard-setting process. A number of such comments resulted in revisions and clarifications to the standard and amendments.⁵⁸ Some of the more significant of these include:

- *Expanding Auditor Judgment*: In response to comments, the Board made changes to the proposed standard to allow for more auditor judgment, in appropriate circumstances. For example, in its proposal, all related party relationships or transactions that were not previously disclosed to the auditor, as well as those that would require disclosure in the company's financial statements, would have been considered to be a significant risk, requiring additional audit attention in all cases. In response to comments, the Board removed from the reproposal the requirement that the auditor always treat each related party relationship or transaction previously undisclosed by management as a significant risk. In making this change, the Board observed that not all undisclosed related party relationships or transactions might represent a significant risk. Instead, the additional procedures would only be required in circumstances where previously undisclosed transactions were determined by the auditor to require disclosure in the financial statements or consideration as a significant risk. This change, which is retained in the standard being adopted by the Board, could eliminate potentially unnecessary audit work.
- *Clarifying the Auditor's Responsibilities to Identify a Company's Related*

⁵⁸ Section C contains a more detailed discussion of comments received by the Board during the reproposal process, including the Board's response to significant comments received on the reposed standard and amendments.

Parties: In response to comments received, the Board made clarifications to the proposed standard to emphasize that the auditor's efforts to identify a company's related parties and relationships and transactions with its related parties begins with management's work. The approach taken in the Board's reproposal in this area recognizes that the company is responsible for the preparation of its financial statements, including the identification of the company's related parties, and that the auditor begins the audit with information obtained from the company. This approach is retained in the standard being adopted by the Board. Additionally, in response to comments received on the repropose standard, several clarifying changes have been made. Those changes emphasize more prominently the auditor's responsibility to perform procedures to test the accuracy and completeness of the company's identification of its related parties, taking into account the information gathered during the audit. Those changes also clarify that Appendix A of the standard contains examples of information and sources of information that may be gathered by the auditor during the audit.

- *Clarifying the Focus Regarding Executive Officers:* As proposed, the other amendments provided direction to the auditor to consider the potential risks of material misstatement relating to a company's executive compensation arrangements as part of the auditor's risk assessment procedures. While some commenters were fully supportive of this approach, other commenters on the proposal raised concerns regarding whether the Board intended that the auditor make an assessment of the reasonableness of executive compensation

arrangements. As repropoed, the other amendments relating to this area were clarified to explicitly provide that the procedures required for the auditor to obtain an understanding of a company's financial relationships and transactions with its executive officers do not require the auditor to make any determinations regarding the appropriateness or reasonableness of the company's compensation arrangements with its executive officers. This approach is retained in the amendments being adopted by the Board.

Overview of the Standard and Amendments and Key Improvements from Existing Standards

The following discussion provides a summary of the standard and amendments being adopted by the Board, key improvements from existing standards, and changes being made to the repropoed standard and amendments.

Auditing Standard No. 18, *Related Parties*

Overview of the Standard: The standard is intended to strengthen auditor performance requirements for identifying, assessing, and responding to the risks of material misstatement associated with a company's relationships and transactions with its related parties. Among other things, the standard requires the auditor to:

- Perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties, including 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 transactions involving related parties. The new procedures are performed in conjunction with the auditor's risk assessment procedures pursuant to Auditing Standard No. 12.

- Evaluate whether the company has properly identified its related parties and relationships and transactions with its related parties.⁵⁹ In making that evaluation, the auditor performs procedures to test the accuracy and completeness of management's identification, taking into account information gathered during the audit. If the auditor identifies information that indicates that undisclosed relationships and transactions with a related party might exist, the auditor performs procedures necessary to determine whether undisclosed relationships or transactions with related parties in fact exist.
- Perform specific procedures if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists.
- Perform specific procedures regarding each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk.
- Communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, and other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

The Existing Standard: The existing requirements for auditing relationships and

⁵⁹ To further assist the auditor's efforts in this area, the other amendments include a complementary provision that expands existing management representations contained in AU sec. 333, *Management Representations*. However, the auditor may not rely solely on management's representations since they are not a substitute for the application of those audit procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.

transactions with related parties are contained primarily in AU sec. 334. AU sec. 334 recognizes that the auditor performs procedures to identify and evaluate a company's relationships and transactions with its related parties as part of performing an audit of financial statements. In doing so, AU sec. 334 provides guidance and examples of procedures for the auditor's consideration in identifying and evaluating related party transactions. Examples of procedures in AU sec. 334 include procedures to obtain information from management (such as obtaining the names of all related parties and inquiring whether there were any transactions with these parties during the period) as well as procedures intended to assist the auditor in identifying related parties that have not been disclosed to the auditor by management (such as reviewing filings with the SEC, reviewing company accounting records and certain invoices, and making inquiries of other auditors). Notably, AU sec. 334 states that not all of the procedures may be required in every audit. It further states that, in the absence of evidence to the contrary, related party transactions should not be assumed to be outside the ordinary course of business.⁶⁰ Finally, AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions.

Key Improvements from the Existing Standard: The standard includes some auditing concepts and procedures from AU sec. 334 that relate to identifying and evaluating related parties and related party transactions. However, the standard differs from AU sec. 334 in a number of key respects. These include:

- *Adding Basic Requirements:* AU sec. 334 suggests procedures for the auditor's consideration, noting that not all of them may be required in every audit. The

⁶⁰ Thus, AU sec. 334 could be misunderstood to create a "presumption of validity" for the business purpose of related party transactions in situations where experience suggests a need for heightened scrutiny.

standard requires basic procedures for the auditor's response to the risks of material misstatement associated with a company's relationships and transactions with its related parties that focus on those related party transactions that require disclosure in the financial statements or that are determined to be a significant risk. These procedures are designed to assist the auditor in identifying red flags that indicate potential risks of material misstatement. Additionally, the standard requires more in-depth procedures that are designed to be scalable and commensurate with the company's facts and circumstances.

- *Enhancing Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties:* Unlike AU sec. 334, which includes limited direction for obtaining an understanding of the company's relationships and transactions with its related parties, the standard requires the performance of specific procedures in this area, including obtaining an understanding of the terms and business purposes (or the lack thereof) of related party transactions.
- *Aligning with the Risk Assessment Standards:* Since the adoption of AU sec. 334, the Board adopted and amended a number of auditing standards, including its risk assessment standards. The standard is designed to align with and build upon the risk assessment standards that were adopted in 2010. The new procedures are intended to be performed in conjunction with the procedures performed during the auditor's risk assessment.
- *Improving the Auditor's Focus on Accounting:* As noted above, AU sec. 334

states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions. The standard requires that the auditor evaluate both the accounting for, and disclosure of, related party transactions.

- *Adding Audit Committee Communications:* AU sec. 334 does not mention communications with audit committees regarding related party transactions. The standard requires the auditor to communicate with the audit committee (or its chair) to obtain information during the auditor's risk assessment, as well as to communicate to the audit committee regarding the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.
- *Emphasizing a Complementary Audit Approach:* The standard requires the auditor to take into account information gathered during the audit when evaluating a company's identification of its related parties, for example, information with respect to significant unusual transactions.

Changes from the Reproposed Standard: The Board is adopting the standard substantially as repropoed, except for certain clarifications and changes that are being made largely in response to comments. One change more prominently emphasizes that the auditor's evaluation of whether a company has properly identified its related parties and relationships and transactions with related parties requires the auditor to perform procedures to test the accuracy and completeness of the company's identification of its related parties and relationships and transactions with its related parties. That change also provides that the auditor's evaluation takes into account the information gathered during the audit. Another change clarifies that Appendix A of the standard contains examples of information and sources of information that may be

gathered by the auditor during the audit. More detail regarding the changes made to the standard is included in Section C.

Amendments Regarding Significant Unusual Transactions

The amendments regarding significant unusual transactions revise AU sec. 316 and other PCAOB auditing standards with the intent of strengthening the auditor's performance requirements for the identification and evaluation of significant unusual transactions. Among other things, the amendments regarding significant unusual transactions:

- Require the auditor to perform procedures to identify significant unusual transactions;
- Require the auditor to perform procedures to obtain an understanding of, and evaluate, the business purpose (or the lack thereof) of identified significant unusual transactions; and
- Add factors for the auditor to consider in evaluating whether significant unusual transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

The amendments regarding significant unusual transactions include targeted enhancements to AU sec. 316, as well as amendments to Auditing Standard No. 12 and Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*. The amendments regarding significant unusual transactions also include conforming changes to other PCAOB auditing standards to provide for consistency in the use of the term "significant unusual transactions" throughout the Board's standards. During the reproposal process, the Board added a number of clarifying changes, including some intended to enhance the complementary linkages between the auditor's work relating to significant unusual transactions and related party transactions. This approach is maintained in the amendments being adopted by the Board.

Existing Standards Regarding Significant Unusual Transactions: Existing auditing requirements regarding significant unusual transactions are principally contained in AU sec. 316.⁶¹ Specifically, AU sec. 316.66 recognizes that during a financial statement audit, the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment. AU sec. 316.66 requires that, if the auditor becomes aware of significant unusual transactions during the course of an audit, the auditor should gain an understanding of the business rationale of such transactions and whether that rationale (or the lack thereof) suggests that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. In addition, the existing risk assessment standards anticipate that the auditor will consider risks of material misstatement that are posed by significant transactions that are outside the normal course of business for the company or otherwise appear unusual due to their timing, size, or nature.⁶²

Key Improvements from the Existing Standards: The amendments regarding significant unusual transactions are designed to improve existing Board standards in the following key respects:

- *Conforming Descriptions of Significant Unusual Transactions:* The amendments regarding significant unusual transactions amend AU sec. 316.66 to describe significant unusual transactions as 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. The amendments regarding significant unusual transactions

⁶¹ See AU secs. 316.66–.67.

⁶² See paragraph 71.g. of Auditing Standard No. 12.

- also include conforming changes to introduce a uniform description of "significant unusual transactions" throughout the Board's standards.
- *Improving Requirements for Identifying Significant Unusual Transactions:* The amendments regarding significant unusual transactions require the performance of specific procedures intended to improve the auditor's identification of significant unusual transactions, for example, by amending Auditing Standard No. 12 to require the auditor to make inquiries of management and others.
 - *Improving the Auditor's Evaluation of Significant Unusual Transactions:* The amendments regarding significant unusual transactions to AU secs. 316.66-.67A include basic procedures for obtaining information for evaluating significant unusual transactions. The basic procedures include: (i) reading the underlying documentation relating to significant unusual transactions and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction; (ii) determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures; and (iii) evaluating the financial capability of the other parties to the transaction with respect to significant uncollected balances, guarantees, and other obligations. The basic procedures are designed to assist the auditor in identifying red flags that indicate potential risks of material misstatement. Additionally, the standard requires more in-depth procedures that are designed to be scalable and commensurate with the facts and circumstances of the audit.
 - *Enhancing Attention to the Business Purpose (or the Lack Thereof) of Significant*

Unusual Transactions: The amendments regarding significant unusual transactions to AU secs. 316.66-.67 are intended to enhance the auditor's evaluation of the business purpose of significant unusual transactions by, among other things, expanding the factors considered by the auditor in evaluating whether the business purpose (or the lack thereof) indicates that such transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

- *Emphasizing a Complementary Audit Approach:* The amendments to AU secs. 316.66-.67A emphasize a complementary audit approach by requiring the auditor to take into account other work performed during the audit, for example, information gathered with respect to related party transactions, when identifying a company's significant unusual transactions.
- *Emphasizing Accounting and Disclosure:* The amendments regarding significant unusual transactions to AU sec. 316.67A are intended to heighten the auditor's attention to accounting matters relative to significant unusual transactions. The new requirements emphasize that the auditor must evaluate whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework.⁶³

Changes from the Reproposed Amendments: The Board is adopting the amendments substantially as repropose, with some clarifying changes. More detail regarding those changes is included in Section C.

⁶³ See paragraphs 30-31 of Auditing Standard No. 14, *Evaluating Audit Results*, which address the auditor's evaluation of the presentation of the financial statements, including the disclosures.

Financial Relationships and Transactions with Executive Officers

The other amendments are intended to provide for improved audit procedures in complementary areas, including requiring that the auditor perform procedures, as part of the auditor's risk assessment, to obtain an understanding of the company's financial relationships and transactions with its executive officers.⁶⁴ These new procedures are intended to heighten the auditor's attention to incentives or pressures for the company to achieve a particular financial position or operating result, recognizing the key role that a company's executive officers may play in the company's accounting decisions or in a company's financial reporting.

As discussed previously, clarifications were made to the other amendments to explicitly provide that the auditor's work relating to a company's financial relationships and transactions with its executive officers does not include an assessment of the appropriateness or reasonableness of executive compensation arrangements.

The Existing Standards and Key Improvements: The existing risk assessment standards require the auditor to consider obtaining an understanding of compensation arrangements with senior management (including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses) as part of obtaining an understanding of the company. The other amendments strengthen existing requirements by requiring the auditor, as part of the audit risk assessment process, to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. This reflects that a company's executive officers are a group that, because of their position in the company, can exert influence over the company's accounting and financial statement presentation.

No Changes from Reproposed Amendments: The Board is adopting the amendments

⁶⁴ See Section C – Other Amendments to PCAOB Auditing Standards, for a discussion of the applicable definition of the term "executive officer."

regarding financial relationships and transactions with executive officers as repropoed. A discussion of the comments received is included in Section C.

Other Amendments to PCAOB Auditing Standards

In addition to the other amendments relating to financial relationships and transactions with executive officers, the other amendments being adopted by the Board revise other auditing standards to conform them to the standard and amendments and, where appropriate, include new requirements that complement the standard and amendments regarding significant unusual transactions.

For example, the other amendments include changes to AU sec. 333, relating to management's written representations to the auditor, to include a representation that management has made available to the auditor the names of all related parties and relationships and transactions with related parties. Additionally, the other amendments to AU sec. 333 require the auditor to obtain relevant written representations from management: (i) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor, and (ii) if the company's financial statements include an assertion that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction.

Other new requirements in the other amendments complement the requirements in the standard and amendments through improvements to the auditor's: (i) communications with a predecessor auditor; (ii) procedures during the period subsequent to the balance sheet date through the date of the auditor's report; and (iii) procedures during reviews of interim financial information. These and the other amendments being adopted by the Board are discussed in greater detail in Section C.

The Board is adopting the other amendments substantially as repropoed, with only

minor clarifying changes. More detail regarding those changes is included in Section C.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

B. Board's Statement on Burden on Competition

Not applicable. The Board's consideration of the economic impacts of the standard and amendments are discussed in Section D.

C. Board's Statement on Comments on the Proposed Rules Received From Members, Participants or Others

The Board released the proposal for public comment on February 28, 2012. The Board received 37 written comment letters relating to the proposal. The Board discussed the proposal with the SAG on May 17, 2012.

The Board released the reproposal for public comment on May 7, 2013. The Board received 24 written comment letters relating to the reproposal. The Board discussed the reproposal with the SAG on May 15, 2013.

The Board has carefully considered all comments received. The Board's response to the comments it received on the reproposal and the changes made to the rules in response to the comments received are discussed below. Additionally, below is a comparison of the objective and key requirements of the proposed rules with the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the AICPA.

1. *Discussion of the Proposed Rules and Comments Received*

Introduction

After considering the comments received, the Board is adopting the standard and amendments substantially as repropoed, except for certain clarifications and changes that are being made largely in response to comments.

A recurring theme from comments received on both the proposal and repropoal dealt with including additional discussion and examples in the standard and amendments. Several commenters requested that the Board include additional discussion and examples contained in the proposing and repropoing releases in the text of the standard and amendments. Some commenters suggested that not including additional discussion and examples could affect the consistency of implementation and the initial and recurring implementation costs.

The Board considered these comments and determined, as it has done in other projects, to include performance requirements in the standard and amendments and to provide additional discussion and examples primarily in an appendix to its adopting release. As noted in the repropoal, this approach promotes a clear separation between the required procedures and the Board's additional discussion regarding the application of the standard and amendments. To assist auditors in implementing the standard and amendments, the discussion below includes additional discussion and examples previously included in the proposing and repropoing releases, modified to address the standard and amendments being adopted by the Board.

The discussion below relates to: Auditing Standard No. 18, *Related Parties*; Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions; Other Amendments to PCAOB Auditing Standards; Audits of Brokers and Dealers; and Effective Date.

Auditing Standard No. 18, *Related Parties*

Commenters generally supported the Board's standard-setting efforts to strengthen the existing auditing standard, with many commenters noting that the repropoed standard could

have a positive impact on audit quality. Many commenters also suggested changes for further improving the repropoed standard, including some clarifications and editorial suggestions.

The Board is adopting the standard, substantially as repropoed, but is making certain revisions to clarify and refine various aspects of the standard. The most significant changes include:

- *Clarifying the Scope of the Auditor's Inquiries Regarding Related Party Transactions (Paragraph 5)*: Paragraph 5 of the standard includes a revision to clarify the scope of the auditor's inquiries of management to include transactions with its related parties that were modified during the period under audit.
- *Including Examples of Others Within the Company of Whom the Auditor Might Inquire (Paragraph 6)*: A footnote has been added to paragraph 6 of the standard to provide examples of others within the company that the auditor might inquire of regarding the company's relationships and transactions with related parties.
- *Providing Direction Regarding Timing of Communications (Paragraph 8)*: Paragraph 8 of the standard includes a revision that notes that the communication to engagement team members pursuant to paragraph 8 can be more effective when it occurs at an early stage of the audit.
- *Providing Direction Regarding Intercompany Accounts (Paragraph 13)*: A note has been added to paragraph 13 of the standard to clarify that the procedures performed by the auditor should address the risks of material misstatement associated with the company's intercompany accounts.
- *Clarifying the Auditor's Responsibility for Evaluating the Company's Identification of its Related Parties (Paragraph 14)*: Paragraph 14 includes revisions to highlight that

- the auditor's evaluation of a company's identification of its related parties includes performing procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, and that such evaluation takes into account the information gathered during the audit.
- *Clarifying the Auditor's Responsibility Regarding Appendix A (Paragraph 14):* Language has been added to paragraph 14 and Appendix A (referred to in paragraph 14) to clarify that Appendix A contains examples of information and sources of information that may be gathered during the audit.
 - *Expanding the Examples Contained in Appendix A (Appendix A):* The examples of sources of information contained in Appendix A of the standard have been expanded to include the company's "disclosures contained on the company's website" (in addition to the company's disclosures in SEC filings, which is already included as an example in Appendix A).
 - *Clarifying the Procedures Performed If the Auditor Identifies a Related Party or Relationship or Transaction with a Related Party Previously Undisclosed to the Auditor (Paragraph 16):* Paragraph 16 includes a number of clarifications, the most significant of which include revisions clarifying that paragraph 16 requires the auditor to perform initial procedures intended to help the auditor understand and evaluate the nature of the undisclosed related party or relationship or transaction with a related party identified by the auditor. Taking into account the information gathered from performing those procedures, the auditor then performs additional procedures to evaluate any broader implications for the audit.

The following sections discuss the standard being adopted by the Board, the existing standard, significant comments received, and the Board's responses, including a description of the changes from the repropose standard. The following sections also include additional discussion and examples that could be useful to auditors in implementing the standard. The sections are organized by the following topical areas:

- Introduction (Paragraph 1)
- Objective (Paragraph 2)
- Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 – 9)
- Identifying and Assessing Risks of Material Misstatement (Paragraph 10)
- Responding to the Risks of Material Misstatement (Paragraphs 11 – 13)
- Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14 – 16)
- Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17 – 18)
- Communications with the Audit Committee (Paragraph 19)

Introduction (Paragraph 1 of the Standard)

Discussion of Paragraph 1 of Auditing Standard No. 18

Paragraph 1 of the standard states that the standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.

A footnote to paragraph 1 of the standard provides that the auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties" and the financial

statement disclosure requirements with respect to related parties (which is referred to as a "framework neutral" approach).⁶⁵

In contrast to the specific required procedures contained in the standard, AU sec. 334 provides guidance on procedures that the auditor should consider to identify related party relationships and transactions, and to satisfy himself concerning the required financial statement accounting and disclosures.⁶⁶ The standard also improves upon the existing standard by using a framework neutral approach. The existing standard, on the other hand, refers the auditor to the definition of a related party contained in GAAP.

After considering all comments received, the Board is adopting paragraph 1 of the standard as repropounded.

Objective (Paragraph 2 of the Standard)

Discussion of Paragraph 2 of Auditing Standard No. 18

Paragraph 2 of the standard states that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements. A footnote refers the auditor to other relevant standards, including paragraphs 30-31 of Auditing Standard No. 14, *Evaluating Audit Results*, and paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*.

⁶⁵ For SEC filings that include financial statements prepared in accordance with or reconciled to U.S. Generally Accepted Accounting Principles ("GAAP"), see, e.g., Financial Accounting Standards Board's ("FASB") Accounting Standards Codification Topic 850, *Related Party Disclosures*. For SEC filings that include financial statements prepared in accordance with International Financial Reporting Standards, as issued by the International Accounting Standards Board ("IFRS"), see, e.g., International Accounting Standard No. 24, *Related Party Disclosures*.

⁶⁶ See AU secs. 334.01–.02.

The intent of the objective is to focus the auditor on the end result - obtaining sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

In contrast, the existing standard does not specifically describe an objective for the auditor's work regarding a company's relationships and transactions with its related parties.

Discussion of Comments Received on Paragraph 2 of the Reproposed Standard

The Board considered all comments received, including the following significant comments:

Including the Consideration of "Fraud" as an Explicit Objective: A few commenters recommended that the objective of the standard refer to the risk of fraud as an explicit objective of the standard. The Board considered similar comments received on the proposal in developing its reproposal. As noted in the reproposal, related party transactions warrant special attention by the auditor, in part, because of their historic association with material misstatements that are associated with fraudulent financial reporting. The standard requires the auditor to perform specific procedures intended to provide for heightened scrutiny of the company's identification of, accounting for, and disclosure of its related parties and relationships and transactions with related parties. Since some related party transactions may be routine and occur in the ordinary course of business, the Board determined to take a risk-based approach that aligns with and builds upon its risk assessment standards.⁶⁷ The risk assessment standards emphasize that the auditor's responsibilities for assessing and responding to fraud are an integral part of the audit

⁶⁷ See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to Other PCAOB Standards*, PCAOB Release 2010-004 (August 5, 2010).

process rather than a separate, parallel process. In the Board's view, this represents an effective and efficient audit approach. This is in contrast to the approach taken in the existing standard, which states that in the absence of evidence to the contrary, related party transactions should not be assumed to be outside the ordinary course of business.⁶⁸

Incorporating Materiality into the Objective: A few commenters recommended including a reference to materiality in the objective of the standard. The Board considered these comments but noted that auditing standards require the auditor to design and perform audits to identify material misstatements. Also, direction regarding the auditor's considerations of materiality already is contained in Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*.

The Board is adopting paragraph 2 of the standard as repropoed, except for an additional reference to paragraph 30 of Auditing Standard No. 14 that has been added to footnote 2. Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 through 9 of the Standard) *Discussion of Paragraphs 3 through 9 of Auditing Standard No. 18*

Paragraph 3 of the standard builds upon the foundational risk assessment requirements contained in Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Chiefly, paragraph 3 of the standard requires the auditor to perform specific 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

⁶⁸ AU sec. 334.06.

the financial statements, in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12.⁶⁹

Understanding the nature and business purpose (or the lack thereof) of a company's relationships and transactions with its related parties is important for the auditor's evaluation of the company's accounting for and disclosure of related party transactions because a company's relationships and transactions with its related parties could pose increased risks of material misstatement. For example, to improve the appearance of its financial condition, a company and a related party could attempt to "dress up" the appearance of the company's balance sheet at period end by agreeing to have the company temporarily pay down its related party debt prior to the balance sheet date while having an undisclosed side agreement to subsequently borrow the same or a comparable amount shortly after period end.

Paragraph 3 further provides that the procedures to be performed to obtain an understanding of the company's relationships and transactions include: (i) procedures to obtain an understanding of the company's process; (ii) performing inquiries; and (iii) communicating with the audit engagement team and other auditors.

The existing standard suggests some similar procedures for the auditor's consideration. For example, the existing standard states in AU sec. 334.05 that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component of the entity to the total entity. AU sec. 334.05 further states that the auditor should consider controls over management activities and the business purpose served by the various components of the entity. AU sec. 334.09 states that, after identifying related party transactions,

⁶⁹ In addition, the other amendments make a conforming amendment to Auditing Standard No. 12.

the auditor should apply the procedures that the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. Additionally, paragraph 71 of Auditing Standard No. 12 states that one factor to be considered in determining whether a risk represents a significant risk is whether the risk involves significant transactions with related parties.

Obtaining an Understanding of the Company's Process (Paragraph 4 of the Standard)

Paragraph 4 of the standard also aligns with and builds upon the requirements in Auditing Standard No. 12. Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to: (i) identify the types of potential misstatement; (ii) assess the factors that affect the risks of material misstatement; and (iii) design further audit procedures.⁷⁰ Paragraph 4 of the standard requires that, in conjunction with obtaining an understanding of internal control over financial reporting, the auditor obtain an understanding of the controls that management has established to: (i) identify related parties and relationships and transactions with related parties; (ii) authorize and approve transactions with related parties; and (iii) account for and disclose relationships and transactions with related parties in the financial statements.

Obtaining an understanding of the company's controls, including its policies and procedures, is important to an auditor's consideration of the risks that a company's relationships and transactions with related parties may pose for material misstatement of the company's financial statements. The standard recognizes that material features of companies' policies and procedures for the review, approval, or ratification of related party transactions will vary depending on both the size and complexity of the company and the types of transactions covered

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See paragraph 18 of Auditing Standard No. 12.

by such policies and procedures. The standard should not be read to imply that such policies and procedures should be in writing or adhere to any particular framework.

AU sec. 334, issued before the adoption of the risk assessment standards, is similar, but not as specific. Among other things, AU sec. 334.05 states that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities. AU sec. 334.05 further states that the auditor should consider controls over management activities.

Performing Inquiries (Paragraphs 5 through 7 of the Standard)

Briefly, paragraphs 5 through 7 of the standard require the auditor to make specific inquiries of: (i) company management; (ii) others within the company likely to have additional knowledge regarding the company's related parties or relationships or transactions with the company's related parties; and (iii) the company's audit committee.

Appropriately focused inquiries can inform the auditor's understanding of the nature of the relationships between the company and its related parties, and the terms and business purposes (or the lack thereof) of transactions involving related parties. In addition, inquiries can assist the auditor in determining the extent of audit procedures that should be performed to determine whether the company has identified its related parties and relationships and transactions with its related parties.

The inclusion of the phrase "(or the lack thereof)" throughout the standard and amendments is intended to promote a questioning and skeptical approach by the auditor when obtaining an understanding of the business purpose of related party transactions. Sharpening the auditor's focus on evaluating the business purpose of related party transactions is particularly

appropriate in view of the risk of material misstatement involving related party transactions.⁷¹

The importance of identifying transactions that appear to lack a business purpose also is reinforced in other parts of the standard. For example, the standard requires the auditor to communicate to the audit committee the identification of significant related party transactions that appear to the auditor to lack a business purpose.

Paragraph 5 contains a list of inquiries of management that consist of basic information that the auditor should obtain as part of obtaining an understanding of the company's financial relationships and transactions with its related parties, such as the names of the company's related parties and the nature of the company's relationships and transactions with those related parties. A footnote to paragraph 5 refers the auditor to AU sec. 333, *Management Representations*, and notes that obtaining such representations from management complements the performance of procedures in paragraph 5 and is not a substitution for those inquiries.

Paragraph 6 provides that the auditor also inquire of others within the company regarding their knowledge of the same matters that are the subject of the auditor's inquiries of management pursuant to paragraph 5 of the standard.

A footnote to paragraph 6 states that examples of "others" within the company who may have such knowledge include: personnel in a position to initiate, process, or record transactions with related parties and those who supervise or monitor such personnel; internal auditors; in-house legal counsel; the chief compliance/ethics officer or person in equivalent position; and the

⁷¹ See, e.g., paragraph 15 of FASB Statement No. 57, *Related Parties*, which states "[w]ithout disclosure to the contrary, there is a general presumption that transactions reflected in financial statements have been consummated on an arm's-length basis between independent parties. However, that presumption is not justified when related party transactions exist because the requisite conditions of competitive, free-market dealings may not exist. Because it is possible for related party transactions to be arranged to obtain certain results desired by the related parties, the resulting accounting measures may not represent what they usually would be expected to represent."

human resource director or person in equivalent position. These examples of "others" included in the standard are not intended to imply that these individuals could not also be members of "management" for a particular company.

The inquiries required in paragraph 6 provide an opportunity for the auditor to corroborate the information obtained from management. Paragraph 6 does not, however, require the auditor to inquire of others within the company regarding matters that the auditor does not believe are reasonably within their knowledge.

Paragraph 7 of the standard provides that the auditor also should make inquiries of the company's audit committee, or its chair, regarding the audit committee's understanding of the company's relationships and transactions with related parties, focusing on those that are significant to the company.⁷² Additionally, the standard provides that the auditor should inquire as to whether any member of the audit committee has concerns regarding the company's relationships or transactions with related parties. The inquiries of the audit committee, or its chair, pursuant to paragraph 7 of the standard work in concert with the auditor's communications with the audit committee pursuant to paragraph 19 of the standard to provide an opportunity for the auditor to corroborate management's responses. The audit committee communication requirements in the standard are intended to provide the auditor with a forum to discuss sensitive areas that potentially may involve the financial interests of members of the company's management.

The inquiries in paragraphs 5 through 7 of the standard could be performed at the same time as the inquiries about the risks of material misstatement, including fraud risks, that are performed as part of the auditor's risk assessment, as required by paragraphs 54 through 58 of

⁷² Paragraph 8 of Auditing Standard No. 16, *Communications with Audit Committees*, also requires the auditor to make certain inquiries of the audit committee.

Auditing Standard No. 12. These inquiries also would provide an opportunity for the auditor to discuss, as appropriate, the company's financial relationships and transactions with its executive officers with the audit committee, or its chair, as part of the auditor's procedures to obtain an understanding of the company's relationships and transactions with its related parties.

In contrast to the new requirements contained in the standard, the existing standard describes a variety of specific audit procedures for the auditor's consideration in determining the existence of related parties.⁷³ These specific procedures include requesting from appropriate management personnel the names of all related parties and inquiring whether there were any transactions with these parties during the period. The existing standard has no audit committee communication requirement. The procedures in paragraph 5 through 7 of the standard provide more specific procedures for the auditor regarding the use of inquiries of management and others.

Communicating with the Audit Engagement Team and Other Auditors (Paragraphs 8 and 9 of the Standard)

Paragraphs 8 and 9 of the standard require the auditor to communicate to engagement team members and, if applicable, other auditors, relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties. A footnote to paragraph 8 states that this communication, which can be more effective when it occurs at an early stage of the audit, complements the discussion among engagement team members regarding risks of material misstatement in accordance with paragraph 49 of Auditing Standard No. 12. That footnote also refers the auditor to paragraph 5 of Auditing Standard No. 10, *Supervision of the Audit Engagement*. If the auditor

⁷³ See AU sec. 334.07.

is using the work of another auditor, paragraph 9 of the standard further requires the auditor to make certain inquiries of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.⁷⁴

Communicating information to engagement team members regarding a company's related parties and relationships and transactions with related parties might increase the likelihood that the engagement team will identify related parties or relationships or transactions with related parties previously undisclosed to the auditor by management. Effective communication to engagement team members might also highlight evidence that corroborates or contradicts information provided by management about relationships and transactions with related parties. Additionally, effective communication to engagement team members could enhance the auditor's understanding of the company's relationships and transactions with its related parties.

Examples of matters regarding related parties that the engagement team might discuss include: (i) information that could indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor; (ii) sources of information that could indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor; (iii) how entities controlled by management (e.g., variable interest entities) might be used to facilitate earnings management; and (iv) how transactions between the company and a known business partner of a member of management could be arranged to facilitate fraudulent financial reporting or asset misappropriation.

⁷⁴ The standard does not include a specific requirement for the auditor to make similar inquiries of engagement team members because existing standards already require engagement team members to bring relevant matters to the attention of the audit engagement partner. See, e.g., paragraph 5 of Auditing Standard No. 10.

In addition, under PCAOB standards, a principal auditor may use the work and reports of other auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the company's financial statements.⁷⁵

Exchanging relevant information about related parties with the other auditor can assist the principal auditor in understanding the overall nature of the company's relationships and transactions with related parties and in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor.

AU sec. 334.08 contains audit procedures intended to provide guidance for identifying material transactions that may be indicative of the existence of previously unidentified related party relationships. One such procedure is to provide audit personnel performing segments of the audit, or auditing and reporting separately on the accounts of related components of the reporting entity, with the names of known related parties so that they may become aware of transactions with such parties during their audits. Further, AU sec. 334.07.g., suggests a number of audit procedures for determining the existence of related party relationships, including making inquiries of other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions. Finally, paragraph .13 of AU sec. 9334, *Related Parties: Auditing Interpretations of Section 334*, states that the principal auditor and the other auditor should obtain from each other the names of known related parties and that, ordinarily, the exchange should be made at an early stage of the audit. In contrast to the suggested procedures provided in the existing standard, the standard provides specific procedures for the auditor regarding this topic.

Discussion of Comments Received on Paragraphs 3 through 9 of the Reproposed Standard

⁷⁵ See paragraph .01 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

The Board considered all comments received, including the following significant comments:

Inquiring Regarding "Modifications" to Related Party Transactions: One commenter stated that modifications to transactions with related parties during the period may give rise to a risk of material misstatement. This commenter suggested clarifying the scope of paragraph 5.d. of the repropose standard by adding the word "modified" after the phrase "the transactions entered into." This change would clarify that the auditor's inquiries regarding the company's related party transactions entered into during the audit period would include inquiries regarding any such transactions that were modified during that period. The Board considered this comment and agreed that this would be a useful change. The Board has made a change to paragraph 5.d. to reflect the commenter's suggestion.

Providing Additional Direction Regarding the Auditor's Inquiries: Two commenters recommended including additional direction regarding the auditor's inquiries. One commenter suggested providing further direction on the nature and extent of the auditor's inquiries. Another commenter suggested that the Board provide examples of others within the company of whom the auditor might inquire to clarify the intent of the requirement in paragraph 6. The Board considered these comments and has added a new footnote to paragraph 6. That new footnote states that examples of "others" within the company who may have such knowledge include: personnel in a position to initiate, process, or record transactions with related parties and those who supervise or monitor such personnel; internal auditors; in-house legal counsel; the chief compliance/ethics officer or person in equivalent position; and the human resources director or person in equivalent position.⁷⁶ The Board declined to add more specific requirements because

⁷⁶ These examples of "others" had been included in the proposed standard but were removed from the reproposal because the Board did not wish to suggest that the auditor should make inquiries of each of these individuals in all instances. Additionally, one commenter on the

determining the nature and extent of the auditor's inquiries is an area that would benefit from the auditor's consideration of the facts and circumstances of the audit.

Timing of the Auditor's Communications: At the SAG discussion, a suggestion was made to include direction regarding the timing of the auditor's communication to the engagement team. The Board considered this comment, noting that, similar to the approach under the existing standard, this communication would generally occur at an early stage of the audit as it would be performed in conjunction with the risk assessment procedures.⁷⁷ Further, the proposing release had noted that communicating information about related parties at an early stage of the audit would benefit such discussions and should continue throughout the audit. The Board has revised the footnote to paragraph 8 of the standard to indicate that this communication can be more effective when it occurs at an early stage of the audit.

The Board is adopting paragraphs 3 through 9 of the standard substantially as repropoed, except for, as described above: (i) revising item d. of paragraph 5 to clarify that auditors' inquiries include inquiries regarding any transactions that were modified during the period; (ii) adding a footnote to paragraph 6 that includes examples of others within the company to whom the auditor may address inquiries; and (iii) revising the footnote to paragraph 8 to indicate that the communication can be more effective when it occurs at an early stage of the audit.

Identifying and Assessing Risks of Material Misstatement (Paragraph 10 of the Standard)

Discussion of Paragraph 10 of Auditing Standard No. 18

proposal observed that some of the "others" might also be members of management in some companies. However, in view of comments indicating that additional examples in the standard would be helpful, the Board believes that these examples could be useful to auditors, and including them in a footnote to the standard should avoid the notion that these examples in and of themselves impose requirements.

⁷⁷ See AU sec. 9334.13.

Paragraph 10 of the standard aligns with the risk assessment requirements contained in Auditing Standard No. 12, which require the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 10 of the standard states that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties. A footnote to paragraph 10 refers the auditor to paragraph 59 of Auditing Standard No. 12.

The clause "including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties" in paragraph 10 is intended to highlight, among other things, that the auditor's assessment of risk includes a focus on risks related to the company's less than complete identification of its related parties or relationships or transactions with related parties. Such a focus helps support the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties.

Due to their nature, transactions with related parties might involve difficult measurement and recognition issues that can lead to errors in financial statements, for example, when terms are not properly considered in accounting determinations. Related parties might also buy or sell goods or services at prices that differ significantly from prevailing market prices or offer unusual rights of return or extended payment terms.

Additionally, as previously discussed, under the risk assessment standards, the auditor is required to determine whether any of the identified and assessed risks of material misstatement

are fraud risks or other significant risks.⁷⁸ The standard does not mandate that all related party transactions be presumed to be or deemed to be significant risks or designated as a fraud risk. Under the risk assessment approach, the auditor's assessment is based on the facts and circumstances of the audit, including the facts and circumstances of a company's relationships and transactions with related parties. However, depending on the facts and circumstances, assessed risks of material misstatement associated with related parties and relationships and transactions with related parties might also represent fraud risks or other significant risks. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, provides examples of fraud risk factors, including some concerning related parties.⁷⁹

The complexity of a transaction is a factor considered by auditors when assessing risks of material misstatement associated with related party transactions. Further, when the substance of a related party transaction differs materially from its form, or when a company's related parties operate through an extensive and complex range of relationships and structures, heightened scrutiny is warranted. For example, depending upon the facts and circumstances, the creation of a variable interest entity in which the company's economic interest (its obligation to absorb losses or its right to receive benefits) is disproportionately greater than the company's stated power might represent a fraud risk or other significant risk, especially in the presence of other fraud risk factors.⁸⁰ Examples of fraud risk factors regarding related parties that individually, or in combination with other fraud risk factors, might indicate the existence of a fraud risk, include

⁷⁸ See paragraphs 59.f., 70, and 71 of Auditing Standard No. 12.

⁷⁹ See AU sec. 316.85.A.2, Section a., under "Opportunities."

⁸⁰ Paragraph 10 of Auditing Standard No. 12 states that obtaining an understanding of the nature of the company includes understanding the company's significant investments, including equity method investments, joint ventures and variable interest entities.

significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.⁸¹

The existence of dominant influence is another factor considered by auditors when assessing the risks of material misstatement. Related parties, due to their ability to control or significantly influence, may be in a position to prevent a company from pursuing its own separate interests. Identifying the risks of material misstatement associated with dominant influence can assist the auditor's assessment of the risks of material misstatement. AU sec. 316.85 already describes the principle of dominant influence in the example of a fraud risk factor by stating that the ineffective monitoring of management as a result of domination of management by a single person or small group, without compensating controls, provides an opportunity for management to engage in fraudulent financial reporting.

Examples of factors that may signal dominant influence exerted by a related party include:

- Significant transactions are referred to the related party for approval;
- There is little or no debate among management and the board of directors regarding business proposals initiated by the related party; or
- The related party played a leading role in starting the company and continues to play a leading role in managing the company, even if the related party is no longer formally part of management or the board of directors.

⁸¹ The amendments regarding significant unusual transactions separate this example into two examples – (i) related party transactions that are also significant unusual transactions and (ii) significant transactions with related parties whose financial statements are not audited or are audited by another firm.

The existence of dominant influence by itself, or in the presence of other fraud risk factors (e.g., use of an intermediary whose involvement serves no apparent business purpose), might indicate the existence of a fraud risk.

The other amendments to PCAOB auditing standards complement the requirements of paragraph 10 by amending AU sec. 316.85.A.2 to include the exertion of dominant influence by or over a related party as an example of a fraud risk factor. The other amendment to AU sec. 316.85.A.2 expands that concept to encompass all related parties outside of management of the company. The amendments do not define dominant influence, as doing so might result in some auditors being overly focused on the definition itself, instead of focusing on the red flags associated with dominant influence that might create risks of material misstatement at the financial statement level.

AU sec. 334 does not provide specific guidance for the auditor regarding the identification and assessment of risks of material misstatement associated with related party transactions. In fact, AU sec. 334.06 provides that, in the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business.⁸²

Discussion of Comments Received on Paragraph 10 of the Reproposed Standard

The Board considered all comments received, including the following significant comments:

Referencing Information Obtained from Past Audits: One commenter recommended requiring the auditor to determine that there were no changed circumstances for material related

⁸² Thus, AU sec. 334.06 could be misunderstood to create a "presumption of validity" for the business purpose of related party transactions in situations where experience suggests a need for heightened scrutiny.

party transactions previously authorized and approved. Another commenter suggested including a reference to the requirements pertaining to information obtained from past audits contained in the risk assessment standards both to improve the effectiveness of the audit process and to remind auditors of their responsibility regarding the information previously obtained regarding ongoing matters.

The Board considered these comments, noting that paragraph 10 requires that, in identifying and assessing the risks associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4 through 9 and the risk assessment procedures required by Auditing Standard No. 12, which address information obtained from past audits.⁸³ Thus, the auditor is already required to take such information obtained from past audits into account in identifying and assessing risks of material misstatement. Further, the revisions made to item d. of paragraph 5, which require the auditor to inquire of management regarding transactions with related parties modified during the period under audit, should assist the auditor in identifying transactions for which the auditor would not be able to rely on information obtained from past audits.

The Board is adopting paragraph 10 of the standard as repropoed.

Responding to the Risks of Material Misstatement (Paragraphs 11 through 13 of the Standard)

Discussion of Paragraphs 11 through 13 of Auditing Standard No. 18

Paragraph 11 of the standard aligns with the requirement in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, for the auditor to design and

⁸³ Paragraphs 41 through 45 of Auditing Standard No. 12 note that the auditor's risk assessment procedures require the auditor to consider information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements.

implement audit responses that address the identified and assessed risks of material misstatement. Paragraph 11 states that this includes designing and performing audit procedures that address the risks of material misstatement associated with related parties and relationships and transactions with related parties. Footnotes to paragraph 11 refer the auditor to relevant paragraphs of the risk assessment standards. A note to paragraph 11 refers the auditor to the new requirements in paragraphs .66-.67A of AU sec. 316 for related party transactions that are also significant unusual transactions.

AU sec. 334 also provides guidance to the auditor regarding audit procedures to evaluate identified related party transactions. For example, AU sec. 334.09 provides that, after identifying related party transactions, the auditor should apply the procedures the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient appropriate evidential matter and should extend beyond inquiry of management. AU sec. 334.09 includes procedures that should be considered and footnote 6 of AU sec. 334.09 provides that, until the auditor understands the business sense of material transactions, he cannot complete his audit.⁸⁴ AU sec. 334.10 includes other procedures that the auditor should consider when the auditor believes it necessary to fully understand a particular transaction, and notes that those procedures might not otherwise be deemed necessary to comply with generally accepted auditing standards.

⁸⁴ AU sec. 411.06 requires the auditor to consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. Understanding the "business sense" of material transactions is encompassed by this consideration.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk (Paragraph 12 of the Standard)

Briefly, paragraph 12 of the standard requires the auditor to perform certain basic procedures (supplemented by more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances) regarding related party transactions that are either required to be disclosed in the financial statements or determined to be a significant risk.⁸⁵

Focusing the auditor's attention on related party transactions that are required to be disclosed in the financial statements or determined to be a significant risk is intended to make the auditor's evaluation of whether the company's related party transactions are properly accounted for and disclosed most effective.

One important focus of the procedures required by paragraph 12 is the auditor's evaluation of the business purpose (or the lack thereof) of the related party transactions that are required to be disclosed or determined to be a significant risk. The procedures in paragraph 12 are designed to work with the procedures in paragraphs 3 through 9 to provide the auditor with additional information to understand and assess the business purpose (or the lack thereof) of the targeted related party transactions that are subject to paragraph 12. Understanding the business purpose of related party transactions is an important consideration in assessing and responding to risks of material misstatement and requires the auditor to understand other factors underlying the transaction. For example, although a company may assert that it has utilized a related party transaction to achieve a particular goal, the company may, in fact, have used the transaction for

⁸⁵ The SEC expects that auditors will provide "heightened scrutiny" of a company's related party transactions. See SEC Accounting and Auditing Enforcement Release ("AAER") No. 3427, *In the Matter of the Application of Wendy McNeeley, CPA*, at 10–12 (December 13, 2012), which states in part that the SEC and courts have repeatedly held that related party transactions require heightened scrutiny by auditors and notes the importance of the auditor understanding the business purpose of material related party transactions.

some other purpose.⁸⁶ Obtaining an understanding of the terms and business purpose of a related party transaction includes understanding why the company entered into the transaction with a related party versus an unrelated party. A business purpose that appears inconsistent with the nature of the company's business might represent a fraud risk factor.

Performing Basic Procedures: Paragraphs 12.a.-d. contains the basic procedures to be applied to related party transactions that are either required to be disclosed in the financial statements or determined to be a significant risk. Paragraph 12.a. requires the auditor to read the underlying documentation relating to the company's related party transaction(s) and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction. This requirement, together with the other requirements in paragraphs 12.b.-d., require the auditor to evaluate appropriate information regarding the transaction, including, for example, the executed contract, and to consider whether the contract and other underlying documentation is appropriately authorized and approved, and is consistent with explanations from inquiries of management and others. The auditor also considers how that information compares to other available audit evidence. For example, when evaluating the responses to inquiries of management and others, the auditor takes into account information obtained from other sources. Such sources could include, for example, SEC filings that include a description of the registrant's policies and procedures for the review, approval, or ratification of "related person" transactions or that identify any "related person" transaction where such policies and

⁸⁶ For example, a broker or dealer might use related party transactions to make the size of their operations appear smaller to avoid regulatory requirements.

procedures did not require review, approval or ratification or where such policies and procedures were not followed.⁸⁷

In particular, paragraph 12.d. of the standard requires the auditor to evaluate the financial capability of the related party with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations. This requirement applies only to items that are individually or collectively significant. Obtaining evidence to evaluate the financial capability of a related party can inform the auditor's evaluation of the business purpose (or the lack thereof), including whether the substance of that transaction differs materially from its form.⁸⁸

Performing Other Procedures: Paragraph 12.e. requires the auditor to supplement the basic required procedures contained in paragraphs 12.a.-d. with more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. This approach provides the auditor with the opportunity to scale the audit based on the auditor's judgment regarding other procedures that are necessary to address the identified and assessed risks of material misstatement. This requires the auditor to make a determination about what procedures are needed to evaluate the accounting and disclosure of the related party transactions.

⁸⁷ See Instruction 1 to Item 404(a) of SEC Regulation S-K for the definition of "related person." Disclosure requirements regarding "related persons" in Regulation S-K may differ from "related party" disclosures. See also, Securities Act Release No. 33-8732A, *Executive Compensation and Related Person Disclosure* (August 29, 2006), <http://www.sec.gov/rules/final/2006/33-8732afr.pdf>.

⁸⁸ See, e.g., *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005), noting that "among transactions calling for close inspection are related-party transactions, including transactions between a company and its officers or directors. Such dealings are viewed with extreme skepticism in all areas of finance.... The reason for this is apparent: Although in an ordinary arms-length transaction, one may assume that parties will act in their own economic self-interest, this assumption breaks down when the parties are related. A company that would perform a thorough credit-risk assessment before extending a loan might not do so if the loan were to one of its officers or directors."

For example, related party transactions might pose valuation and measurement issues that are not present in arm's-length transactions. Consequently, the auditor's tests regarding valuation of a receivable from an entity under common control might be more extensive than for a trade receivable of the same amount from an unrelated party because the common controlling parties may be motivated to obscure the substance of the transaction.

The procedures contained in paragraph 12.e. are designed to work with other procedures that the auditor performs during the audit to address the relevant assertions associated with each related party transaction that requires disclosure.⁸⁹ For example, if a company makes a material purchase of property, plant and equipment from an unconsolidated related party, the auditor could inspect the asset to obtain audit evidence that supports management's assertion regarding the existence of the asset. Further, the auditor might examine underlying documents supporting the transfer of title and ownership to obtain audit evidence that supports management's assertion regarding its rights and obligations.

The economic substance of a related party transaction may differ materially from its form. AU sec. 411.06 requires that the auditor consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. Thus, the procedures performed pursuant to paragraph 12.e. are intended to address the auditor's concerns

⁸⁹ See paragraph 8 of Auditing Standard No. 13, which requires the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure. 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. See also, paragraph 17 of Auditing Standard No. 13, which states that tests of controls must be performed in the audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when necessary to support the auditor's reliance on the accuracy and completeness of financial information used in performing other audit procedures.

about whether the substance of a related party transaction differs materially from its form. For example, evaluating the collectability of receivables due from companies owned or controlled by officers of the company under audit might include questions beyond evaluating the financial capability of the related party to pay.

Examples of other procedures that might be appropriate for the auditor to perform pursuant to paragraph 12.e., depending on the nature of the transaction and the risks of material misstatement of the financial statements, include:

- Inquiring directly of the related party regarding the business purpose of the transaction;
- Inspecting information in the possession of the related party or other parties to the transaction, if available;
- Reading public information regarding the related party and the transaction, if any;
- Reading the financial statements or other relevant financial information obtained from the related party, if available, to understand how the related party accounted for the transaction;
- Confirming the terms of the transaction with other parties with knowledge of the transaction (e.g., banks, guarantors, agents, or attorneys), if any;
- Determining whether there are any side agreements or other arrangements (either written or oral) with the related party, including confirming that none exist, if appropriate;
- Evaluating the transferability and value of collateral provided by the related party, if any; and
- Performing procedures at the related party, if possible.

In certain circumstances, an auditor may decide to perform audit procedures at the related party in order to obtain sufficient appropriate audit evidence to support the auditor's opinion. The auditor, however, may not be able to perform procedures at the related party's premises because the related party may not allow the auditor to perform such procedures. However, in all cases the auditing standards require the auditor to obtain sufficient appropriate audit evidence to support his or her audit opinion.⁹⁰

Aggregating Transactions for Disclosure: Accounting principles applicable to the company may allow the aggregation of related party transactions that require disclosure (e.g., by type of related party transaction). A note to paragraph 12 of the standard addresses the auditor's responsibility for aggregated related party disclosures. That note states that, 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 in paragraph 12 of the standard for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement. The Board notes that a "selection of transactions" could be the selection of one transaction from the aggregation in the appropriate circumstances.

Existing standards require the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each

⁹⁰ Paragraph 2 of the standard states that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements. As provided by paragraph 14 of the standard, the auditor's evaluation should be supported by auditing procedures and evidence obtained from procedures performed during the audit, including procedures designed to test the accuracy and completeness of the related parties and relationships and transactions with related parties disclosed by the company to the auditor.

significant account and disclosure.⁹¹ AU sec. 334.08-.09 contains procedures that the auditor should consider performing when responding to risks arising from related party relationships and transactions and directs the auditor to apply the procedures the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of identified related party transactions and their effect on the financial statements, noting that those procedures should extend beyond inquiry of management.

Intercompany Accounts (Paragraph 13 of the Standard)

Paragraph 13 of the standard requires the auditor to perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ. This requirement is based on the procedure in the existing standard, AU sec. 334.09.e., which requires the auditor to consider arranging for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information. Other existing standards also reference the importance of the auditor's review of consolidating accounts.⁹²

A new note to paragraph 13 states that the procedures performed should address the risks of material misstatement associated with the company's intercompany accounts.

Discussion of the Comments Received on Paragraphs 11 through 13 of Auditing Standard No. 18

The Board considered all comments received, including the following significant comments:

⁹¹ See paragraph 8 of Auditing Standard No. 13.

⁹² See, e.g., paragraph .10 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, and paragraphs .28-.34 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

Evaluating the Financial Capability of the Related Party: One commenter recommended that the standard should require the auditor to consider evaluating the financial capability of a related party and that the standard should include appropriate alternative procedures if information regarding the related party's financial capability is not readily available. Another commenter stated that the evaluation of the financial capability of the related party should not result in significant additional time by management or the auditor. The Board considered these comments noting that auditors are currently performing procedures to evaluate the financial capability of counterparties in a variety of audit areas today, regardless of whether the counterparty is a related party. For example, auditors might examine the company's support regarding the financial capability of another party as part of evaluating the company's decision to recognize revenue on a particular transaction.

Performing Procedures on Intercompany Balances: Some commenters recommended providing additional direction, including specific procedures that the auditor should perform pursuant to paragraph 13. One commenter recommended requiring the auditor to determine the business purpose for intercompany transactions, and whether the transactions have "economic substance."

The Board considered these comments, noting that the preparation of consolidated financial statements could involve complex matters regarding intercompany transactions. For example, a company could consolidate a subsidiary that has a different year-end. The risks of material misstatement with intercompany transactions could include not only the risks associated with intercompany account balances, but also the resulting effect on the consolidated financial statements, after elimination of such balances. The procedures performed pursuant to paragraph 13 should address the risks of material misstatement. Those procedures could include examining

account reconciliations and material transactions, regardless of their timing. The procedures performed pursuant to paragraphs 3 through 9 apply to intercompany transactions and include inquiring of management regarding the business purpose of the transaction and the business purpose for entering into the transaction. Some intercompany transactions might give rise to significant risks of material misstatement that are subject to the procedures in paragraph 12.

The Board considered including additional direction regarding intercompany transactions, but noted that such direction could be viewed as making the requirement unnecessarily prescriptive, which could result in unnecessary costs. However, to remind auditors of the need to address the potential risks of material misstatement, the Board added a note to paragraph 13, which states that the procedures performed should address the risks of material misstatement associated with the company's intercompany accounts. Further, based on comments received, the header preceding paragraph 13 has been revised to refer to "Intercompany Accounts."

The Board is adopting paragraphs 11 through 13 of the standard, substantially as repropoed, except for changing the header to paragraph 13 and adding a new note to paragraph 13, discussed above.

Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14 through 16 and Appendix A of the Standard)

Discussion of Paragraphs 14 through 16 and Appendix A of Auditing Standard No. 18

Briefly, paragraphs 14 through 16 of the standard address the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties. Appendix A includes examples of information and sources of information

that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Paragraph 14 of the standard requires the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties.

Paragraph 14 states that evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. Paragraph 14 also states that this evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, taking into account the information gathered during the audit. Paragraph 14 further requires that, as part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

Paragraph 14 of the standard focuses the auditor on a key aspect of the objective by requiring the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Paragraph 14 recognizes that the company is responsible for the preparation of its financial statements, including, in the first instance, the identification of the company's related parties and relationships and transactions with related parties, and that the auditor begins the audit with information obtained from the company. While paragraph 14 of the standard anticipates that the auditor would start his or her work regarding related parties with the names of related parties and relationships and transactions with related parties identified by the company, the auditor may not merely rely on management's

representations⁹³ as to the accuracy and completeness of the information provided to the auditor.

While management has the primary responsibility for preparing the company's financial statements, the auditor should be sensitive throughout the audit to the possibility that management may not have informed the auditor of all related parties or relationships or transactions with related parties.

Paragraph 14 also recognizes that the auditor's procedures to evaluate whether the company has properly identified its related parties should extend beyond the inquiries pursuant to paragraphs 5 through 7 of the standard. Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

A note to paragraph 14 of the standard refers the auditor to Appendix A, which describes examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Many of the examples contained in Appendix A of the standard are contained in AU secs. 334.07-.08. The standard does not require an auditor to perform procedures with respect to each source of information referenced in Appendix A. The information and sources relevant to a particular audit would depend on the facts and circumstances of the audit and, thus, not all of the information or sources of information in Appendix A would need to be considered in every audit. However, other auditing standards, or

⁹³ To further assist the auditor's efforts in identifying related parties, the other amendments include a complementary provision that expands existing management representations contained in AU sec. 333 to state that the company has provided the names of all related parties and all relationships and transactions with its related parties to the auditor. However, the auditor may not solely rely on management's representations.

the performance of auditing procedures in other areas, may impose requirements on the auditor to perform auditing procedures with respect to certain of those sources (for example, reading confirmation responses and responses to inquiries of the company's lawyers).⁹⁴ Appendix A also states that the examples contained in that Appendix are not intended to represent a comprehensive listing.

Paragraph 14 precludes the auditor's reliance on the company's identification of its related parties without the auditor taking additional steps, including following up on possible contradictory information gathered during the audit. Thus, while the standard does not require the auditor to search public information indiscriminately to identify a company's related parties, the standard does anticipate that the auditor will take additional steps, including following up on inconsistencies or red flags that arise during the audit. For example, the auditor might review public documents for information regarding a company's related parties and transactions with related parties, particularly when such information is readily available.⁹⁵ Additionally, a review of relevant available public information might be appropriate in situations in which information comes to the auditor's attention that suggests that related parties previously undisclosed to the auditor might exist.

In general, the steps performed by the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties include: (i) performing risk assessment procedures to obtain an understanding of the company's

⁹⁴ See, e.g., AU sec. 330, *The Confirmation Process*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

⁹⁵ Paragraph 11 of Auditing Standard No. 12 requires that as part of obtaining an understanding of the company the auditor should consider reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements.

relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements; (ii) identifying and assessing risks associated with a company's relationships and transactions with its related parties, including whether the company has properly identified its related parties and relationships and transactions with related parties; (iii) designing and performing audit procedures that address and respond to the risks of material misstatement associated with the company's related parties and transactions, including procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company; and (iv) performing specific procedures that address related party relationships or transactions identified by the auditor that were previously undisclosed by company management. Performing these procedures should position the auditor to obtain sufficient evidence to provide reasonable assurance to support the auditor's opinion.

The approach in paragraph 14 also considers that the auditor's efforts to identify and evaluate a company's significant unusual transactions and obtain an understanding of a company's financial relationships and transactions with its executive officers might assist the auditor in identifying information that might indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Also, the amendments to AU sec. 560, *Subsequent Events*, require that during the "subsequent period" the auditor inquire regarding whether there have been any changes in the company's related parties and whether the company has entered into any significant new related party transactions. This could inform the auditor's evaluation of the company's identification of its related parties and relationships and transactions with related parties.

Pursuant to paragraph 15 of the standard, if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor then performs the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. The standard requires that these procedures extend beyond inquiry of management.

Pursuant to paragraph 16 of the standard, if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should perform certain procedures targeted at enhancing the auditor's understanding of the previously undisclosed related party or relationship or transaction. The procedures contained in paragraph 16 are intended to focus the auditor on (i) obtaining additional information and evaluating the related party or relationship or transaction with a related party that the auditor has identified, and (ii) assessing the impact of the new information on all aspects of the audit.

Specifically, the procedures contained in paragraph 16 require that if the auditor determines that an undisclosed related party or relationship or transaction exists, the auditor should:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;

- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of the standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;
- f. Perform the following procedures, taking into account the information gathered from performing the procedures in a. through e. above:
 - i. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
 - ii. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
 - iii. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1.

A footnote to paragraph 16 refers the auditor to AU sec. 333.04, which states that, if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified. Another footnote refers the auditor to paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessment.

As described above, the procedures required by paragraphs 16.a.–e. are performed to obtain the information necessary to evaluate the related party or relationship or transaction with a related party previously undisclosed to the auditor that the auditor has determined exists. Significantly, because of the potential for fraud, paragraph 16.b. of the standard requires the auditor to evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor. If the related party transaction is either required to be disclosed or is determined to be a significant risk, the auditor is required to perform the procedures in paragraph 12 of the standard.

Paragraph 16.f. requires the auditor to take into account the information gathered from the procedures in paragraph 16.a.–e. regarding the relationship or transaction identified by the auditor to assess the impact on the audit. For example, paragraph 16.f.iii. requires the auditor to reassess the implications for the audit if the company's nondisclosure indicates that fraud or an illegal act may have occurred.

Determining that a related party transaction that was previously undisclosed to the auditor exists could have significant implications for the audit. This information contradicts representations made by management to the auditor and may contradict the auditor's preliminary assessment of whether the company has properly identified its related parties and relationships and transactions with related parties. Identifying such contradictory information requires the auditor to reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk.

The auditor takes the information gathered from performing the procedures set forth in paragraph 16 into account when evaluating whether the company has properly identified its related parties and relationships and transactions with related parties pursuant to paragraph 14 of the standard.

In contrast to the approach set forth in paragraphs 14 through 16, the existing standard contains a variety of procedures that are less specific and focused. For example, AU sec. 334.05 alerts the auditor to the fact that business structure and operating style are occasionally deliberately designed to obscure related party transactions. AU sec. 334.05 states that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component to the total entity and should consider controls over management activities, and the business purpose served by the various components of the entity. AU sec. 334.07 states that determining the existence of transactions with related parties beyond those that are clearly evident requires the application of specific audit procedures and provides examples of such procedures. AU sec. 334.07 further states that the auditor should place emphasis on testing material transactions with parties the auditor knows are related to the reporting entity. AU sec.

334.08 includes procedures that are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships.

Discussion of the Comments Received on Paragraphs 14 through 16 and Appendix A of the Reproposed Standard

The Board considered all comments received, including the following significant comments:

Clarifying the Auditor's Responsibility Regarding Appendix A: Many commenters recommended clarifying the auditor's responsibilities for the examples of information and sources of information contained in Appendix A. Some of the commenters recommended including clarifying language regarding the scope of the auditor's responsibilities with respect to Appendix A; others suggested qualifying language stating that the auditor is not required to perform procedures with respect to each type or source of information referenced in Appendix A.

The Board considered these comments, noting that Appendix A is intended to provide examples of information and sources of information and does not provide a comprehensive or mandatory listing. Further, other auditing standards may impose requirements on the auditor to perform procedures regarding the examples contained in Appendix A. Accordingly, the suggested qualifying language would not be appropriate. The Board, however, made certain revisions intended to clarify the applicability of Appendix A by revising the note in paragraph 14 and similar language in Appendix A to state that Appendix A contains examples of information and sources of information that the auditor may gather during the audit.

Clarifying the Auditor's Responsibility for Evaluating the Company's Identification of Its Related Parties: Many commenters recommended a number of clarifications to paragraph 14 of the reproposed standard. Several commenters recommended incorporating footnote 14 into

paragraph 14 of the repropoed standard to clarify that the auditor's evaluation of the company's identification of its related parties and relationships and transactions with related parties requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company. Other commenters recommended clarification regarding the extent of the auditor's evaluation in paragraph 14 and whether it is based on the information gathered during the audit.

In response to these comments, the Board made a number of clarifications. Specifically, the Board incorporated footnote 14 of the repropoed standard into paragraph 14 to clarify that the auditor's evaluation requires the auditor to perform procedures to test the accuracy and completeness of the company's identification. Additionally, the revisions give more prominence to the requirement and clarify that, in performing the evaluation required by paragraph 14, the auditor takes into account the information gathered during the audit. This revision, in conjunction with the clarifications to the note regarding the examples and sources of information contained in Appendix A (discussed below), is intended to further describe the auditor's responsibilities for evaluating the company's identification of its related parties and relationships and transactions with its related parties.

Examples Included in Appendix A: A few commenters suggested revisions to the examples of information or sources of information contained in Appendix A to the standard. The Board considered these comments, noting that Appendix A contains examples of information and sources of information that the auditor may gather during the audit and does not represent a comprehensive listing. The Board revised Appendix A to include "disclosures contained on the company's website" (in addition to the company's disclosures in SEC filings, which is already included as an example in Appendix A) as another example of a source of information that may

be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Verifying the Ownership Structure Between the Company and Its Related Parties: One commenter stated that verifying the ownership structure between the company and its related parties may be one of the most difficult aspects of an audit. That commenter recommended that the Board outline procedures for verifying the ownership structure between the company and the related parties disclosed to the auditor by management, including the levels of direct and indirect control, and changes in those levels during the period under audit. The Board considered this comment, noting that determining the procedures for verifying these matters (for example, determining whether the company or its management is able to exercise significant influence over another entity) requires an evaluation of the facts and circumstances. Additionally, in making such a determination, the auditor's response should address the risks of material misstatement.⁹⁶ Including additional direction in a context that is so heavily facts and circumstances driven could make the standard unnecessarily complex and prescriptive, making it potentially more difficult to apply.⁹⁷

⁹⁶ The auditor may also be required to perform procedures on these matters by other auditing standards, such as AU sec. 332.

⁹⁷ See, e.g., Canadian Public Accountability Board, *Auditing in Foreign Jurisdictions CPAB Special Report* (2012) <http://www.cpab-crc.ca/en/topics/PublicSpecialReports/Pages/default.aspx>, which noted that the existence of related parties and transactions are more likely to represent an audit risk for operations in foreign jurisdictions when the legal or regulatory environment requires reliance on complex business structures or when dominant shareholders are involved in the operations of the business. That report also noted that because the identification of related parties may also be more difficult in foreign jurisdictions, it is important that auditors have a heightened sensitivity to possible related-party transactions by performing procedures to determine the ownership and management structure of significant customers and suppliers.

Setting Appropriate Expectations Regarding the Auditor's Responsibilities: Some commenters stated that the extent of the auditor's procedures necessary for evaluating management's identification of its related parties and relationships did not take into account the responsibility of management. One commenter recommended including additional context, similar to that contained in International Standard on Auditing No. 550, *Related Parties*, to recognize that the nature of related party transactions could compromise the auditor's ability to detect material misstatements associated with related parties, even though the audit is properly planned and performed. Another commenter stated that the objective appears to require performance of procedures equivalent to a forensic engagement to uncover all related parties and transactions.

The Board considered these comments and did not agree that additional changes were necessary to address the appropriate expectations for the auditor's responsibilities with respect to identifying related parties and relationships and transactions with related parties.⁹⁸ Additionally, the Board had already taken note of commenters' requests to clarify its proposal to focus the auditor's attention first on information provided by management and is also adopting revisions to AU sec. 333 to provide for additional written representations by management pertaining to its related parties. Moreover, the Board declined to pursue an alternative that would have designated related party transactions as fraud risks, which would have resulted in more forensic-type procedures. Instead, the Board's approach overall to the auditor's responsibility to identify a company's related parties has been targeted and risk-based, requiring heightened scrutiny in areas that have historically represented high risk of material misstatement. The Board believes this

⁹⁸ For example, the auditor's responsibility to perform procedures to identify related party transactions that are material to the financial statements is reflected in Section 10A(a) of the Exchange Act.

approach appropriately recognizes the auditor's existing responsibilities for the identification of related parties and relationships and transactions with related parties in a cost-sensitive way.

Applicability of Paragraph 16 to Related Party Transactions Identified by the Auditor That Are "Clearly Trivial": Several commenters recommended that the procedures required by paragraph 16 should not be required if the related party transaction identified by the auditor is "clearly trivial," as that term is described in Auditing Standard No. 14.⁹⁹ Those commenters generally noted that such an approach would avoid unnecessary work.

The Board considered these comments, noting that the auditor might not be able to determine if the previously undisclosed transaction identified by the auditor is "clearly trivial" without the information that would be obtained from the procedures in paragraph 16.a.-d. of the repropoed standard." For example, inquiring of management regarding why the transaction was not disclosed to the auditor and evaluating that explanation would be important to determining whether the transaction is "clearly trivial." Further, taking into account information regarding a related party transaction identified by the auditor that is "clearly trivial" generally would not significantly impact the auditor's evaluation of the matters in paragraphs 16.f-h. of the repropoed standard.¹⁰⁰

The use of the phrase "clearly trivial" could also result in other consequences. For example, providing such an exception could inappropriately focus the auditor's evaluation on

⁹⁹ Paragraph 10 of Auditing Standard No. 14 states that "clearly trivial" is not another expression for "not material." Paragraph 10 also states that matters that are clearly trivial will be of a smaller order of magnitude than the materiality level established in accordance with Auditing Standard No. 11, and will be inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature, or circumstances. Paragraph 10 further states that when there is any uncertainty about whether one or more items is clearly trivial, the matter is not considered trivial.

¹⁰⁰ Paragraphs 16.f-h. of the repropoed standard are now contained in paragraphs 16.f.i-iii. of the standard.

quantitative considerations to the detriment of qualitative considerations and might allow management an opportunity to influence the auditor's evaluation. In addition, providing such an exception could create confusion regarding paragraph 16.h. of the repropoed standard (paragraph 16.f.iii of the standard), which refers to Section 10A of the Exchange Act. Section 10A of the Exchange Act applies to information indicating that fraud or another illegal act has or might have occurred, whether or not perceived to have a material effect on the financial statements of the company.

However, after considering these comments, the Board did make revisions to paragraph 16 to clarify that the procedures performed pursuant to paragraph 16 focus the auditor on obtaining additional information both by (i) performing the initial procedures in paragraph 16.a.-e. so that the auditor can evaluate the nature and potential impact of the previously undisclosed related party or relationship or transaction that the auditor has identified, and (ii) performing additional procedures to evaluate the implications for the audit, including the auditor's risk assessment, taking into account the information gathered from performing the procedures in paragraph 16.a.-e. These revisions should clarify the auditor's approach.

The Board also made technical changes to paragraph 16.h. of the repropoed standard to more closely align with the corresponding requirement contained in paragraph 23 of Auditing Standard No. 14. Paragraph 23 of Auditing Standard No. 14 states that if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79-82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Exchange Act, 15 U.S.C. § 78j-1.

As revised, if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor is required to

perform certain initial procedures. Those procedures required by paragraphs 16.a.-e. focus the auditor on obtaining additional information and evaluating the related party or relationship or transaction with a related party that the auditor has identified. A footnote to paragraph 16.b. refers the auditor to AU sec. 333.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. After performing the procedures in paragraph 16.a.-e., the auditor performs the procedures in paragraphs 16.f.i-iii. of the standard taking into account the information previously gathered by the auditor, to assess the broader impact of the auditor's findings on the audit.

"Other" Related Parties Previously Undisclosed to the Auditor: One commenter recommended that paragraph 16 be clarified to include that the auditor also inquire of management about the possible existence of transactions with *other* undisclosed related parties. The Board considered this comment, noting that while this inquiry was not explicitly stated, assessing whether there are *other* undisclosed related parties is a component of the auditor's response once a related party or a relationship or transaction with a related party previously undisclosed to the auditor by management has been identified by the auditor.

Inquiring of management regarding the identification of the possible existence of transactions with other undisclosed related parties and relationships and transactions with related parties, including whether there are any *other* undisclosed related parties, would generally be encompassed in the auditor's procedures performed in discharging the auditor's responsibilities once the auditor has determined that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Based on the auditor's reassessment of risk, the

auditor performs additional procedures that would include such inquiries, but also would extend beyond inquiring of management.

Significantly, paragraph 16.f.ii. of the standard¹⁰¹ requires the auditor to reassess the risks of material misstatement and perform additional procedures as necessary, if such reassessment results in a higher risk. This would include procedures designed to address the risk of transactions with *other* undisclosed related parties.

To clarify the auditor's responsibilities regarding *other* undisclosed related parties, the Board added a new footnote to paragraph 16 that refers the auditor to paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.

The Board is adopting paragraphs 14 through 16 and Appendix A as repropoed, with the following changes:

- a. revising paragraph 14 to highlight that the auditor performs procedures to test the accuracy and completeness of management's identification, taking into account information gathered during the audit;
- b. clarifying in the note to paragraph 14 that Appendix A contains examples of information and sources of information that the auditor may gather during the audit;
- c. revising Appendix A to include a new example, "disclosures contained on the company's website";

¹⁰¹ Paragraph 16.g. of the repropoed standard is now contained in paragraph 16.f.ii. of the standard.

- d. revising paragraph 16 to clarify that the auditor performs the procedures in 16.f.i.-iii., taking into account the information gathered from performing the procedures in paragraph 16.a.-e.;
- e. adding a new footnote to paragraph 16.f.ii., referring to paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments; and
- f. revising paragraph 16.f.iii. to more closely align with paragraph 23 of Auditing Standard No. 14, which states if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79-.82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17 and 18 of the Standard)

Discussion of Paragraphs 17 and 18 of Auditing Standard No. 18

Paragraph 17 of the standard aligns with requirements in Auditing Standard No. 14 to require the auditor to evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. Paragraph 17 states that this includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial

reporting framework. A footnote to paragraph 17 refers the auditor to paragraphs 30 and 31 of Auditing Standard No. 14.

The auditor's evaluation of a company's accounting and disclosure of relationships and transactions with related parties is important to the protection of investor interests because the substance of related party transactions might differ materially from their form. Furthermore, related party transactions not only may involve difficult measurement and recognition issues, but may also be used to engage in financial statement fraud and conceal misappropriation of assets.

Paragraph 17 is intended to align the auditor's evaluation with the objective of the standard and to focus the auditor on both the accounting and disclosure of the company's relationships and transactions with related parties. Footnote 1 to paragraph 1 of the standard states that the auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company. Unlike the existing standard, paragraph 17 of the standard does not include a separate requirement to evaluate whether the substance of a related party transaction differs materially from its form because that evaluation is part of the auditor's evaluation of whether the financial statements have been presented fairly in conformity with the applicable financial reporting framework pursuant to AU sec. 411.06.

Consistent with the existing standard, evaluating substance over form does not require the auditor to challenge the appropriateness of the accounting standards. However, financial statements may not be presented fairly if they do not include information about the matters that affect their use, understanding, and interpretation.¹⁰² For example, to improve the appearance of its financial condition, a company and a related party could attempt to "dress up" the appearance

¹⁰² See AU sec. 411.04.

of the company's balance sheet at period-end. Some period-end "window-dressing" transactions might involve side agreements undisclosed to the auditor, while others might represent transactions that the auditor is aware of, in which management placed more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction.

AU sec. 334 requires the auditor to consider whether sufficient appropriate evidence has been obtained to understand each related party relationship, as well as the effect of each material related party transaction on the financial statements. The existing standard states that the auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure. Further, AU sec. 334.02 states that the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form. Additionally, Auditing Standard No. 14 describes the auditor's responsibility for evaluating the presentation of financial statements, including disclosures, more generally. Auditing Standard No. 14 requires the auditor to evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.¹⁰³ Furthermore, AU sec. 411.06 requires the auditor to consider whether the substance of transactions or events differs materially from their form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework.

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (Paragraph 18 of the Standard)

¹⁰³ See paragraph 30 of Auditing Standard No. 14.

Paragraph 18 of the standard states that if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion.

Financial reporting frameworks permit management to assert that a related party transaction that is required to be disclosed in the financial statements was conducted on terms equivalent to those prevailing on an arm's-length basis only when support for such an assertion exists. Management's refusal to modify such a disclosure when support for that statement does not exist represents a departure from GAAP and IFRS. Such a misstatement would require the auditor to express either a qualified or adverse opinion on the financial statements. A decision by management to remove, at the auditor's request, such an assertion from the financial statements due to management's inability to provide the auditor with sufficient appropriate audit evidence might affect the auditor's assessment of internal control over financial reporting.

The requirements in paragraph 18 of the standard are complemented by the other amendments to AU sec. 333, which require the auditor to obtain written representations from management when management has asserted that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

AU sec. 334 includes requirements regarding the auditor's evaluation of assertions that related party transactions occurred on terms equivalent to those occurring on an arm's-length basis. AU sec. 334.12 notes the difficulty in substantiating such representations and states that, except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. AU sec. 334 also states

that if such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, the auditor should express a qualified or adverse opinion because of a departure from GAAP, depending on materiality.

After considering all comments received, the Board is adopting paragraphs 17 and 18 of the standard as repropoed, except for the addition of a reference to paragraph 30 of Auditing Standard No. 14 in footnote 19 to paragraph 17.

Communications with the Audit Committee (Paragraph 19 of the Standard)

Discussion of Paragraph 19 of Auditing Standard No. 18

Paragraph 19 of the standard requires the auditor to communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with its related parties, as well as other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

Both the auditor and the audit committee benefit from a meaningful exchange of information regarding significant risks of material misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports, including matters arising from a company's relationships and transactions with related parties.

Paragraph 19 of the standard is intended to work in tandem with paragraph 7 of the standard. The inquiries of the audit committee, or its chair, pursuant to paragraph 7, can be more effective when they occur at an earlier point in the audit, when the auditor is obtaining an understanding of the company's relationships and transactions with its related parties. This can avoid situations where the auditor's communications regarding a company's relationships and transactions with its related parties might first occur at the end of the audit. This is consistent with Auditing Standard No. 16, which anticipates timely and robust communications between the

auditor and the audit committee throughout the audit. These communications also provide an opportunity for the auditor to corroborate the information obtained from management regarding the company's relationships and transactions with its related parties.

The communication required by paragraph 19 of the standard provides an opportunity for the auditor to communicate information obtained during the audit relevant to those earlier inquiries pursuant to paragraph 7. For example, the auditor might discuss relationships or transactions with related parties that are significant to the company that were not previously discussed with the audit committee, or its chair. The auditor also would communicate significant matters to the audit committee if the auditor encountered these matters during the review of interim financial information.¹⁰⁴

In all cases, the auditor's communications with the audit committee pursuant to paragraph 19 of the standard would cover all the items listed in paragraphs 19.a.-e., to the extent applicable. Such communications involve matters such as the identification of related parties and relationships and transactions with related parties that were previously undisclosed to the auditor, which, as described in the paragraph below, may be of particular interest and concern to the audit committee. Thus, the auditor's communications pursuant to paragraph 19 are not intended to be done only when an exception is identified by the auditor. Doing so would not provide for the proactive communication that should occur with the audit committee regarding what the auditor found as a result of the auditor's evaluation of the company's identification of, accounting for, and disclosure of, its relationships and transactions with its related parties. Further, these communications cannot be made by management as the communication requirements involve

¹⁰⁴ See paragraph .34 of AU sec. 722, *Interim Financial Information*.

communication of the auditor's evaluation of certain matters and management is not in a position to communicate the auditor's evaluation and views.

As noted in paragraph 19, the auditor's communications to the audit committee may not be limited to only those examples of significant matters included in paragraph 19 of the standard. For example, in evaluating the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, the auditor might identify other significant matters that might be of interest to the audit committee, such as concerns over the company's process for identifying related parties and relationships and transactions with related parties.

AU sec. 334 does not include specific requirements regarding the auditor's communication with the audit committee. Other existing auditing standards, however, require that the auditor communicate significant matters to the audit committee, including those encountered during a review of interim financial information.¹⁰⁵

Discussion of the Comments Received on Paragraph 19 of the Reproposed Standard

The Board considered all comments received, including the following significant comments:

Communicating Significant Matters: Many commenters recommended revising paragraph 19.a. of the reproposed standard to allow for additional auditor judgment. Some of these commenters suggested that paragraph 19.a. of the reproposed standard be revised to only require the communication of "significant" related parties or relationship or transactions with related parties that were previously undisclosed to the auditor.

The Board considered these comments and believes that communicating all related party relationships and transactions previously undisclosed to the auditor to the audit committee is

¹⁰⁵ See Auditing Standard No. 16 and AU sec. 722.34.

beneficial. For example, such communications could inform the audit committee of such matters that management had previously concealed from the audit committee as well as from the auditor. While the auditor determines the impact of the identification of a related party relationship or transaction on the audit, these communications can inform the audit committee of matters that might be important to their oversight of management and the financial reporting process. Further, this communication also serves as an opportunity to corroborate management's explanation regarding why the related party transaction was undisclosed to the auditor.

Form of the Communications: At the SAG discussion, the point was raised as to whether the auditor's communications with the audit committee should be communicated in writing or orally. The Board considered this comment, noting that paragraph 19 of the standard is aligned with the requirements in Auditing Standard No. 16, which includes specific requirements on the nature and timing of auditor communications with the audit committee. Paragraph 25 of Auditing Standard No. 16 states that generally the communications can be made orally or in writing.¹⁰⁶ The Board is adopting paragraph 19 of the standard as repropoed.

Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

Significant unusual transactions can present increased risks of material misstatement of the financial statements due to fraud or error. The amendments regarding significant unusual transactions being adopted by the Board improve the existing standards regarding the auditor's identification and evaluation of a company's significant unusual transactions.

Many commenters generally supported the Board's efforts to strengthen the existing standards regarding significant unusual transactions. A few commenters noted that the

¹⁰⁶ Paragraph 25 of Auditing Standard No. 16 also states that the auditor must document the communications in the work papers, whether such communications took place orally or in writing.

improvements could have a positive impact on audit quality. However, some commenters suggested certain revisions to clarify and refine the repropoed amendments regarding significant unusual transactions.

After considering the comments received, the Board is adopting the amendments regarding significant unusual transactions substantially as repropoed, with certain minor revisions that include:

- *Clarifying the Phrase "Infrequent or Significant Unusual Transactions" in the Amendments to AU sec. 722 (Identifying Significant Unusual Transactions):* The amendments to Appendix B of AU sec. 722 include revisions to clarify that the "occurrence of infrequent transactions" and the "occurrence of significant unusual transactions" are separate examples; and
- *Clarifying the Auditor's Evaluation of Identified Significant Unusual Transactions in the Amendments to Paragraph .67 of AU sec. 316 (Evaluating Significant Unusual Transactions):* The amendments to AU sec. 316.67 include revisions to clarify that, in considering the business purpose (or the lack thereof) of the significant unusual transaction, the auditor should evaluate whether the transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party of the company.

The following sections describe the amendments regarding significant unusual transactions being adopted by the Board and existing requirements, as well as discuss the significant comments received and Board responses, where applicable. The sections are organized by the following topical areas:

- Identifying Significant Unusual Transactions

- Evaluating Significant Unusual Transactions

Identifying Significant Unusual Transactions

Discussion of the Amendments Regarding Identifying Significant Unusual Transactions

The amendments regarding identifying significant unusual transactions: (i) align the description of significant unusual transactions in the Board's auditing standards; (ii) enhance the requirements for identifying a company's significant unusual transactions; and (iii) revise and add to the examples of fraud risk factors described in AU sec. 316.

Aligning the Descriptions of Significant Unusual Transactions

Amendments to AU sec. 316.66: The amendments regarding significant unusual transactions revise AU sec. 316.66 to describe significant unusual transactions as 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. This description is consistent with the existing description in paragraph 71.g. of Auditing Standard No. 12. The amendments to AU sec. 316.66 also state that significant unusual transactions may be used to engage in fraudulent financial reporting or conceal misappropriation of assets.

Conforming Amendments: The amendments regarding significant unusual transactions also make conforming changes to introduce a uniform description of "significant unusual transaction" throughout the Board's standards. Specifically, the amendments align the terminology in: (i) paragraph 14 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*; (ii) paragraph 12 of Auditing Standard No. 9, *Audit Planning*; (iii) paragraph 13 of Auditing Standard No. 12; (iv) paragraph 15.c. of Auditing Standard No. 13; (v), paragraph .85.A.2 of AU sec. 316; and (vi) AU sec. 722.55.B1.

In general, the description of a significant unusual transaction included in the amendments permits the auditor flexibility in applying the description to different companies of different sizes and in different industries. The description of a significant unusual transaction is designed so that the auditor determines whether a transaction is a significant unusual transaction based on the specific facts and circumstances of the company under audit.

A significant unusual transaction does not necessarily need to occur infrequently. Whether a transaction constitutes a significant unusual transaction should be based upon the specific facts and circumstances. The timing or frequency of transactions is only one element to be considered in determining whether a transaction is a significant unusual transaction.

Enhancing Requirements for Identifying Significant Unusual Transactions

Existing requirements relating to the auditor's consideration of fraud in a financial statement audit recognize that during an audit the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment.¹⁰⁷ The risk assessment standards also anticipate that the auditor might come across 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. For example, paragraph 71.g. of Auditing Standard No. 12 states that one factor that should be evaluated for the auditor's determination of which risks are significant risks is whether the risk involves significant transactions outside the normal course of business or that otherwise appear to be unusual due to their timing, size, or nature.

¹⁰⁷ See AU secs. 316.66–.67.

The amendments include changes to existing standards that require the performance of procedures as part of the auditor's risk assessment process to identify significant unusual transactions. As discussed below, these procedures include: (i) inquiring of management and others; (ii) understanding controls relating to significant unusual transactions; and (iii) taking into account other information obtained during the audit.

Inquiring of Management and Others (Paragraphs 56-57 of Auditing Standard No. 12):

The amendments regarding significant unusual transactions build on existing requirements in Auditing Standard No. 12 that require the auditor to make inquiries of management and others within the company about the risks of material misstatement.¹⁰⁸ Specifically, the amendments regarding significant unusual transactions revise paragraph 56.a. of Auditing Standard No. 12 to require the auditor to inquire of company management regarding whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties. The amendments regarding significant unusual transactions also revise paragraphs 56.b. and 56.c. of Auditing Standard No. 12 to require the auditor to inquire of the audit committee and internal audit personnel (if applicable), respectively, regarding whether the company has entered into any significant unusual transactions.

The amendments regarding significant unusual transactions also amend paragraph 57 of Auditing Standard No. 12, which currently requires that the auditor inquire of others within the company about their views regarding fraud risks and includes the example of employees involved in initiating, recording, or processing complex or unusual transactions. The

¹⁰⁸

See paragraphs 56 and 57 of Auditing Standard No. 12.

amendments add significant unusual transactions as an example of a complex or unusual transaction to paragraph 57 of Auditing Standard No. 12.

Inquiring of management and others within the company regarding the existence of significant unusual transactions as part of the auditor's risk assessment procedures is an important step – but not the only step – in the auditor's identification of significant unusual transactions. The auditor might determine that there are significant unusual transactions despite management's assertion that there are no significant unusual transactions (e.g., through other procedures performed during the audit, such as reading minutes of the board of directors meetings and performing journal entry testing).

Understanding Controls Relating to Significant Unusual Transactions (Paragraph 73A of Auditing Standard No. 12): Auditing Standard No. 12 requires that the auditor obtain a sufficient understanding of each component of internal control over financial reporting to: (i) identify the types of potential misstatements; (ii) assess the factors that affect the risks of material misstatement; and (iii) design further audit procedures.¹⁰⁹

The amendments regarding significant unusual transactions build on the risk assessment standards by adding paragraph 73A to Auditing Standard No. 12. That paragraph requires the auditor to obtain an understanding of the controls management has established to identify, authorize and approve, and account for and disclose, significant unusual transactions in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18 through 40, 72, and 73 of Auditing Standard No. 12.

¹⁰⁹ See paragraph 18 of Auditing Standard No. 12.

Taking into Account Other Information Obtained During the Audit (AU sec. 316.66): The amendments regarding significant unusual transactions add a note to AU sec. 316.66 stating that the auditor's identification of significant unusual transactions should take into account information obtained from: (i) the risk assessment procedures required by Auditing Standard No. 12 (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial reporting), and (ii) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

Examples of those procedures include:

- Reading minutes of meetings of the board of directors and its committees;¹¹⁰
- Reading periodic and current reports, and other relevant company filings with the SEC and other regulatory agencies;¹¹¹
- Inspecting confirmation responses and responses to inquiries of the company's lawyers;¹¹²
- Obtaining an understanding of the company's selection and application of accounting principles, including related disclosures (e.g., reading accounting policy manuals and technical memoranda prepared by or for management);¹¹³

¹¹⁰ See AU sec. 560.12.c. and AU sec. 722.18.a.

¹¹¹ See paragraph 11 of Auditing Standard No. 12, which requires the auditor to consider reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements as part of obtaining an understanding of the company.

¹¹² See paragraph .06 of AU sec. 337.

¹¹³ See paragraph 7.c. of Auditing Standard No. 12.

- Performing analytical procedures during the audit;¹¹⁴ and
- Performing journal entry testing, including inquiring of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments as required by existing standards.¹¹⁵

Also, the auditor might identify significant unusual transactions when examining information gathered during the audit. For example, an auditor might identify a significant unusual transaction by scanning a population of invoices for unusual items when determining a sample of items to be tested. By doing so, the auditor might identify an unusual item in terms of dollar amount, the date on which the item was shipped (e.g., on a Sunday when the shipping department is closed), or an unusually high concentration of transactions during a given time period.

Appendix A to the standard includes examples of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. These examples could also be helpful in identifying significant unusual transactions.

The amendments add a second note to AU sec. 316.66 that states that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions.

¹¹⁴ See paragraphs 46 through 48 of Auditing Standard No. 12.

¹¹⁵ See AU secs. 316.58 through 62.

Also, the amendments to AU sec. 560 require that during the "subsequent period" the auditor inquire regarding whether the company has entered into any significant unusual transactions. This could inform the auditor's identification of a company's significant unusual transactions.

Improving the auditor's identification of significant unusual transactions also can inform the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties, as a significant unusual transaction might also be a related party transaction previously undisclosed to the auditor.

Revising and Adding to the Examples of Fraud Risk Factors

The amendments regarding significant unusual transactions also revise certain examples of fraud risk factors contained in AU sec. 316. For example, AU sec. 316.85A.2 notes that significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm can provide opportunities to engage in fraudulent financial reporting. The amendments regarding significant unusual transactions separate that existing example into two distinct examples, namely: (i) related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business); and (ii) significant transactions with related parties whose financial statements are not audited or are audited by another firm. The amendments also add contractual arrangements lacking a business purpose as an example of a fraud risk factor.

Discussion of the Comments Received on the Reproposed Amendments Regarding Identifying Significant Unusual Transactions

The Board considered all comments received, including the following significant comments:

Identifying Significant Unusual Transactions Is the Auditor's Responsibility: One commenter noted that the repropose procedures for identifying significant unusual transactions

(performing inquiries, understanding controls, and taking other information into account) are performed as part of the auditor's risk assessment process rather than to enable the auditor to perform an initial identification of significant unusual transactions – which, in that commenter's view, is the role of management. That commenter suggested clarifying that management is responsible for identifying the company's significant unusual transactions, consistent with the changes regarding a company's related parties. Another commenter stated that, as the size and complexity of a company increases, the likelihood of an auditor being able to identify significant unusual transactions diminishes proportionately.

The Board considered these comments, noting that the determination of whether a transaction is a significant unusual transaction is the responsibility of the auditor. The auditor takes management's responses to inquiries and other procedures into account when identifying significant unusual transactions. However, the information provided by management is not the sole consideration. The auditor's procedures for identifying significant unusual transactions are performed as part of the auditor's risk assessment, and the auditor's procedures should be sufficient to identify risks of material misstatement of the financial statements, based on the size and complexity of the company.

Clarifying the Phrase "Infrequent or Significant Unusual Transactions" in the Amendments to AU sec. 722: AU sec. 722.55 contains examples of situations about which the auditor would ordinarily inquire of management when conducting a review of interim financial information. A few commenters suggested revisions to clarify the repropoed amendment to the tenth bullet of AU sec. 722.55, which as repropoed stated "the occurrence of infrequent or significant unusual transactions." In response to comments, the Board revised the tenth bullet

into two separate items: one bullet relating to the occurrence of infrequent transactions and the other relating to the occurrence of significant unusual transactions.

The Board is adopting the amendments regarding the identification of significant unusual transactions substantially as repropoed, except for the revision to AU sec. 722 discussed above.

Evaluating Significant Unusual Transactions

Discussion of the Amendments Regarding Evaluating Significant Unusual Transactions

The amendments regarding the evaluation of significant unusual transactions address the following areas: (i) evaluating the business purpose (or the lack thereof) of significant unusual transactions; (ii) evaluating the accounting and disclosure of significant unusual transactions; and (iii) other matters regarding significant unusual transactions.

Evaluating the Business Purpose (or the Lack Thereof) of Significant Unusual Transactions

The amendments regarding significant unusual transactions strengthen the auditor's evaluation of whether the business purpose (or the lack thereof) for significant unusual transactions indicates that those transactions were entered into to engage in fraud.

Existing AU sec. 316.66 requires that once an auditor becomes aware of significant unusual transactions, the auditor should gain an understanding of the business rationale for such transactions and whether that rationale (or the lack thereof) suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. Existing AU sec. 316.67 identifies several matters that the auditor should consider in understanding the business rationale for those transactions.

The amendments build on the existing requirements in AU secs. 316.66-.67 and include additional procedures to more specifically focus the auditor's attention on critically evaluating whether the business purpose (or the lack thereof) for significant unusual transactions indicates

that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.

Those improvements are accomplished through: (i) revisions to AU sec. 316.66; (ii) adding AU sec. 316.66A; and (iii) revisions to AU sec. 316.67. Each of those amendments is discussed in further detail below.

Revisions to AU sec. 316.66: Because a company might use a significant unusual transaction to engage in fraudulent financial reporting or to obscure the company's financial position or operating results, existing standards require the auditor to perform procedures to evaluate significant unusual transactions identified by the auditor and discuss the auditor's evaluation of such transactions with the audit committee.¹¹⁶ The amendments to AU sec. 316.66 are intended to improve the auditor's evaluation of significant unusual transactions, including the auditor's evaluation of the business purpose (or the lack thereof), and whether the transactions have been appropriately accounted for and adequately disclosed in the company's financial statements, by requiring the auditor to perform specific procedures to evaluate significant unusual transactions. Improving the auditor's evaluation of significant unusual transactions should also result in a more meaningful exchange of information between the auditor and the audit committee.

Adding AU sec. 316.66A: The amendments regarding evaluating significant unusual transactions add a new paragraph to AU sec. 316, paragraph AU sec. 316.66A, which requires that the auditor design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. The procedures include:

¹¹⁶ See AU secs. 316.66–.67 and paragraph 13.d. of Auditing Standard No. 16.

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

A footnote to item c. of the amendments to AU sec. 316.66A also states that examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

Item d. of the amendments to AU sec. 316.66A provides an opportunity for the auditor to scale the audit by supplementing the basic required procedures with more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. Those procedures should: (i) address the assessed risks of material misstatement; (ii) provide an understanding of the business purpose (or the lack thereof) that is sufficient to evaluate whether the transaction was entered into to commit fraudulent financial reporting or misappropriate

assets; and (iii) provide the auditor with sufficient audit evidence to evaluate whether the financial statement accounting and disclosure requirements have been met.

Examples of other procedures that might be appropriate, depending on the nature of the significant unusual transaction and the risks of material misstatement of the financial statements, include:

- Inquiring directly of the other party regarding the business purpose of the transaction;
- Reading public information regarding the transaction and the parties to the transaction, if available;
- Reading the financial statements or other relevant financial information obtained from other parties involved in the transaction, if available, to understand how the other party accounted for the transaction;
- Evaluating the transferability and value of collateral provided by the other party, if any;
- Confirming the terms of the transaction with other parties with knowledge of the transaction (e.g., banks, guarantors, agents, or attorneys), if any; and
- Confirming whether there are any side agreements or other arrangements (either written or oral) with the other party.

The amendments regarding significant unusual transactions were designed to establish basic procedures for the auditor to identify and evaluate significant unusual transactions and allow the auditor to assess risks and respond to risks based on the facts and circumstances, including the size and complexity of the company and the assessed significance of the identified risks of material misstatement in the financial statements.

Significant unusual transactions, like all transactions, are subject to the requirements contained in AU sec. 411.06, which requires that the auditor consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. That evaluation encompasses an understanding of the "business sense" of material transactions, which was referred to in footnote 6 of AU sec. 334.

Existing standards require that the auditor design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.¹¹⁷ This includes designing and performing audit procedures in a manner that addresses the assessed risks of material misstatement associated with significant unusual transactions. The procedures contained in AU sec. 316.66A work in conjunction with the procedures that the auditor performs during the audit to address the relevant assertions associated with each significant unusual transaction.

Revisions to AU sec. 316.67: The amendments regarding significant unusual transactions also require the auditor to evaluate certain matters when evaluating whether the business purpose (or the lack thereof) of a significant unusual transaction suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. The amendments incorporate the list of matters currently in AU sec. 316.67 and add the following matters:

- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial

¹¹⁷ See also paragraph 8 of Auditing Standard No. 13.

- or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);
- 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 other, more clearly independent, parties on an arm's-length basis;¹¹⁸ and
 - The transaction enables the company to achieve certain financial targets.

These additional matters are intended to improve the auditor's evaluation of the business purpose (or the lack thereof) for significant unusual transactions, including whether they may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. For example, considering whether a transaction enables the company to achieve certain financial targets is an important consideration when evaluating whether that transaction has been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. These additional matters also represent areas that may be relevant to the auditor's evaluation of whether the financial statements contain the information regarding the significant unusual transaction essential for a fair presentation in conformity with the applicable financial reporting framework.

Including these additional matters in the auditor's evaluation of a significant unusual transaction can also assist the auditor in the identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor because it focuses the auditor on the substance of the relationship or transaction. For example, relationships such as

¹¹⁸ See Section II.C. of Securities Act Release No. 33-8056, *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations* (January 22, 2002), <http://www.sec.gov/rules/other/33-8056.htm>.

those with entities managed by former officers, interlocking directors/ownership, significant customers and suppliers, competitors, strategic alliances or partnerships, or collaborative arrangements could represent matters that involve related parties or relationships or transactions with related parties previously undisclosed to the auditor. Further, a related party could be involved in a significant unusual transaction either directly or indirectly, through the use of an intermediary whose involvement in the transaction appears to serve no apparent business purpose.

A footnote to AU sec. 316.67 references the requirement, contained in paragraph 16 of the standard, that the auditor perform certain procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

Evaluating the Accounting and Disclosure of Significant Unusual Transactions

The amendments add a new paragraph to AU sec. 316, paragraph .67A, to require the auditor to evaluate whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements. AU sec. 316.67A further states that this includes evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework. A footnote directs the auditor to paragraphs 30 and 31 of Auditing Standard No. 14, which address the auditor's evaluation of the presentation of the financial statements, including the disclosures.

A note to AU sec. 316.67A states that, in evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in accordance with the financial reporting framework, the auditor considers management's

disclosure regarding significant unusual transactions in other parts of the company's SEC filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

Other Matters Regarding Significant Unusual Transactions

The amendments regarding significant unusual transactions also make a number of other related amendments, including adding a new paragraph, paragraph 11A, to Auditing Standard No. 13 and making a conforming amendment to Auditing Standard No. 16.

The new paragraph 11A to Auditing Standard No. 13 reminds auditors that significant unusual transactions can affect the risks of material misstatement due to error or fraud, and that the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to the repropose amendments to AU secs. 316.66-.67A regarding significant unusual transactions.

The amendments regarding significant unusual transactions also amend the auditor communication requirements in Auditing Standard No. 16. The amendments revise paragraph 13.d. of Auditing Standard No. 16 to refer to the "business purpose (or the lack thereof)" instead of the "business rationale" of a significant unusual transaction. In the Board's view improving the auditor's identification and evaluation of significant unusual transactions should enhance the quality of the auditor's discussions with the audit committee.

Discussion of the Comments Received on the Reproposed Amendments Regarding Evaluating Significant Unusual Transactions

The Board considered all comments received, including the following significant comments:

Clarifying the Auditor's Evaluation of Identified Significant Unusual Transactions: One commenter suggested several clarifying revisions to the factors in AU sec. 316.67 that are relevant to the auditor's evaluation of whether the business purpose (or the lack thereof) of a significant unusual transaction indicates that the transaction may have been entered into to engage in fraud. For example, that commenter suggested revising the fourth bullet to state "the transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party." The Board considered these suggestions and agrees that emphasizing that a related party might be involved in a significant unusual transaction in place of the company is an important clarification, and has revised AU sec. 316.67, accordingly.

Understanding Economic Substance Versus Commercial Substance: One commenter stated that repropose AU sec. 316.67 did not distinguish "commercial substance" (a term used in connection with accounting for nonmonetary transactions) from "economic substance" (a doctrine governing all transactions). That commenter suggested revising this factor in AU 316.67 so that "commercial substance" is understood to only refer to nonmonetary transactions. The Board considered this comment, noting that the auditor's evaluation does not impose accounting requirements on the auditor as the standard and amendments follow a "framework neutral" approach.

Understanding "Financial Targets": A few commenters suggested improving the auditor's evaluation of whether a significant unusual transaction enables the company to achieve certain financial targets pursuant to AU sec. 316.67, by including required procedures to obtain an understanding of the company's financial targets. The Board considered these comments noting that the auditor's understanding of a company's financial targets is already informed by

information obtained during the auditor's risk assessment process.¹¹⁹ The procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers required by the other amendments to Auditing Standard No. 12 further inform the auditor's understanding. The information obtained from such procedures informs the auditor's evaluation of whether a company's significant unusual transaction enables the company to achieve certain financial targets.

The Board is adopting the amendments regarding the evaluation of significant unusual transactions substantially as repropoed, except for the revisions discussed above to AU sec. 316.67 and the addition of a reference to paragraph 30 of Auditing Standard No. 14 in footnote 25B of AU sec. 316.67A.

Other Amendments to PCAOB Auditing Standards

The Board is also adopting other amendments to PCAOB auditing standards, including: (i) amendments regarding a company's financial relationships and transactions with its executive officers; (ii) other new requirements that complement the standard and amendments; and (iii) amendments that conform other auditing standards to the standard and amendments being adopted by the Board, including conforming amendments that revise the references to the Board's superseded auditing standard, AU sec. 334.

After considering the comments received, the Board is adopting the other amendments substantially as repropoed. The Board is, however, making a number of minor clarifications in response to comments. These include:

- *Clarifying the Auditor's Inquiries of Management (AU sec. 560)*: The amendments to paragraph 12 of AU sec. 560 include revisions to clarify that the auditor should

¹¹⁹ See paragraphs 16 and 17 of Auditing Standard No. 12.

inquire regarding both whether there have been any changes in the company's related parties and whether there have been any significant new related party transactions; and

- *Revising the First Illustrative Letter in AU sec. 722 (AU sec. 722):* The amendments to AU sec. 722 include revisions to clarify that the auditor should obtain a representation from management that management has provided "all financial records and related data, including the names of all related parties and all relationship and transactions with related parties" whether the auditor is using the first illustrative letter or the second illustrative letter contained in AU sec. 722.

The following sections describe the other amendments being adopted by the Board and existing requirements, as well as discuss the significant comments received and Board responses, including revisions made, where applicable. The sections are organized by the following areas:

- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*
- AU sec. 315, *Communications Between Predecessor and Successor Auditors*
- AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*
- AU sec. 333, *Management Representations*
- AU sec. 560, *Subsequent Events*
- AU sec. 722, *Interim Financial Information*

Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement

Discussion of the Amendments to Auditing Standard Auditing Standard No. 12

In some circumstances, a company's financial relationships and transactions with its executive officers can create risks of material misstatement that relate pervasively to the financial statements. The other amendments to Auditing Standard No. 12 require the auditor to

perform specific procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment.

As described in the following sections, the other amendments to Auditing Standard No. 12: (i) add a new paragraph, paragraph 10A, to Auditing Standard No. 12; (ii) revise paragraph 11 of Auditing Standard No. 12; and (iii) make a related conforming amendment to the risk assessment standards.

Paragraph 10A of Auditing Standard No. 12: The other amendments add paragraph 10A to Auditing Standard No. 12 to require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. Paragraph 10A states that those procedures should be designed to identify risks of material misstatement and should include, but not be limited to: (i) reading the employment and compensation contracts between the company and its executive officers; and (ii) reading the proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers. The other amendments are intended to assist the auditor in identifying and assessing risks associated with a company's financial relationships and transactions with its executive officers. The other amendments anticipate that the additional procedures to be performed would contribute to the auditor's consideration of fraud in a financial statement audit pursuant to AU sec. 316, which recognizes certain incentives and pressures on management to commit fraud as examples of fraud risk factors.¹²⁰

¹²⁰ See AU sec. 316.85, which 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: (i) significant financial interests in the entity; (ii) significant portions of their compensation (e.g., bonuses, stock options, and earn-out

Performing procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers assists the auditor in understanding whether those relationships and transactions affect the risks of material misstatement.¹²¹ For example, the auditor could consider whether the company's internal control over financial reporting is designed and operating to address the risk that management might seek accounting results solely to boost certain executive officers' compensation. This understanding could also assist the auditor in determining areas where management bias might occur (for example, certain accounting estimates, including fair value measurements).

Reading proxy statements and other relevant company filings with the SEC that are available to the auditor can provide the auditor with relevant information regarding a company's financial relationships and transactions with its executive officers that informs the auditor's understanding of the company. In addition, the risk assessment standards require that the auditor consider reading public information about the company, for example, SEC filings.¹²²

arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow; or (iii) personal guarantees of debts of the entity.

¹²¹ For example, a May 2010 academic study that examined SEC accounting and auditing enforcement releases from 1998 to 2007 noted that the most commonly cited motivations for fraud included the need to: (i) meet external earnings expectations of analysts and others; (ii) meet internally set financial targets or make the company look better; (iii) conceal the company's deteriorating financial condition; (iv) increase the stock price; (v) bolster financial position for pending equity or debt financing; (vi) increase management compensation through achievement of bonus targets and through enhanced stock appreciation; and (vii) cover up assets misappropriated for personal gain. That study indicated that the chief executive officer and/or chief financial officer were named in 89 percent of the cases involving fraudulent financial reporting brought by the SEC during that period. See M. Beasley, J. Carcello, D. Hermanson, and T. Neal, *Fraudulent Financial Reporting 1998–2007: An Analysis of U.S. Public Companies*, Committee of Sponsoring Organizations of the Treadway Commission (May 2010) at 3, http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.

¹²² See paragraph 11 of Auditing Standard No. 12.

The information obtained regarding a company's financial relationships and transactions with its executive officers, in conjunction with other information obtained during the risk assessment process (e.g., information about company performance measures),¹²³ could be used to identify account balances that are likely to be affected and that could have a significant effect on the financial statements. That information could be used by the auditor to identify and assess risks of material misstatement due to fraud and to design appropriate audit responses. In addition, obtaining an understanding of a company's financial relationships and transactions with its executive officers could identify information that indicates the existence of related party relationships or transactions previously undisclosed to the auditor.

The amendments to paragraph 10A are not intended to call into question the policies and procedures of the company with respect to its compensation arrangements with executive officers, but rather to assist the auditor in identifying and assessing risks of material misstatement associated with those financial relationships and transactions. Such risks could include unrecognized compensation, self-dealing or other conflicts of interest, or possible illegal acts. If present, these conditions may call into question the integrity of management's representations or represent violations of the company's established policies and procedures. In addition, these procedures could identify potential instances of management override of internal controls that could inform the auditor whether others in the company are willing to challenge management or whether management might be dominating others in the company.

The purpose of the procedures in paragraph 10A is to further the auditor's risk assessment rather than to require the auditor to determine the appropriateness of a company's compensation agreements with its executive officers. The amendments would not require the auditor to assess

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See paragraphs 16 and 17 of Auditing Standard No. 12.

the appropriateness of the compensation of executive officers. The procedures performed are intended to occur in the context of the auditor's process for assessing the risks of material misstatement of the company's financial statements.

The other amendments do not change the existing requirement in paragraph 10 of Auditing Standard No. 12 to consider obtaining an understanding of compensation arrangements with senior management. The population for the procedures required by paragraph 10A of the other amendments is the list of "executive officers," as defined in SEC Rule 3b-7 or included on Schedule A of Form BD,¹²⁴ while the existing requirement in paragraph 11 of Auditing Standard No. 12 continues to apply to what may be a larger population of a company's management.

The term "senior management" is not a defined term in Auditing Standard No. 12. For certain companies or brokers or dealers, senior management might be the same population as its executive officers. Further, the individuals the company considers to be its "senior management" may differ among issuers and among broker-dealers. The existing standard anticipates that a company's or broker's or dealer's facts and circumstances may affect the composition of its "senior management." The auditor could: (i) gain an understanding of the compensation arrangements with a larger group of "senior management" under Auditing Standard No. 12 in order to obtain an understanding of the company and then (ii) perform the procedures under the other repropoed amendments regarding the financial arrangements with a smaller group of "executive officers."

The other amendments do not require the auditor to evaluate the company's identification of its "executive officers," for SEC filing and other regulatory purposes. In the Board's view, the

¹²⁴ See Exchange Act Rule 3b-7, 17 CFR §240.3b-7, and Schedule A of Form BD. See generally Item 401(b) of Regulation S-K, 17 CFR §229.401(b).

SEC rules cited in the amendments provide a definition of the term "executive officers" that provides sufficient direction to auditors.¹²⁵

Amendments to Paragraph 11: The other amendments also include other changes designed to strengthen the auditor's consideration of the risks of material misstatement associated with financial relationships and transactions with its executive officers.

For example, the amendments to Auditing Standard No. 12 amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider making inquiries regarding the structuring of the company's compensation for executive officers to the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company.

An auditor performing this inquiry could take into account other available audit evidence, such as disclosures in SEC filings that: (i) describe the company's compensation policies and practices that present material risks to the company¹²⁶ and (ii) disclose fees paid to compensation consultants, in certain circumstances.¹²⁷ An auditor performing this inquiry could inquire of the audit committee, or its chair, regarding its views on executive officer compensation at the same time the auditor makes inquiries regarding how the audit committee exercises oversight of the company's assessment of fraud risks and the establishment of controls to address fraud risks as required by paragraph 56.b.(4) of Auditing Standard No. 12.

¹²⁵ See Item 401(b) of Regulation S–K, 17 CFR §229.401(b). For a discussion of "executive officer" for foreign private issuers, see the discussion in this section titled "Identifying the Executive Officers of Foreign Private Issuers."

¹²⁶ See Securities Act Release No. 33–9089, *Proxy Disclosure Enhancements* (December 16, 2009), <http://www.sec.gov/rules/final/2009/33-9089.pdf>.

¹²⁷ See Item 407(e)(3)(iii) of Regulation S–K.

In addition, the amendments to paragraph 11 of Auditing Standard No. 12 also require the auditor to consider performing procedures to obtain an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

Based on the auditor's assessment of risk, the auditor might determine that additional procedures are necessary. For example, the auditor might read available reports from the internal audit function that contain an evaluation of the expense report process. In other cases, the auditor might determine that it is necessary to inspect executive officer expense reimbursement documentation for unusual items.

Conforming Amendment to the Risk Assessment Standards: The other amendments include a conforming amendment to Auditing Standard No. 12. The change aligns Auditing Standard No. 12 with the requirement in paragraph 3 of the standard, which states that the procedures in paragraphs 4 through 9 of the standard are performed in conjunction with the risk assessment procedures required by Auditing Standard No. 12. That amendment removes the note to the final bullet of paragraph 10 of Auditing Standard No. 12.

Discussion of the Comments Received on the Reproposed Amendments to Auditing Standard No. 12

The Board considered all comments received, including the following significant comments:

Revisions Included in Paragraph 10A of the Reproposed Amendments: Commenters who commented on the revisions included in paragraph 10A of the repropose amendments to Auditing Standard No. 12 generally were supportive of the revisions to the repropose amendments. Some commenters stated that it is sufficiently clear that the auditor: (i) should obtain an understanding of the company's financial relationships and transactions with its

executive officers as part of the auditor's risk assessment; and (ii) is not required to assess the appropriateness of executive officer compensation. One commenter stated that the repropoed amendments addressed their concerns regarding the proposed amendments. Another commenter recommended including additional language stating that the amendments are not intended to call into question the policies and procedures of the company. The Board considered these comments and believes that the revisions contained in the repropoed amendments sufficiently acknowledge that the auditor is not required to assess the appropriateness or reasonableness of compensation arrangements with executive officers.

Alternatives to Reading Each Compensation Arrangement: One commenter expressed their support for the auditor to obtain an understanding of compensation arrangements with the company's executive officers. That commenter suggested including further clarification to these amendments, including, for example, considering whether such an understanding could be achieved by the auditor assessing the company's internal control over such arrangements as opposed to reading each compensation arrangement. The Board considered this comment, but noted that the purpose of these procedures is to obtain information regarding individuals who perform specific functions at the company, as part of the auditor's risk assessment. Relying on a company's process may not provide the information necessary for the auditor to identify incentives and pressures that may result in risks of material misstatement. Further, reading the documents underlying the financial relationships and transactions with a company's executive officers could identify information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist and also informs the auditor's evaluation of whether a significant unusual transaction enables the

company to achieve financial targets as part of the auditors evaluation pursuant to AU sec. 316.67.

Identifying the "Executive Officers" of Foreign Private Issuers: One commenter expressed concern that the auditor would need to determine which individuals fall within the definition of "executive officers" if foreign private issuers do not identify "executive officers" in their filings with the SEC. The Board considered this comment and determined not to make revisions.

The auditor's risk assessment procedures with respect to a company's financial relationships and transactions with its executive officers begins with the company's identification of its executive officers. These procedures do not require the auditor to evaluate the company's identification of its executive officers for SEC filing or other regulatory purposes. The company's identification of its executive officers is generally available from its SEC filings or other company information.

For example, foreign private issuers might identify their executive officers in their SEC filings:

- Some foreign private issuers currently disclose their "executive officers" in their filings with the SEC (e.g., some foreign private issuers simply disclose "executive officers" in Form 20-F, and some foreign private issuers voluntarily file their annual report on Form 10-K and disclose their executive officers).
- Some home country filing requirements require a foreign company to determine executive officers using a similar definition to Rule 3b-7. For example, in Canada, National Instrument 51-102, *Continuous Disclosure Obligations* states that "executive officer means, for a reporting issuer, an individual who is (a) a chair, vice-chair or

president; (b) a vice-president in charge of a principal business unit, division or function including sales, finance or production; or (c) performing a policy-making function in respect of the issuer." Canadian foreign private issuers are also required to disclose such individuals in annual information filings with the SEC.

Further, the individuals comprising a company's "[d]irectors and senior management" determined pursuant to item F. of the General Instructions to Form 20-F would include, among others, those individuals who, on the basis of title or policy making function, qualify as "executive officers" under Rule 3b-7.

In addition, foreign private issuers might identify their executive officers for a number of other reasons, for example:

- If more than 50% of a foreign company's voting securities are held by U.S residents, the company must determine its eligibility to be a "foreign private issuer" by considering, among other things, whether the majority of its "executive officers" or directors are U.S. citizens or residents.¹²⁸
- A foreign private issuer listed on the New York Stock Exchange ("NYSE") would need to identify its executive officers for purposes of complying with Section 303A.12(b), *Certification Requirements* of the NYSE Listed Company Manual, which requires that each listed company chief executive officer must promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any non-compliance with any applicable provisions of Section 303A of the NYSE Listed Company Manual.

¹²⁸ "Foreign private issuer" is defined in Rule 405 of Regulation C under the Securities Act of 1933 and Rule 3b-4(c) under the Exchange Act.

Although the Board did not revise the amendments to Auditing Standard No. 12 for this comment, the Board's consideration of this comment did prompt a change to the amendments to AU sec. 316.81A to include a reference to Item 16F of Form 20-F to remind auditors of foreign private issuers of their responsibilities.

Performing Procedures Relating to Individuals Outside of the Company's Executive Officers: Some commenters suggested that the auditor's procedures should not be limited to "executive officers," because compensation arrangements with persons outside the definition of "executive officers" (e.g., the most highly compensated individuals, or individuals holding a material block of stock options that are in a position to influence the company) also might create incentives and pressures that could create risks of material misstatement.

The Board considered these comments, noting that the intent of the amendments was to sharpen the auditor's focus on a company's financial relationships and transactions with individuals that could pose increased risks of material misstatement because of the ability of those individuals to have direct involvement in the company's financial reporting. However, the amendments do not change the existing requirement that the auditor consider obtaining an understanding of the compensation arrangements with what may be a larger group of individuals, a company's senior management. The Board agrees that financial relationships with individuals outside of a company's executive officers also may warrant the auditor's attention. However, obtaining an understanding of the compensation arrangements with individuals outside of management should be based upon the company's facts and circumstances.

Expanding the Examples of Executive Officer Compensation: One commenter suggested including in the amendments a discussion of the basic components of many of today's executive compensation plans and requiring the auditor to read and understand each of the documents

underlying those common components. The Board considered this comment but did not make changes, noting that the requirement to obtain an understanding of the company's financial relationships and transactions with its executive officers is intended to provide an overarching requirement for the auditor that can be applied to all companies as part of the auditor's risk assessment procedures and apply to companies of different size and complexity. Additionally, the Board notes that the auditor might have an overall understanding of the issues pertinent to compensation arrangements with the company's executive officers due to the existing responsibility under Auditing Standard No. 12 to consider obtaining an understanding of the compensation arrangements with the company's senior management.

The Board is adopting the amendments to Auditing Standard No. 12 as repropoed.

AU sec. 315, *Communications Between Predecessor and Successor Auditors*

Discussion of the Amendments to AU sec. 315

The Board is adopting amendments to AU sec. 315, *Communications Between Predecessor and Successor Auditors*. AU sec. 315 provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place, but does not specifically address a company's relationships or transactions with its related parties or its significant unusual transactions. AU sec. 334 notes that determining the existence of relationships with related parties requires the application of audit procedures that may include inquiring of predecessor auditors concerning their knowledge of existing relationships and the extent of management involvement in material transactions.¹²⁹

The amendments to AU sec. 315 require the auditor to make inquiries regarding the predecessor auditor's understanding of the company's relationships and transactions with related

¹²⁹ See AU sec. 334.07.g. and AU secs. 9334.12–13.

parties and significant unusual transactions. The amendments also include within the successor auditor's review of the predecessor auditor's working papers any documentation regarding relationships and transactions with related parties and significant unusual transactions.

Inquiring of a predecessor auditor regarding the company's relationships and transactions with related parties and significant unusual transactions can assist the successor auditor in determining whether to accept the engagement. Such inquiries also can benefit the successor auditor in obtaining an understanding of the company's relationships and transactions with its related parties and in identifying significant unusual transactions.

After considering all comments received, the Board is adopting the amendments to AU sec. 315 as repropoed.

AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*

Discussion of the Amendments to AU sec. 316

The amendments to AU sec. 316 expand the discussion in the standard regarding certain audit requirements contained in Section 10A of the Exchange Act. The amendments emphasize the auditor's responsibility to investigate and disclose possible fraud to management, the audit committee and, upon the satisfaction of certain conditions, the SEC, consistent with the auditor's responsibility under Section 10A of the Exchange Act.

Improving the auditor's identification and evaluation of significant unusual transactions could lead to more instances of auditors becoming aware of indications that fraud or another illegal act has or may have occurred.

In addition, the other amendments to AU sec. 316 also add a new example of a fraud risk factor, the exertion of dominant influence by or over a related party.

The Board's consideration of the comments received regarding the amendments to paragraph 10A of Auditing Standard No. 12, regarding the audits of foreign private issuers, prompted a change to the amendments to AU sec. 316.81A. Specifically, to assist auditors of foreign private issuers with their responsibility when there is a change in a registrant's certifying accountants, a reference to Item 16F of Form 20-F in the amendments to AU sec. 316.81A has been included.

After considering all comments received, the Board is adopting the amendments to AU sec. 316 as repropoed, except for adding a reference to Item 16F of Form 20-F to AU sec. 316.81A.

AU sec. 333, Management Representations

Discussion of the Amendments to AU sec. 333

The amendments to AU sec. 333 require that the auditor obtain certain written representations each interim period regarding a company's relationships and transactions with its related parties. AU sec. 333 currently requires auditors to obtain written representations from management for the periods covered by the auditor's report. That standard addresses representations covering financial statements; completeness of information; recognition, measurement, and disclosure; and subsequent events. Additionally, AU sec. 333 currently requires the auditor to obtain a representation regarding the recognition, measurement, and disclosure of related party transactions.

The amendments to AU sec. 333.06 require that the auditor obtain written representations from management indicating that management has disclosed to the auditor the names of all of the company's related parties and all relationships and transactions with related parties. The standard also amends AU sec. 333.06 to require the auditor to obtain a written representation from

management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor.

Side agreements or other arrangements (either written or oral) undisclosed to the auditor could represent a risk of material misstatement of the financial statements for both related party and significant unusual transactions. For example, the lack of an arm's-length relationship in related party transactions can raise questions about whether all transaction terms have been disclosed to the auditor. Similarly, significant unusual transactions occurring close to the end of the period that pose difficult substance over form questions also could involve side agreements or other arrangements undisclosed to the auditor. The existence of implicit or informal understandings (either written or oral) could have a significant impact on the financial accounting and disclosure of relationships and transactions with related parties and significant unusual transactions.

In addition, the amendments to AU sec. 333 require that the auditor obtain written representations from management in situations in which the financial statements include an assertion by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction. This requirement complements the auditor's evaluation, required by paragraph 18 of the standard, when management has asserted that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

After considering all comments received, the Board is adopting the amendments to AU sec. 333 as repropoed.

AU sec. 560, *Subsequent Events*

Discussion of the Amendments to AU sec. 560

AU sec. 560 currently requires the auditor to perform auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles.¹³⁰ AU sec. 560 currently does not require the auditor to inquire regarding the company's relationships and transactions with its related parties and its significant unusual transactions.

The amendments to AU sec. 560.12 require that during the "subsequent period" the auditor inquire regarding related party transactions and significant unusual transactions. Events or transactions that occur subsequent to the balance sheet date, but prior to the issuance of the financial statements, may have a material effect on the financial statements. Making specific inquiries during the "subsequent period" regarding a company's relationships and transactions with its related parties and its significant unusual transactions can benefit the auditor's identification of matters that might require disclosure in the financial statements.

Discussion of the Comments Received on the Reproposed Amendments to AU sec. 560

The Board considered all comments received, including the following significant comment:

Clarifying the Auditor's Inquiries of Management: One commenter recommended revising the inquiry in item v. of the repropose amendments to AU sec. 560.12 to clarify that there are two separate inquiries. The Board considered this comment and in the interest of clarity, revised the repropose amendments to place each inquiry into a separate bullet.

The Board is adopting the amendments to AU sec. 560 substantially as repropose, with the clarifying change noted above.

¹³⁰ See AU sec. 560.12.

AU sec. 722, Interim Financial Information

Discussion of Amendments to Auditing Standard No. 12

AU sec. 722 currently requires the auditor to inquire of management that has responsibility for financial and accounting matters concerning unusual or complex matters that might have an effect on the interim financial information. Generally, the amendments to AU sec. 722 require that the auditor obtain certain written representations each interim period regarding a company's relationships and transactions with its related parties. The other amendments revise AU sec. 722 to be consistent with the amendments to AU sec. 333 that require the auditor to obtain written representations each interim period regarding the company's related parties and the absence of side agreements or other arrangements.

Discussion of the Comments Received on the Reproposed Amendments to AU sec. 722

The Board considered all comments received, including the following significant comment:

Revising the First Illustrative Letter in AU sec. 722: One commenter recommended that a change that had been made in the reproposal to expand item 2.a. of the *second* illustrative letter of AU sec. 722 should also be made to the corresponding item in the *first* illustrative representation letter. That commenter recommended that item 2.a. in the first illustrative letter be revised to state that management has made available to the auditor "all financial records and related data, including the names of all related parties and all relationships and transactions with related parties." The Board considered this comment and made the revisions suggested by the commenter so that the letters were consistent.

The Board is adopting the amendments to AU sec. 722 substantially as reproposed, with the clarification discussed above.

Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act¹³¹ provided the Board with oversight authority with respect to audits of brokers and dealers that are registered with the SEC. On July 30, 2013, the SEC adopted amendments to SEC Rule 17a-5 under the Exchange Act to require, among other things, that audits of brokers' and dealers' financial statements be performed in accordance with the standards of the PCAOB for fiscal years ending on or after June 1, 2014.¹³²

In its reproposal, the Board solicited comment regarding whether there were specific issues relating to audits of brokers and dealers of which the Board should be aware. Commenters did not provide examples of specific audit issues, but did provide views on the applicability of the standard and amendments to audits of brokers and dealers. For example, many commenters stated that the reproposed standard and amendments should apply to audits of brokers and dealers and provided various rationales. Some commenters noted that the financial reporting risks that the reproposal is designed to target also exist at these entities and in some cases more prevalently. Other commenters noted that the scalability of the standard and amendments allow the auditor to focus on the specifics of the company, making the standard and amendments appropriate for audits of brokers and dealers.

Further, at the May 17, 2012 SAG meeting, the point was raised that a robust auditing standard on related parties was important for both regulators of brokers and dealers and for users of their financial statements. Several scenarios were discussed by which related party

¹³¹ Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

¹³² See Rule 17a-5, 17 CFR § 240.17a-5 SEC, *Broker-Dealer Reports*, Exchange Act Release No. 34-70073, (July 30, 2013), 78 Federal Register 51910 (August 21, 2013), <http://www.sec.gov/rules/final/2013/34-70073.pdf>.

transactions might be improperly used by brokers and dealers, including scenarios where the brokers and dealers could use related party transactions to: (i) overpay for goods and services and disguise capital withdrawals; (ii) avoid the imposition of higher capital requirements and capital charges; (iii) structure a broker's or dealer's business model to appear smaller; and (iv) transfer customer assets to parties that are not approved custodians.

Additionally, the results of the Board's oversight activities regarding audits of brokers and dealers have identified deficiencies regarding the auditor's efforts in the area of related parties, suggesting that this is an area warranting heightened scrutiny.¹³³

The standard and amendments, if approved by the SEC, will be applicable to all audits performed pursuant to PCAOB standards, including audits of brokers and dealers.

Effective Date

The Board determined that the standard and amendments will be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of interim financial information within those fiscal years.

In determining the effective date, the Board considered the comments received. Many commenters noted that the effective date in the reproposing release was reasonable, if the final standard and amendments were approved three to four months prior to the effective date contemplated in the reproposing release. Those commenters generally indicated that this would have allowed sufficient time for firms to incorporate the new requirements into their methodologies, guidance, audit programs, and staff training. Given the date of the adoption of the standard and amendments, the Board determined that the standard and amendments should be

¹³³ See The Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers (August 20, 2012) and The Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers (August 19, 2013).

applicable, subject to SEC approval, to audits of financial statements for fiscal years beginning on or after December 15, 2014.

One commenter recommended that the amendments to AU sec. 722 become effective in the first interim period following the first annual period that the standard and amendments are effective. The Board considered this comment but noted that the amendments to AU sec. 722, which encompass inquiries of and representations from management, are designed to complement the standard and amendments. Performing those procedures for reviews of interim financial information during the first year of implementation (the fiscal year beginning on or after December 15, 2014) can inform the auditor's efforts in these critical areas for the audit performed during the first year of implementation.

2. *Comparison of the Objective and Key Requirements of the Proposed Rules with the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants*

Introduction

This comparison, which was prepared for informational purposes only, compares certain significant differences between the objective and certain key requirements of the standard and amendments with the analogous standards of the IAASB and the ASB of the AICPA.

This comparison is not a summary of, or a substitute for, the standard or the amendments. This comparison may not represent the views of the IAASB or the ASB regarding the interpretations of their standards.

The analogous standards of the IAASB discussed in this comparison include:

- International Standard on Auditing 550, *Related Parties* ("ISA 550");
- International Standard on Auditing 210, *Agreeing the Terms of Audit Engagements* ("ISA 210");

- International Standard on Auditing 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* ("ISA 240");
- International Standard on Auditing 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* ("ISA 315");
- International Standard on Auditing 510, *Initial Audit Engagements-Opening Balances* ("ISA 510");
- International Standard on Auditing 560, *Subsequent Events* ("ISA 560");
- International Standard on Auditing 580, *Written Representations* ("ISA 580");
- International Standard on Auditing 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* ("ISA 600");
and
- International Standard on Review Engagements 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*, ("ISRE 2410").

The analogous standards of the ASB discussed in this comparison include:

- AU-C Section 550, *Related Parties* ("AU-C Section 550");
- AU-C Section 210, *Terms of Engagement* ("AU-C Section 210");
- AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit* ("AU-C Section 240");
- AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* ("AU-C Section 315");

- AU-C Section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements* ("AU-C Section 510");
- AU-C Section 560, *Subsequent Events and Subsequently Discovered Facts* ("AU-C Section 560");
- AU-C Section 580, *Written Representations* ("AU-C Section 580");
- AU-C Section 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* ("AU-C Section 600");
and
- AU-C Section 930, *Interim Financial Information* ("AU-C Section 930").¹³⁴

This comparison is organized in the following sections: the auditing standard; the amendments regarding significant unusual transactions; and the other amendments to PCAOB auditing standards.¹³⁵ This comparison does not cover the application and explanatory material in the analogous standards of the IAASB or ASB.¹³⁶

¹³⁴ These AU–C sections are contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification* ("SAS No. 122"). In October 2011, the ASB adopted SAS No. 122, which contains 39 clarified SASs with "AU–C" section numbers for each clarified SAS. The "AU–C" is a temporary identifier to avoid confusion with references to existing "AU" sections in AICPA Professional Standards.

¹³⁵ This comparison does not cover the requirements contained in the risk assessment standards. Appendix 11 of PCAOB Release No. 2010–004, *Auditing Standards Related to Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, contains a comparison of the objectives and requirements of those standards with the analogous standards of the IAASB and the ASB.

¹³⁶ Paragraph A59 of International Standard on Auditing 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, states that the Application and Other Explanatory Material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of AU–C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that although application and other explanatory material "does not in

Auditing Standard, *Related Parties*

Introduction (Paragraph 1 of the Standard)

PCAOB

The standard refers auditors to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties," and the financial statement disclosure requirements with respect to related parties. The standard does not include a definition for an arm's-length transaction.

IAASB

Paragraph 10(b) of ISA 550 defines a related party as a party that is either:

- i. A related party as defined in the applicable financial reporting framework; or
- ii. Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - c. Another entity that is under common control with the reporting entity through having:
 - (i) Common controlling ownership;
 - (ii) Owners who are close family members; or
 - (iii) Common key management.

itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section."

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

ISA 550 also defines an arm's-length transaction as a transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

ASB

AU-C Section 550 defines a related party as that term is defined in generally accepted accounting principles. AU-C Section 550 also contains a definition of arm's-length transaction that is similar to the definition in ISA 550.

Objective (Paragraph 2 of the Standard)

PCAOB

Paragraph 2 of the standard states that the auditor's objective is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

IAASB

Paragraph 9 of ISA 550 states that the objectives of the auditor are:

- (a) Irrespective of whether the applicable financial reporting framework establishes related party requirements to obtain an understanding of related party relationships and transactions sufficient to be able:

- i. To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
- ii. To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:
 - a. Achieve fair presentation (for fair presentation frameworks);
or
 - b. Are not misleading (for compliance frameworks); and

(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

ASB

Paragraph 9 of AU-C Section 550 contains a similar objective to the objective in ISA 550 for fair presentation frameworks.

Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 – 9 of the Standard)

PCAOB

Paragraph 3 of the standard requires that the auditor 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 in

conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Paragraph 3 of the standard states that the procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company's process (paragraph 4);
- b. Performing inquiries (paragraphs 5-7); and
- c. Communicating with the audit engagement team and other auditors (paragraphs 8-9).

A note to paragraph 3 of the standard states that 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.

Another note to paragraph 3 of the standard states that performing the risk assessment procedures described in paragraphs 4-9 of the 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 related parties and relationships and transactions with related parties.

IAASB

Paragraph 11 of ISA 550 states that as part of the risk assessment procedures and related activities required by ISA 315 and ISA 240, the auditor shall perform the audit procedures and related activities set out in paragraphs 12-17 of ISA 550 to obtain information relevant to

identifying the risks of material misstatement associated with related party relationships and transactions.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Obtaining an Understanding of the Company's Process (Paragraph 4 of the Standard)

PCAOB

Paragraph 4 of the standard requires that in conjunction with obtaining an understanding of internal control over financial reporting, the auditor obtain an understanding of the company's process for:

- a. Identifying related parties and relationships and transactions with related parties;
- b. Authorizing and approving transactions with related parties; and
- c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

IAASB

Paragraph 14 of ISA 550 requires that the auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to:

- a. Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
- b. Authorize and approve significant transactions and arrangements with related parties; and
- c. Authorize and approve significant transactions and arrangements outside the normal course of business.

ASB

Paragraph 15 of AU-C Section 550 contains similar requirements to those in ISA 550.

*Performing Inquiries (Paragraphs 5 – 7 of the Standard)*PCAOB

Paragraph 5 of the standard requires the auditor to inquire of management regarding:

- a. The names of the company's related parties during the period under audit, including changes from the prior period;
- b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);
- c. The nature of any relationships, including ownership structure, between the company and its related parties;
- d. The transactions entered into, modified, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;
- e. The business purpose for entering into a transaction with a related party versus an unrelated party;
- f. 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; and
- g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

Paragraph 6 of the standard requires the auditor to inquire of others within the company regarding their knowledge of the matters in paragraph 5 of the standard. Paragraph 6 also

requires the auditor to identify others within the company to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding:

- a. The company's related parties or relationships or transactions with related parties;
- b. The company's controls over relationships or transactions with related parties; and
- c. The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Paragraph 7 of the standard requires the auditor to inquire of the audit committee, or its chair, regarding:

- a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
- b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties, and, if so, the substance of those concerns.

IAASB

Paragraph 13 of ISA 550 requires the auditor to inquire of management regarding:

- a. The identity of the entity's related parties, including changes from the prior period;
- b. The nature of the relationships between the entity and these related parties; and
- c. Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

ASB

Paragraph 14 of AU-C Section 550 contains similar requirements to those in ISA 550.

Identifying and Assessing Risks of Material Misstatement (Paragraph 10 of the Standard)

PCAOB

Paragraph 10 of the standard aligns with the existing requirements for the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 10 states that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties or relationships or transactions with related parties. Paragraph 59 of Auditing Standard No. 12 requires that the auditor identify which risks are significant risks. Further, paragraph 71 of Auditing Standard No. 12 provides factors that the auditor should evaluate in determining which risks are significant risks. Those factors include: (i) whether the risk involves significant transactions with related parties; (ii) whether the risk involves significant transactions that are outside the normal course of business; and (iii) whether the risk is a fraud risk. The amendments regarding significant unusual transactions revise paragraph .85A.2 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, to state that a related party transaction that is also a significant unusual transaction (e.g., a significant related party transaction outside the normal course of business) is an example of a fraud risk factor.

A note to paragraph 10 of the standard states that, in identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4-9 of the standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

IAASB and ASB

Paragraph 18 of ISA 550 and paragraph 19 of AU-C Section 550 require that the auditor identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. ISA 550 and AU-C Section 550 require the auditor to treat identified significant related party transactions outside the normal course of business as giving rise to significant risks.

Responding to the Risks of Material Misstatement (Paragraphs 11-13 of the Standard)

PCAOB

Paragraph 11 of the standard aligns with existing requirements that the auditor design and implement audit responses that address the identified and assessed risks of material misstatement. Paragraph 11 of the standard states that this includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.

A note to paragraph 11 of the standard states that the auditor should look to the requirements of AU secs. 316.66-.67A for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). That note further states that for such related party transactions, AU sec. 316.67 requires 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.

IAASB

Paragraph 20 of ISA 550 requires that the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material

misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21-24 of ISA 550.

ASB

Paragraph 21 of AU-C Section 550 contains similar requirements to those in ISA 550.

Transactions with Related Parties Required to Be Disclosed in the Financial Statements or Determined to Be a Significant Risk (Paragraph 12 of the Standard)

PCAOB

Paragraph 12 of the standard requires that for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:

- a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. 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;
- c. Determine whether any exceptions to the company's established policies or procedures were granted;
- d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
- e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

A note to paragraph 12 of the standard states that 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 in paragraph 12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

IAASB

Paragraph 23 of ISA 550 requires that for identified significant related party transactions outside the entity's normal course of business, the auditor shall:

- a. Inspect the underlying contracts or agreements, if any, and evaluate whether:
 - i. The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
 - ii. The terms of the transactions are consistent with management's explanations; and
 - iii. The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- b. Obtain audit evidence that the transactions have been appropriately authorized and approved.

ASB

Paragraph 24 of AU-C Section 550 contains similar requirements to those in ISA 550.

Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14-16 of the Standard)

PCAOB

Paragraph 14 of the standard requires that the auditor evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, taking into account information gathered during the audit. Paragraph 14 requires that as part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

A note to paragraph 14 of the standard states that Appendix A contains examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Other PCAOB auditing standards might impose requirements relating to the sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist (e.g., reading confirmation responses and responses to inquiries of the company's lawyers).¹³⁷

Paragraph 15 of the standard requires that if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously

¹³⁷ See, e.g., AU sec. 330, *The Confirmation Process*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Paragraph 15 also states that those procedures should extend beyond inquiry of management.

Paragraph 16 of the standard describes the procedures that the auditor is required to perform if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Paragraph 16 of the standard requires that the auditor:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of the standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;

- f. Perform the following procedures, taking into account the information gathered from performing the procedures in a. through e. above:
- (i) Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
 - (ii) Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
 - (iii) Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1.

IAASB and ASB

Paragraph 15 of ISA 550 requires the auditor to remain alert, during the audit, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. Paragraph 15 of ISA 550 further requires that, in particular, the auditor inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- (a) Bank and legal confirmations obtained as part of the auditor's procedures;
- (b) Minutes of meetings of shareholders and of those charged with governance; and

- (c) Such other records and documents as the auditor considers necessary in the circumstances of the entity.

Paragraph 21 of ISA 550 requires that if the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships and transactions.

Paragraph 22 of ISA 550 requires that if the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

- a. Promptly communicate the relevant information to the other members of the engagement team;
- b. Where the applicable financial reporting framework establishes related party requirements;
 - (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation;
 - (ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
- c. Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions;

- d. Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor and perform additional audit procedures as necessary; and
- e. If the nondisclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17—18 of the Standard)

PCAOB

Paragraph 17 of the standard aligns with the existing requirement that the auditor evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. Paragraph 17 states that this includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.

IAASB

Paragraph 25 of ISA 550 requires that in forming an opinion on the financial statements, the auditor shall evaluate:

- a. Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- b. Whether the effects of the related party relationships and transactions:

- (i) Prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or
- (ii) Cause the financial statements to be misleading (for compliance frameworks).

ASB

Paragraph 26 of AU-C Section 550 contains similar requirements to the requirements in ISA 550 for fair presentation frameworks.

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (Paragraph 18 of the Standard)

PCAOB

Paragraph 18 of the standard requires that if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.

A note to paragraph 18 of the standard further states that a preface to a statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

IAASB

Paragraph 24 of ISA 550 states that if management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to

those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion.

ASB

Paragraph 25 of AU-C Section 550 contains similar requirements to those in ISA 550.

Communications with the Audit Committee (Paragraph 19 of the Standard)

PCAOB

Paragraph 19 of the standard requires that the auditor communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. Paragraph 19 of the standard also requires that the auditor communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and

- e. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

IAASB

Paragraph 27 of ISA 550 requires that the auditor communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

ASB

Paragraph 27 of AU-C Section 550 contains similar requirements to those in ISA 550.

Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

Identifying Significant Unusual Transactions

PCAOB

The amendments to paragraph 56.a. of Auditing Standard No. 12 require the auditor to inquire of management regarding whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involve related parties. The amendments regarding significant unusual transactions to paragraph 56.b. of Auditing Standard No. 12 require that the auditor inquire of the audit committee or equivalent, or its chair, regarding whether the company has entered into any significant unusual transactions. The amendments regarding significant unusual transactions to paragraph 56.c. of Auditing Standard No. 12 require similar inquiries of internal audit personnel.

A note to AU sec. 316.66 states that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions.

That note refers the auditor to paragraphs 14-16 of Auditing Standard No. 18. That note further states that Appendix A of the standard includes examples of such information and examples of sources of such information.

IAASB and ASB

ISA 315, ISA 550, AU-C Section 315, and AU-C Section 550 do not contain similar requirements for the auditor to those in the PCAOB's amendments described above.

Evaluating Significant Unusual Transactions

PCAOB

The amendments regarding significant unusual transactions add paragraph .66A to AU sec. 316. That paragraph requires the auditor to design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. AU sec. 316.66A requires that those procedures include the following:

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been appropriately authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and

- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

The amendments to AU sec. 316.67 require that the auditor evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

The amendments require that, in making that evaluation, the auditor evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);
- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor;
- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party of the company;
- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);
- 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 other, more clearly independent, parties on an arm's-length basis;

- The transaction enables the company to achieve certain financial targets;
- 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); and
- Management has discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Further, the amendments add paragraph 11A to Auditing Standard No. 13. That paragraph requires that because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-.67A.

The amendments to AU sec. 316.67A require that the auditor evaluate whether significant unusual transactions identified by the auditor have been properly accounted for and disclosed in the financial statements.

IAASB

Paragraph 16 of ISA 550 requires that if the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required by paragraph 15 or through other audit procedures, the auditor shall inquire of management about:

- (a) The nature of these transactions; and

(b) Whether related parties could be involved.

Paragraph 32(c) of ISA 240 requires the auditor to evaluate whether the business rationale (or the lack thereof) of a significant transaction outside the normal course of business suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. Paragraph 23 of ISA 550 requires the auditor to perform certain procedures for identified significant related party transactions outside the entity's normal course of business.

ASB

AU-C Section 550 and AU-C Section 240 contain similar requirements to those in ISA 550 and ISA 240.

Other Amendments to PCAOB Auditing Standards

Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement

PCAOB

The other amendments to paragraph 10A of Auditing Standard No. 12 require that to assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its

executive officers. The other amendments to Auditing Standard No. 12 also include a definition of executive officer that aligns with definitions used in SEC filings.

In addition, the other amendments amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider:

- Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and
- Obtaining an understanding of the company's established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

IAASB and ASB

ISA 315 and AU-C Section 315 do not contain similar requirements for the auditor to those in the PCAOB's amendments described above.

AU sec. 315, *Communications Between Predecessor and Successor Auditors*

PCAOB

The other amendments to other PCAOB Auditing Standards amend AU sec. 315, *Communications Between Predecessor and Successor Auditors*, to require the auditor to inquire of the predecessor auditor regarding the predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions. The other amendments also require the successor auditor to review documentation regarding related parties and significant unusual transactions.

IAASB and ASB

Neither ISA 210 and ISA 510, nor AU-C Section 210 and AU-C Section 510 contain similar requirements to those in the PCAOB's amendments described above.

AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*

PCAOB

The other amendments to AU sec. 316.81A describe the auditor's responsibility, under certain conditions, to disclose possible fraud to the SEC to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change on Form 8-K and the fraud or related risk factors constitute a *reportable event* or are the source of a *disagreement*, as these terms are defined in Item 304 of Regulation S-K and Item 16F of Form 20-F. These requirements also include reports that may be required pursuant to Section 10A(b) of the Securities Exchange Act of 1934 (the "Exchange Act") relating to an illegal act that the auditor concludes has a material effect on the financial statements.

IAASB and ASB

ISA 240 and AU-C Section 240 do not inform the auditor of certain obligations under Section 10A of the Exchange Act, which is applicable to auditors of U.S. public companies registered with the PCAOB.

AU sec. 333, *Management Representations*

PCAOB

The other amendments to AU sec. 333, *Management Representations*, require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The other amendments to AU sec. 333 also require the auditor to obtain written representation from management if the

financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction.

IAASB and ASB

Neither ISA 580 and ISRE 2410, nor AU-C Section 580, and AU-C Section 930 contain similar requirements to those in the PCAOB's amendments described above.

AU sec. 560, *Subsequent Events*

PCAOB

The other amendments amend paragraph .12 of AU sec. 560, *Subsequent Events*, to require that during the "subsequent period" the auditor inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:

- Whether there have been any changes in the company's related parties;
- Whether there have been any significant new related party transactions; and
- Whether the company has entered into any significant unusual transactions.

IAASB and ASB

ISA 560 and AU-C Section 560 do not contain similar requirements to those in the PCAOB's amendments described above.

AU sec. 722, *Interim Financial Information*

PCAOB

The other amendments to AU sec. 722, *Interim Financial Information*, require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The other amendments to AU sec. 722 also require the auditor to obtain written representations from management when

management has made an assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in arm's-length transactions.

IAASB

ISA 550 and ISRE 2410 do not contain similar requirements to those in the PCAOB's amendments described above.

ASB

AU-C Section 550 and AU-C Section 930 do not contain similar requirements to those in the PCAOB's amendments described above.

D. Economic Considerations, Including for Audits of Emerging Growth Companies

This discussion describes the Board's approach in adopting the standard and amendments as well as the Board's consideration of the economic impacts of the standard and amendments, including economic considerations pertinent to audits of EGCs.¹³⁸ Additionally, this discussion summarizes the views of commenters with respect to the economic impacts of the standard and amendments.

Introduction and Statutory Background

The Board is adopting the standard and amendments pursuant to its authority under the Act.¹³⁹ The standard and amendments must be approved by the Commission before they are

¹³⁸ Section 3(a)(80) of the Exchange Act defines the term "emerging growth company."

¹³⁹ Pub. L. No. 107-204. Pursuant to Section 101 of the Act, the mission of the Board is to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Section 103 of the Act authorizes the Board to adopt auditing standards for use in public company audits "as required by this Act or the rules of the [U.S. Securities and Exchange] Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." In addition, Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") expanded the

effective. Pursuant to Section 107(b)(3) of the Act, the Commission shall approve a proposed standard if it finds that the standard is "consistent with the requirements of [the] Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors."

In the Board's view, the adoption of the standard and amendments is in the public interest and contributes to investor protection by establishing specific auditor performance requirements designed to heighten the auditor's attention to areas associated with risks of fraudulent financial reporting and that may also involve risks of error. New required audit procedures are intended to improve the auditor's identification, understanding, and evaluation of transactions in the critical areas, which can pose difficult measurement, recognition, and disclosure issues due to factors such as transaction structure, complexity, and/or relationship to company financial targets. Additionally, the standard and amendments establish audit committee communication requirements designed to promote and enhance communications and understanding between the auditor and the audit committee.

The auditor's heightened scrutiny of transactions in the critical areas, and the enhanced understanding of such transactions both by the auditor and the audit committee, should improve the quality of the audit and also may result in improvements in companies' accounting and disclosures in these areas. Additionally, the new requirements are aligned with the Board's risk assessment standards¹⁴⁰ and reflect a cohesive audit approach that should improve the auditor's

authority of the PCAOB to oversee the audits of registered brokers and dealers, as defined in the Exchange Act. See Pub. L. No. 111-203.

¹⁴⁰ In 2010, the Board adopted eight auditing standards to establish a framework for the auditor's assessment of and response to the risks of material misstatement in an audit (the "risk assessment standards"), which reflect the Board's view of the auditor's fundamental approach to the audit. The risk assessment standards cover the entire audit process, from initial

risk-based consideration of the critical areas, as well as provide opportunities for efficient implementation.

The Act was amended by Section 104 of the Jumpstart Our Business Startups Act JOBS Act¹⁴¹ to provide that any additional rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation."¹⁴² As a result, if the standard and amendments are approved by the SEC, they will be subject to a separate determination by the SEC regarding their applicability to audits of EGCs.

The Board is recommending that the SEC determine that the standard and amendments should apply to audits of EGCs. To assist the SEC in making this determination, the Board is providing information herein specifically related to audits of EGCs.

The discussion below includes information regarding: (i) The Need for the Standard and Amendments; (ii) The Baseline (encompassing both existing requirements and audit practices); (iii) The Board's Approach and Consideration of Alternatives; (iv) The Economic Impacts of the Standard and Amendments, including Benefits and Costs; and (v) Economic Considerations Pertaining to Audits of EGCs, including Efficiency, Competition, and Capital Formation.

Need for the Standard and Amendments

planning activities to evaluating audit evidence to forming the opinion to be expressed in the auditor's report. See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release 2010-004 (August 5, 2010).

¹⁴¹ Pub. L. No. 112-106 (April 5, 2012).

¹⁴² See Section 103(a)(3)(C) of the Act, as added by Section 104 of the JOBS Act.

Introduction

Investors are often widely dispersed and significant in number and thus must rely on management to operate and control the company. As a result, investors possess less information about the company than the company's management, a situation that can be described as information asymmetry¹⁴³ between investors and management. Management prepares the company's financial statements that investors use to evaluate a company's financial performance and management's stewardship of the company. An audit provides investors with independent, reasonable assurance that the company's financial statements are fairly presented, in accordance with the relevant accounting framework, and comply with applicable requirements.

A key objective of PCAOB standards is to improve the likelihood that the auditor will detect material misstatements in company financial statements, whether due to error or fraud.¹⁴⁴ The auditor, as a gatekeeper¹⁴⁵ in the financial reporting system, can mitigate risks of material

¹⁴³ Information asymmetry refers to situations involving two or more parties in a relationship in which one party has more, or better, information than the other party. For more information on matters related to the separation of ownership and control of companies and the implications on financial markets, see, e.g., Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property*, 2 Harcourt, Brace and World, New York *passim* (1967); Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 *Journal of Financial Economics* 305 *passim* (1976); and Paul M. Healy and Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 *Journal of Accounting and Economics* 405 *passim* (2001).

¹⁴⁴ Strengthening the requirements for auditing in the critical areas should similarly promote improved performance on audits of broker-dealer financial statements. The approach set forth in the standard should direct auditors to devote more time to areas requiring heightened scrutiny. The auditor's enhanced focus on these areas should improve the reliability of information used in regulatory oversight, which, in turn, should enhance investor protection.

¹⁴⁵ According to the SEC:

The federal securities laws, to a significant extent, make independent auditors "gatekeepers" to the public securities markets. These laws require, or permit us to

misstatement in the financial statements and, thus, risks to investors arising out of their reliance on misstated financial statements, by focusing appropriate auditing effort in areas that warrant heightened scrutiny. Increased attention by the auditor should, in the Board's view, increase the likelihood of the auditor identifying material misstatements.

In considering the need to improve existing auditing standards relating to the critical areas, the Board took into account a variety of factors. Most significantly, the Board considered the need for the standard and amendments against the backdrop of several decades of financial reporting frauds involving related party transactions, significant unusual transactions and financial relationships and transactions with executive officers. Prominent corporate scandals involving these critical areas include many that served as a catalyst for the enactment of the Act.¹⁴⁶ The critical areas addressed by the standard and amendments have continued to be

require, financial information filed with us to be certified (or audited) by independent public accountants. Without an opinion from an independent auditor, the company cannot satisfy the statutory and regulatory requirements for audited financial statements and cannot sell its securities to the public. The auditor is the only professional that a company must engage before making a public offering of securities and the only professional charged with the duty to act and report independently from management.

See SEC Securities Act Release No. 33-7870, *Proposed Rule: Revision of the Commission's Auditor Independence Requirements* (June 30, 2000) at Section II.A. See also, SEC Securities Act Release No. 33-7919, *Final Rule: Revision of the Commission's Auditor Independence Requirements* (November 21, 2000) at Section III.A.

¹⁴⁶ The following illustrative list provides examples of prominent corporate scandals that involve the critical areas. The following list is not all-inclusive and, in some cases, examples involve more than one critical area: (i) with respect to related party transactions: Hollinger, Inc., see SEC Complaint, *SEC, Plaintiff v. Conrad M. Black, F. David Radler and Hollinger, Inc.* (November 15, 2004); MCA Financial Corporation, see SEC AAER No. 2076, *In The Matter of Grant Thornton LLP, Doeren Mayhew & Co. P.C., Peter M. Behrens, CPA, Marvin J. Morris, CPA, and Benedict P. Rybicki, CPA, Respondent* (August 5, 2004); and Adelphia Communications Corporation, see SEC AAER No. 1599, *SEC v. Adelphia Communications Corporation, John J. Rigas, Timothy J. Rigas, Michael J. Rigas, James P. Rigas, James R. Brown, and Michael C. Mulcahey, 02 Civ. 5776 (KW) (S.D.N.Y.)* (July 24, 2002); (ii) with

contributing factors in more recent enforcement cases.¹⁴⁷ These corporate scandals undermine investor confidence and have resulted in significant losses to investors, as well as the loss of many jobs.¹⁴⁸ As discussed below, the Board's oversight activities indicate that auditors' scrutiny of these critical areas continues to be an area of concern.

Additionally, the Board considered: (i) input from the SAG; (ii) studies that suggested the need to improve existing auditing standards to address areas that could pose increased risks of material misstatement; (iii) the actions of other standard setters, such as the IAASB and the ASB of the AICPA, who had revised their auditing standards in certain analogous areas in 2008 and 2011, respectively; and (iv) information obtained through the Board's oversight activities. The

respect to significant unusual transactions: Enron Corporation, *see* SEC Spotlight on Enron, <https://www.sec.gov/spotlight/enron.htm>; Refco, Inc., *see* SEC Complaint, *SEC, Plaintiff, v. Phillip R. Bennett, Defendant* (February 19, 2008); and (iii) with respect to financial relationships and transactions with executive officers: Tyco International, Ltd., *see* SEC AAER No. 3010, *SEC v. L. Dennis Kozlowski, Mark H. Swartz, and Mark A. Belnick, 02-CV-7312 (RWS) (S.D.N.Y. filed Sept. 12, 2002)* (July 14, 2009); WorldCom, Inc., *see 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* (August 2003) at 17-19. Additionally, Section 704 of the Act directed the SEC to study enforcement actions over the five years preceding its enactment "to identify areas of issuer financial reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management" (the "SEC Section 704 Study"). As part of the study, the SEC examined 227 enforcement matters and found that 23 cases included the failure to disclose related party transactions. *See Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002* (January 24, 2003) at 6.

¹⁴⁷ *See, e.g.*, SEC AAER No. 3447, *SEC v. Keyuan Petrochemicals, Inc. and Aichun Li* (February 28, 2013), and SEC AAER No. 3385, *SEC v. China Natural Gas, Inc. and Qinan Ji* (May 14, 2012).

¹⁴⁸ For example, Enron Corporation was the nation's largest natural gas and electric marketer, with reported annual revenue of more than \$150 billion. When it filed for bankruptcy on December 2, 2001, its stock price had dropped in less than a year from more than \$80 per share to less than \$1. *See SEC Settles Civil Fraud Charges Filed Against Richard A. Causey, Former Enron Chief Accounting Officer; Causey Barred From Acting as an Officer or Director of a Public Company* SEC Litigation Release No. 19996 (February 9, 2007).

Board also considered input from commenters on its proposal¹⁴⁹ and reproposal.¹⁵⁰ Commenters were broadly supportive of the Board's standard-setting efforts and generally agreed that improvements to the existing auditing standards were appropriate.¹⁵¹

The Need for Improved Requirements in the Critical Areas

The following discussion describes the need for improvements to existing auditing requirements in each critical area. As more fully described below, the Board believes that its existing standards do not contain sufficient required procedures and are not sufficiently risk-based in critical areas that warrant heightened scrutiny. Increased auditor attention to the critical areas should, in the Board's view, increase the likelihood of the auditor identifying material misstatements.

Relationships and Transactions with Related Parties: The auditor's attention to a company's transactions with its related parties is important because the substance of such transactions may differ materially from their form.¹⁵² A related party relationship provides the

¹⁴⁹ See the proposing release, which included: (i) an auditing standard, *Related Parties* ("proposed standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions ("proposed amendments regarding significant unusual transactions"); and (iii) other amendments to PCAOB auditing standards ("other proposed amendments"). Collectively, these are referred to as the "proposed standard and amendments."

¹⁵⁰ See the reproposing release, which included: (i) an auditing standard, *Related Parties* ("reproposed standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions ("reproposed amendments regarding significant unusual transactions"); and (iii) other proposed amendments to PCAOB auditing standards ("other reproposed amendments"). Collectively, these are referred to as the "reproposed standard and amendments."

¹⁵¹ Section C provides additional discussion of the standard and amendments, as well as discussion of significant comments received and the Board's consideration of such comments.

¹⁵² For example, to improve the appearance of its financial condition, a company and a related party could attempt to "dress up" the appearance of the company's balance sheet at period end by agreeing to have the company temporarily pay down its related party debt prior to

parties with the ability to negotiate transactions on terms that may not be available to other parties on an arm's-length basis. Such non-arm's length transactions potentially provide more of an opportunity for management to act in its own interests,¹⁵³ rather than in the interests of the company and its investors and, in some instances, such transactions have been used to facilitate financial statement fraud and asset misappropriation.¹⁵⁴ Related party transactions also may involve difficult measurement and recognition issues that can lead to errors in financial statements.

The importance to investors of the auditing of related party transactions was emphasized by the U.S. Congress in 1995 through the enactment of Section 10A of the Exchange Act, which requires that each audit of financial statements of an issuer include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."¹⁵⁵ Additionally, SEC actions have identified related party transactions as warranting heightened scrutiny by auditors.¹⁵⁶

the balance sheet date while having an undisclosed side agreement to subsequently borrow the same or a comparable amount shortly after period end.

¹⁵³ See, e.g., paragraph 15 of FASB Statement No. 57, *Related Parties*, which states "[w]ithout disclosure to the contrary, there is a general presumption that transactions reflected in financial statements have been consummated on an arm's-length basis between independent parties. However, that presumption is not justified when related party transactions exist because the requisite conditions of competitive, free-market dealings may not exist. Because it is possible for related party transactions to be arranged to obtain certain results desired by the related parties, the resulting accounting measures may not represent what they usually would be expected to represent."

¹⁵⁴ As noted above, the SEC Section 704 Study identified areas of issuer financial reporting that are most susceptible to fraud, inappropriate manipulation or inappropriate earnings management. As part of that study, the SEC examined 227 enforcement matters and found that 23 cases included the failure to disclose related party transactions. See SEC Section 704 Study.

¹⁵⁵ Section 10A(a)(2) of the Exchange Act, 15 U.S.C. §78j-1(a)(2).

¹⁵⁶ See, e.g., SEC AAER No. 3427, *In the Matter of the Application of Wendy McNeely, CPA*, at 10-12 (December 13, 2012), which states, in part, that the SEC and the courts

The Board's existing standard for the auditing of related party transactions, AU sec. 334, *Related Parties*,¹⁵⁷ was issued in 1983, and has not been substantively revised since then. Among other things, AU sec. 334 has not been revised to align with the Board's risk assessment standards, which provide an overall framework for the auditor's assessment of and response to the risks of material misstatement. Additionally, as discussed below, the existing standard does not reflect an approach that promotes heightened scrutiny by the auditor of a company's relationships and transactions with related parties.

AU sec. 334 provides guidance for the auditor, rather than explicitly requiring the performance of specific procedures.¹⁵⁸ For example, AU sec. 334 includes examples of procedures that the auditor could perform, and indicates that such procedures may not be required in every audit. Such an approach can lead to inadequate auditor effort in an area that historically has posed increased risks of material misstatement. Additionally, the existing standard suggests that related party transactions need not be considered by the auditor as outside the ordinary course of business for a company, unless the auditor is aware of evidence to the contrary. As a result, the auditor may not exercise sufficient professional skepticism in an area that Congress and the SEC have indicated requires heightened scrutiny.

have repeatedly held that related party transactions require heightened scrutiny by auditors. See also *McCurdy v. SEC*, 396 F3d 1258, 1261 (D.C. Cir. 2005) (citing *Howard v. SEC*, 376 F3d 1136, 1149 (D.C. Cir. 2004) noting that related-party transactions "are viewed with extreme skepticism in all areas of finance," aff'g *James Thomas McCurdy, CPA*, 57 S.E.C. 277 (2004)).

¹⁵⁷ AU sec. 334 is one of the Board's interim auditing standards. Shortly after the Board's inception, the Board adopted the existing standards of the AICPA, as in existence on April 16, 2003, on an initial, transitional basis. See *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (April 18, 2003).

¹⁵⁸ See discussion of The Baseline for a detailed discussion of the existing requirements applicable to the critical areas.

The need to revise and strengthen AU sec. 334 has been supported by a number of prominent studies, including studies conducted by the auditing profession prior to the enactment of the Act and the establishment of the Board. For example, the AICPA recommended, after studying over 200 cases reported by their members in which allegations of an audit failure were made, that "required audit procedures be broadened to help ensure the auditor gains a more complete understanding of related party transactions, including the business aspects of transactions."¹⁵⁹

Additionally, the Board considered a synthesis of the academic literature on auditing related party transactions that states that various high profile frauds demonstrate how related party transactions can be used to mislead users of financial statements.¹⁶⁰ The authors find that related party transactions are as common in companies alleged to have committed fraud as in companies in which no fraud has been detected. However, the authors also find that "... when fraud does exist, the presence of related party transactions is one of the top reasons cited for audit failures."¹⁶¹ The authors conclude that the findings in academic literature, combined with the significance of related party transactions in corporate scandals, "are consistent with the PCAOB's reconsideration of auditing of related party transactions."¹⁶²

¹⁵⁹ The Quality Control Inquiry Committee of the AICPA's SEC Practice Section issued a report (the "QCIC Report") making this recommendation in 2002. See AICPA SEC Practice Section, Memo To Managing Partners of SECPS Member Firms, "Recommendations for the Profession Based on Lessons Learned from Litigation" (October 2002), which includes the QCIC Report as an attachment.

¹⁶⁰ See Elizabeth A. Gordon, Elaine Henry, Timothy J. Louwers, and Brad J. Reed, Auditing Related Party Transactions: A Literature Overview and Research Synthesis, *Accounting Horizons* 21 (1): 81-102 (2007).

¹⁶¹ Id. at 82.

¹⁶² Id. at 81. A subsequent study conducted by the same authors analyzes 43 SEC enforcement actions against auditors related to the examination of related party transactions and

While the Board recognizes that transactions with related parties are also used for legitimate purposes, including the efficient procurement of resources,¹⁶³ the Board has concluded that the auditing of related party transactions warrants heightened scrutiny. Notably, the Board has observed, through its oversight activities, deficiencies in the auditing of related party transactions, particularly with respect to audits of smaller public companies. Additionally, as prominent corporate scandals over the past several decades illustrate, issues involving the scrutiny of related party transactions also arise in the audits of large public companies.

As a result of these and other considerations discussed throughout this release, the Board has determined that there is a need to improve its existing auditing standard regarding related parties. In the Board's view, AU sec. 334 does not contain sufficient required procedures, is not risk-based, and does not promote the necessary heightened scrutiny of related party transactions.

Significant Unusual Transactions: The identification and evaluation of a company's significant unusual transactions is important to the audit because such transactions can create complex accounting and financial disclosure issues that create risks of error. Additionally, in some cases, significant unusual transactions have been used to engage in fraudulent financial reporting. For example, significant unusual transactions that are close to period end may be

identified audit practice issues in that area. The authors found that the majority of this sample involved inadequate examination of the related party transaction by the auditor. Although the authors concluded that the audit failures described in these SEC cases were more likely attributable to a lack of professional skepticism and due professional care than deficiencies in the existing standards, the authors provide suggestions to improve audit practice regarding the auditing of related party transactions. Among other things, the authors suggest that auditors use guidance published by the AICPA in a 2001 "Related Party Transaction Toolkit" that suggests that the auditor should perform many of the procedures described as guidance in AU sec. 334 to determine the existence of related parties and identify transactions with known related parties. See Timothy J. Louwers, Elaine Henry, Brad J. Reed, and Elizabeth A. Gordon, *Deficiencies in Auditing Related-Party Transactions: Insights from AAERs*, *Current Issues in Auditing* 2 (2): A10-A16 (2008).

¹⁶³ See Elizabeth A. Gordon, Elaine Henry, and Darius Palia, *Related Party Transactions and Corporate Governance* 9 *Advances in Financial Economics* 1-27, (2004).

entered into to obscure a company's financial position or operating results (e.g., so-called "window-dressing"). Others may involve counterparties that are willing to structure transactions to achieve desired accounting results. In such cases, company management may place more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction.

The Board has considered studies that highlight the risks of material misstatements associated with a company's significant unusual transactions. For example, the *Report Prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs* found that "some U.S. financial institutions and public companies have been misusing structured finance vehicles...to carry out sham transactions that have no legitimate business purpose and mislead investors, analysts, and regulators about companies' activities, tax obligations, and true financial condition."¹⁶⁴ Another study attributed an increased risk of financial misstatement to transactions in which the substance of the transactions might differ materially from their form.¹⁶⁵

Additionally, SEC enforcement actions have highlighted the need for the auditor to scrutinize complex unusual transactions, including understanding their underlying economic purpose.¹⁶⁶ Other SEC cases have addressed instances in which structured transactions obscured

¹⁶⁴ 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), <http://www.gpo.gov/fdsys/pkg/CPRT-107SPRT83559/pdf/CPRT-107SPRT83559.pdf>.

¹⁶⁵ See SEC *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (June 15, 2005), <http://sec.gov/news/studies/soxoffbalancerpt.pdf>.

¹⁶⁶ See, e.g., SEC AAER No. 2775, *In the Matter of Michael Lowther, CPA, Respondent* (January 28, 2008), which discusses the 2001 financial reporting fraud at Enron,

the economic substance of transactions that had a material impact on the company's financial statements.¹⁶⁷

The risk assessment standards require the auditor to consider the risks of material misstatement posed by significant unusual transactions as part of the auditor's risk assessment during the financial statement audit.¹⁶⁸ However, the auditing requirements regarding significant unusual transactions are principally contained in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.¹⁶⁹ That standard provides that the auditor considers the risks of fraud relating to a significant transaction outside the normal course of business for a company if the auditor "becomes aware" of such a transaction.¹⁷⁰ There is no express requirement in AU sec. 316, however, for the auditor to perform specific procedures to identify such transactions or to obtain the information necessary to evaluate the accounting for and disclosure of such transactions, which are key considerations in promoting the auditor's heightened scrutiny of a company's significant unusual transactions.

The Board's staff identified areas of potential weaknesses in the auditor's consideration of significant unusual transactions and in April 2010 issued Staff Audit Practice Alert No. 5,

which included the use of complex structured transactions to obscure the economic substance of certain financing transactions that had a material impact on Enron's financial statements.

¹⁶⁷ See, e.g., SEC AAER No. 1631, *In the Matter of Dynegy, Inc., Respondent* (September 24, 2002). In that action, the Commission determined that Dynegy entered into two massive "round-trip" electricity transactions, that is, simultaneous, pre-arranged buy-sell trades at the same price, terms and volume, in which neither Dynegy nor its trading counterparty earned a profit or incurred a loss and that such transactions lacked economic substance.

¹⁶⁸ See, e.g., paragraph 71.g. of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

¹⁶⁹ See paragraphs .66-.67 of AU sec. 316.

¹⁷⁰ See discussion of The Baseline for a more detailed discussion of the existing standards applicable to the critical areas.

*Auditor Considerations Regarding Significant Unusual Transactions.*¹⁷¹ That alert discusses a range of auditor practice issues pertaining to significant unusual transactions, including the auditor's understanding of transactions close to period end that pose difficult substance over form issues. Similarly, the IAASB staff issued guidance in August 2010 that addressed the auditing of significant unusual or highly complex transactions.¹⁷²

As a result of these and other considerations discussed throughout this release, the Board has determined that there is a need to improve its existing auditing standards regarding significant unusual transactions. In the Board's view, the existing standards in this area do not contain sufficient required procedures to promote the heightened scrutiny necessary for the auditor to identify and evaluate transactions that may be used to intentionally obscure a company's financial results or that may result in erroneous financial reporting.

Financial Relationships and Transactions with Executive Officers: Understanding a company's relationships and transactions with its executive officers is important to an auditor because a company's executive officers are generally in a position to determine or influence a company's accounting and disclosures. A company's financial relationships and transactions with its executive officers (e.g., executive compensation) can create incentives and pressures for executive officers to meet financial targets, which can result in risks of material misstatement of a company's financial statements. Additionally, a company's executive officers, because of their role in the financial reporting process, are in a unique position to commit fraud.¹⁷³

¹⁷¹ See Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010).

¹⁷² See IAASB Staff Questions and Answers, *Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions* (August 2010).

¹⁷³ See, for example, AU sec. 316.08.

Cases involving fraudulent financial reporting illustrate how a company's financial relationships and transactions with its executive officers can create incentives and pressures that can result in risks of material misstatement, including fraud risks.¹⁷⁴ Research that analyzed SEC AAERs from 1998 to 2007 also identified potential motivations for engaging in fraudulent financial reporting that relate to a company's financial targets.¹⁷⁵ For example, the study noted that the most commonly cited motivations for fraud included the need to: (i) meet internal or external earnings expectations of analysts and others; (ii) meet internally set financial targets or make the company look better; (iii) conceal the company's deteriorating financial condition; (iv) increase the stock price; (v) bolster financial position for pending equity or debt financing; (vi) increase management compensation through achievement of bonus targets and through enhanced stock appreciation; and (vii) cover up assets misappropriated for personal gain. The cited motivations support a conclusion that a company's financial relationships and transactions with its executive officers can create incentives and pressures that can result in risks of material misstatement to a company's financial statements. That study noted that the chief executive officer and/or the chief financial officer were named in 89 percent of the cases involving fraudulent financial reporting brought by the SEC during that period.

¹⁷⁴ For example, over the last decade, the SEC has brought a number of cases where management allegedly manipulated compensation expense recognized in the financial statements, while simultaneously obtaining additional compensation for themselves through options backdating. See SEC Spotlight on Stock Options Backdating, which lists AAERs, Commission speeches and testimony, Commission staff speeches, testimony and letters; and non-SEC documents relating to stock options backdating, <http://www.sec.gov/spotlight/optionsbackdating.htm>.

¹⁷⁵ See Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson, and Terry L. Neal, 2010. *Fraudulent Financial Reporting 1998–2007: An Analysis of U.S. Public Companies*, Committee of Sponsoring Organizations of the Treadway Commission (May 2010) at 3, http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.

Under the Board's risk assessment standards, the auditor is required to consider obtaining an understanding of compensation arrangements with the company's "senior management" as part of obtaining an understanding of the company.¹⁷⁶ In the Board's view this continues to be an important consideration for the auditor during the risk assessment process. However, the Board's risk assessment standards require the auditor to "consider" performing procedures to obtain an understanding of certain compensation arrangements as part of "obtaining an understanding of the company" during the auditor's overall risk assessment, but does not require the performance of specific procedures to obtain such an understanding.¹⁷⁷ Most significantly, the Board's risk assessment standards do not require the auditor to perform specific procedures to obtain an understanding of financial relationships and transactions with executive officers, which can motivate or affect company accounting or reporting decisions.

As a result of these and other considerations discussed throughout this release, the Board has determined that there is a need to improve its existing risk assessment standards relating to the auditor's consideration of a company's financial relationships and transactions with its executive officers. In the Board's view, its risk assessment standards in this area are not sufficiently targeted to promote heightened scrutiny of potential risks of material misstatement arising from a company's financial relationships and transactions with its executive officers, in view of the unique role played by the company's executive officers in the company's financial reporting process.

How the Standard and Amendments Address the Need

¹⁷⁶ See paragraph 11 of Auditing Standard No. 12.

¹⁷⁷ See discussion of The Baseline for a detailed discussion of the existing standards applicable to the critical areas.

The Board has determined to improve its requirements relating to identifying, understanding, and addressing certain areas that are widely acknowledged to represent increased risks of material misstatement in company financial statements. As more fully discussed below, these improvements are intended to strengthen the audit of the company's financial statements by improving the auditor's ability to identify and address such risks. In the Board's view, a more focused approach with specific performance requirements should foster the heightened scrutiny that the Board believes is warranted in the critical areas. Such an approach should help mitigate the information asymmetry between company management and investors.

The following sections describe key aspects of the standard and amendments being adopted by the Board, with a focus on how they address the need for improvement described above.¹⁷⁸

Auditing Standard No. 18, Related Parties: The Board is superseding AU sec. 334 and adopting a new standard that establishes specific procedures intended to strengthen auditor performance requirements regarding the auditing of related party transactions. The new requirements establish specific procedures, rather than the approach in the existing standard, which provides guidance and example procedures for the auditor's consideration.

The standard reflects the following key improvements from the existing standard:

- *Adding Basic Requirements:* AU sec. 334 suggests procedures for the auditor's consideration, noting that not all of them may be required in every audit. The standard requires basic procedures for the auditor's response to risks of material misstatement associated with a company's relationships and transactions with its related parties. Specifically, the standard focuses on those

¹⁷⁸ A section-by-section discussion of the standard and amendments is located in Section C.

related party transactions that require disclosure in the financial statements or that are determined to be a significant risk. The basic procedures are designed to assist the auditor in identifying red flags that indicate potential risks of material misstatement. The standard also requires more in-depth procedures that are designed to be scalable and commensurate with the company's facts and circumstances.

- *Enhancing Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties:* Unlike AU sec. 334, which includes limited direction for obtaining an understanding of the company's relationships and transactions with its related parties, the standard requires the performance of specific procedures in this area, including obtaining an understanding of the terms and business purposes (or the lack thereof) of related party transactions.
- *Aligning with the Risk Assessment Standards:* The standard is designed to align with and build upon the risk assessment standards. The procedures are intended to be performed in conjunction with the procedures performed during the auditor's risk assessment.
- *Improving the Auditor's Focus on Accounting:* AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions. The standard requires that the auditor evaluate both the accounting for, and disclosure of, related party transactions.
- *Emphasizing a Complementary Audit Approach:* The standard specifically requires the auditor to take into account other work performed during the

audit, for example, information gathered with respect to significant unusual transactions, when evaluating the company's identification of its related party transactions.

- *Adding Audit Committee Communications:* AU sec. 334 does not mention communications with audit committees regarding related party transactions. The standard being adopted by the Board anticipates two-way communication between the auditor and the audit committee regarding such transactions. This reflects the fact that the new performance requirements contained in the standard and amendments relate to sensitive areas of the audit that potentially involve the interests of company management and, thus, warrant discussion with the audit committee. Specifically, the auditor is required to make inquiries of the audit committee (or its chair) when the auditor is obtaining an understanding of the company, which should occur during the auditor's risk assessment. During these initial communications, the auditor obtains information regarding a company's significant related party transactions and any such relationships or transactions that are of concern to members of the audit committee. The standard further requires that the auditor communicate to the audit committee regarding the auditor's overall evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, including any significant matters the auditor identified during the audit. Among other things, the matters to be communicated related to the auditor's evaluation include the identification of

any related parties (or relationships or transactions with related parties) that were previously undisclosed to the auditor.

Amendments Regarding Significant Unusual Transactions: In this area, the Board is: (i) revising AU sec. 316; (ii) making targeted amendments to certain risk assessment standards (e.g., Auditing Standards Nos. 12 and 13); and (iii) making related changes to other PCAOB auditing standards. These amendments include specific procedures designed to improve the auditor's identification and evaluation of a company's significant unusual transactions. Among other things, they require the auditor to perform specific procedures to (i) identify significant unusual transactions and (ii) obtain an understanding of the business purpose (or the lack thereof) of the company's significant unusual transactions, including whether the transaction was entered into to engage in fraud. In the Board's view, adding specific procedures promotes audit quality by providing the auditor with more insight into the nature of a company's significant unusual transactions, which should enable the auditor to better evaluate whether the financial statements are fairly stated.

The amendments regarding significant unusual transactions are designed to improve existing Board standards in the following key respects:

- *Improving Requirements for Identifying Significant Unusual Transactions:* The amendments regarding significant unusual transactions require the performance of specific procedures intended to improve the auditor's identification of significant unusual transactions, for example, by amending Auditing Standard No. 12 to require the auditor to make inquiries of management and others.
- *Improving the Auditor's Evaluation of Significant Unusual Transactions:* The amendments to AU secs. 316.66-.67A include basic procedures for obtaining

information for evaluating significant unusual transactions. The basic procedures include: (i) reading the underlying documentation relating to significant unusual transactions and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction; (ii) determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures; and (iii) evaluating the financial capability of the other parties to the transaction with respect to significant uncollected balances, guarantees, and other obligations.

- *Enhancing Attention to the Business Purpose (or the Lack Thereof) of Significant Unusual Transactions:* The amendments to AU secs. 316.66-.67 enhance the auditor's evaluation of the business purpose of significant unusual transactions by, among other things, expanding the factors considered by the auditor in evaluating whether the business purpose (or the lack thereof) indicates that such transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.
- *Emphasizing Accounting and Disclosure:* The amendments regarding significant unusual transactions to AU sec. 316.67A are intended to heighten the auditor's attention to accounting matters relative to significant unusual transactions by emphasizing that existing requirements include evaluating whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework.

- *Emphasizing a Complementary Audit Approach:* The amendments regarding significant unusual transactions specifically require the auditor to take into account other work performed during the audit, for example, information gathered with respect to related party transactions, when identifying significant unusual transactions.
- *Enhancing Audit Committee Communications:* The amendments regarding significant unusual transactions are intended to improve the quality of the auditor's communications with the audit committee regarding the business purpose (or the lack thereof) of significant unusual transactions.¹⁷⁹
- *Conforming Descriptions of Significant Unusual Transactions:* The amendments introduce a uniform description of "significant unusual transactions" throughout the Board's standards.

Amendments Regarding Financial Relationships and Transactions with Executive Officers: The Board is revising Auditing Standard No. 12 to require the auditor to perform specific procedures during the risk assessment process to obtain an understanding of the company's financial relationships and transactions with its executive officers. In doing so, the auditor would consider, among other things, the potential for increased risks of material misstatement that could arise out of the company's compensation arrangements with its executive officers.¹⁸⁰

¹⁷⁹ See, e.g., paragraph 13.d of Auditing Standard No. 16, *Communications with Audit Committees*.

¹⁸⁰ The population of the company's "executive officers" is determined by reference to SEC rules and forms. See Section C – Other Amendments to PCAOB Auditing Standards for a discussion of the applicable definition of the term "executive officer."

The revisions improve the existing audit requirements by requiring the auditor to perform specific procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers, as part of the auditor's risk assessment. Specifically, the amendments revise Auditing Standard No. 12 to state that the auditor "should perform" specified procedures to obtain an understanding of the company's financial relationships and transactions with its "executive officers" as part of the auditor's risk assessment.

As noted previously, under the existing risk assessment standards, the auditor is required to "consider" obtaining an understanding of compensation arrangements with senior management as part of obtaining an understanding of the company during the auditor's risk assessment.¹⁸¹ The Board's standards currently do not explicitly require that the auditor obtain information regarding incentives or pressures for the company's executive officers to achieve a particular financial position or operating result as a result of performance based compensation arrangements. The Board has determined to supplement its existing requirements, and has determined that the requirement that the auditor "should perform" procedures relating to executive officer compensation arrangements is appropriate to promote heightened scrutiny.

In the Board's view, a focus on the company's executive officers during the risk assessment process is appropriate in that they generally play a key role in the company's accounting decisions and in a company's financial reporting. However, the new required procedures do not require the auditor to make a determination regarding the appropriateness of a company's compensation agreements with its executive officers.

The Baseline

¹⁸¹ See paragraph 11 of Auditing Standard No. 12.

To consider the economic impacts (including likely benefits and costs) of the standard and amendments, a "baseline" has been identified that can be used as a benchmark against which the standard and amendments can be compared. The baseline, described below, includes existing requirements and also considers audit practices.

Existing Requirements

The auditor's overall responsibility to perform a risk-based audit is contained in the Board's risk assessment standards, Auditing Standards Nos. 8 through 15, which became effective for auditors in December 2010.¹⁸² Among other things, the risk assessment standards require the auditor to consider the risks of material misstatement, whether due to error or fraud, throughout the audit.¹⁸³

The existing requirements that the Board is strengthening through adoption of the standard and amendments are discussed below.

Relationships and Transactions with Related Parties: The risk assessment standards anticipate that the auditor will consider certain risks inherent in significant transactions with related parties in determining the significant risks of the audit¹⁸⁴ and in establishing the materiality level for the audit of the financial statements.¹⁸⁵ However, the existing auditing

¹⁸² See PCAOB Release 2010-004 (August 5, 2010).

¹⁸³ More generally, auditors are required to comply with all standards of the PCAOB, including existing requirements to perform the audit with due professional care, and to obtain sufficient appropriate audit evidence to support the audit opinion. See, e.g., AU sec. 230, *Due Professional Care in the Performance of Work*, and Auditing Standard No. 15, *Audit Evidence*.

¹⁸⁴ See paragraph 71.e. of Auditing Standard No. 12.

¹⁸⁵ See paragraph 7 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, which states that lesser amounts of misstatements could influence the judgment of a reasonable investor because of qualitative factors, e.g., because of

requirements relating to relationships and transactions with related parties are contained primarily in AU sec. 334, one of the Board's interim standards.

AU sec. 334 recognizes that the auditor performs procedures to identify and evaluate a company's relationships and transactions with its related parties as part of performing an audit of financial statements. However, as noted above, it provides guidance and examples of procedures for the auditor's consideration, rather than specific required procedures.

Examples of procedures in AU sec. 334 include: (i) procedures to obtain information from management (such as obtaining the names of all related parties and inquiring whether there were any transactions with these parties during the period); (ii) procedures intended to assist the auditor in identifying related parties that have not been disclosed to the auditor by management (such as reviewing filings with the SEC, reviewing company accounting records and certain invoices, and making inquiries of other auditors); and (iii) procedures the auditor considers, as necessary, to understand the purpose, nature, and extent of identified related party transactions (such as obtaining an understanding of the business purpose of the transaction). Notably, AU sec. 334 states that not all of the procedures may be required in every audit.

AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions. Significantly, the existing standard also states that, in the absence of evidence to the contrary, related party transactions should not be assumed to be outside the ordinary course of business.¹⁸⁶ Thus, AU sec. 334 could be misunderstood to create a

the sensitivity of circumstances surrounding misstatements, such as conflicts of interest in related party transactions.

¹⁸⁶ See AU sec. 334.06.

"presumption of validity" for the business purpose of related party transactions in situations where experience suggests a need for heightened scrutiny.¹⁸⁷

Significant Unusual Transactions: The risk assessment standards anticipate that the auditor will consider risks of material misstatement in a company's financial statements, including those posed by significant unusual transactions.¹⁸⁸ However, the more specific auditing requirements regarding significant unusual transactions are principally contained in AU sec. 316.¹⁸⁹ Specifically, AU sec. 316.66 recognizes that during a financial statement audit, the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment. AU sec. 316.66 requires that, if the auditor becomes aware of significant unusual transactions during the course of an audit, the auditor should gain an understanding of the business rationale of such transactions and whether that rationale (or the lack thereof) suggests that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. However, AU sec. 316 does not specify the procedures to perform to identify significant unusual transactions or to obtain necessary information to understand their business purpose (or the lack thereof).

Financial Relationships and Transactions with Executive Officers: The risk assessment standards require the auditor to consider obtaining an understanding of compensation

¹⁸⁷ This is in contrast to the approach reflected in the standard, which emphasizes the auditor's responsibilities for identifying and assessing risks of material misstatement associated with related parties and relationships and transactions with related parties.

¹⁸⁸ See paragraph 71.g. of Auditing Standard No. 12.

¹⁸⁹ See AU secs. 316.66–.67.

arrangements with senior management (including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses) as part of obtaining an understanding of the company.¹⁹⁰ While this encompasses a company's executive officers, the existing standards do not specifically require the auditor to obtain an understanding of the incentives and pressures posed by executive officer compensation arrangements that can influence a company's accounting and disclosures.

Audit Practices

The Board's understanding of audit practices is based on the Board's general knowledge of audit firm practice arising out of information gathered from its oversight activities, including its inspection, enforcement, and standard-setting activities. Additionally, the Board's understanding also has been informed by a range of studies and other materials it considered in determining the need for improvement of its existing standards. Based on this understanding, the Board believes that audit practices associated with the auditor's efforts regarding the critical areas are inconsistent.

The Board is aware that some firms have adopted audit methodologies that require their engagement teams to perform specific procedures regarding related party transactions not currently required by AU sec. 334. This may have occurred for a number of reasons. For example, the analogous standards of the IAASB and ASB require the auditor to inquire of management regarding the entity's related parties.¹⁹¹ Audit practice also may have been impacted by guidance issued by the AICPA encouraging auditors to perform many of the procedures

¹⁹⁰ See paragraph 11 of Auditing Standard No. 12.

¹⁹¹ See paragraph 13 of ISA 550, *Related Parties*, and paragraph 14 of AU-C 550, *Related Parties*.

suggested in AU sec. 334 for the auditor's consideration.¹⁹² Additionally, some auditors may already perform additional procedures arising out of their consideration of the risks of significant transactions with related parties as potential significant risks.¹⁹³

Further, some auditors may already perform additional procedures regarding significant unusual transactions as a result of robust risk assessments and as a result of guidance from Board staff and the IAASB.¹⁹⁴ Additionally, there has been considerable interest in issues relating to executive compensation, which may have resulted in heightened attention to such issues by some auditors.¹⁹⁵

The Board also is aware through its oversight activities that some firms have exhibited deficient auditing practices with respect to the critical areas. For example, the Board has identified deficiencies regarding the auditing of related party transactions through its triennial inspection program, which focuses on inspections of smaller domestic audit firms. Deficiencies identified include failures to test for undisclosed related parties or transactions with related

¹⁹² See AICPA Practice Alert No. 95–3, *Auditing Related Parties and Related-Party Transactions*, which indicated the auditor should perform most, if not all, of the examples of procedures in AU sec. 334 for determining the existence of related parties and identifying transactions with known related parties, and AICPA Toolkit, *Accounting and Auditing for Related Parties and Related Party Transactions* (2001).

¹⁹³ See paragraph 71.e. of Auditing Standard No. 12.

¹⁹⁴ See Staff Audit Practice Alert No. 5 (April 7, 2010). See also IAASB Staff Questions and Answers, *Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions* (August 2010).

¹⁹⁵ See, e.g., Staff Audit Practice Alert No. 1, *Matters Related To Timing And Accounting For Option Grants* (July 28, 2006).

parties, as well as failures to obtain an understanding of the business purpose of known related party transactions.¹⁹⁶

Additionally, a number of the Board's settled enforcement cases have involved related party transactions.¹⁹⁷ Those PCAOB enforcement actions have identified, among other things:

- Failures to perform sufficient procedures for known related party transactions;¹⁹⁸

¹⁹⁶ See *Report on 2007–2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies*, PCAOB Release No. 2013–001, at 29 (February 25, 2013), http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf, which states, in part:

Inspections staff have observed deficiencies related to firms' failures to test for undisclosed related parties or transactions with undisclosed related parties. Some of those firms failed to identify and address the lack of disclosure of related party transactions in the financial statements. Inspections staff have also identified deficiencies relating to the firms' failure to obtain an understanding of the nature and business purpose of transactions with related parties and to evaluate whether the accounting for those transactions reflects their economic substance.

See also, *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms*, PCAOB Release No. 2007–010, at 7 (October 22, 2007), http://pcaobus.org/Inspections/Documents/2007_10-22_4010_Report.pdf.

¹⁹⁷ See, e.g., *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of P. Parikh & Associates, Ashok B. Rajagiri, CA, Sandeep P. Parikh, CA, and Sundeeep P S G Nair, CA, Respondents*, PCAOB Release No. 105–2013–002 (April 24, 2013); *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Jaspers + Hall, PC, Thomas M. Jaspers, CPA, and Patrick A. Hall, CPA, Respondents*, PCAOB Release No. 105-2008-002 (October 21, 2008); *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Williams & Webster, P.S., Kevin J. Williams, CPA, and John G. Webster, CPA, Respondents*, PCAOB Release No. 105-2007-1 (June 12, 2007); and *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA, Respondents*, PCAOB Release No. 105-2005-022 (November 22, 2005).

¹⁹⁸ See *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA, Respondents*, PCAOB Release No. 105-2005-022 (November 22, 2005) and *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Williams & Webster, P.S., Kevin J. Williams, CPA, and John G. Webster, CPA, Respondents*, PCAOB Release No. 105-2007-1 (June 12, 2007).

- Failures to address management's failure to disclose known related party transactions;¹⁹⁹ and
- Failures to take sufficient steps to determine whether a transaction was a related party transaction, when available information indicated that it was.²⁰⁰

The types of deficiencies observed by the Board through its oversight activities indicate that auditor practice regarding related parties is inconsistent under the existing auditing framework in a wide range of areas, suggesting that this is a challenging area warranting additional auditor effort and focus.

The Board's Approach and Consideration of Alternatives

During the standard-setting process, the Board considered a number of alternatives and made a number of key policy choices with the goal of improving audit quality in the critical areas, while also providing opportunities for an efficient implementation. The following discussion highlights alternatives and policy choices considered by the Board as part of its economic considerations.

Consideration of Alternatives

¹⁹⁹ See Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Turner Stone & Company, LLP and Edward Turner, CPA, Respondents, PCAOB Release No. 2006-010 (December 19, 2006) and Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Timothy L. Steers, CPA, LLC, and Timothy L. Steers, CPA, Respondents, PCAOB Release No. 105-2007-004 (November 14, 2007).

²⁰⁰ See Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Cordovano and Honeck, P.C. and Samuel D. Cordovano, CPA, Respondents, PCAOB Release No. 2008-004 (December 18, 2008) and Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Clyde Bailey, P.C., and Clyde B. Bailey, CPA, Respondents, PCAOB Release No. 2005-021 (November 22, 2005).

Prior to the Board's decision to propose the standard and amendments, the Board requested input from its SAG, as early as 2004.²⁰¹ During these meetings, the Board engaged the SAG in a discussion of issues relating to the auditing of related party transactions. Additionally, the Board discussed whether and, if so, how, to improve its existing standards in complementary areas that might be considered to pose similar risks of material misstatement.

As part of its standard-setting process, the Board initially considered whether new requirements were necessary. This included a review of the Board's oversight efforts through the Board's inspection and enforcement programs to determine the type, range, and prevalence of audit deficiencies cited. In addition, before issuing its proposal, the Board issued Staff Audit Practice Alert No. 5 in April 2010, which discussed a range of auditor practice issues identified by the PCAOB staff pertaining to significant unusual transactions.²⁰²

Staff Audit Practice Alert No. 5 was issued to remind auditors of the risks associated with significant unusual transactions and to compile selected, relevant requirements from existing PCAOB auditing standards into one document. Given that the alert only highlights circumstances for auditor consideration, it did not alter audit requirements with respect to significant unusual transactions.

In considering whether new requirements were necessary, the Board assessed a range of factors, and concluded that it was appropriate to develop standards with more specific requirements to address the critical areas.

²⁰¹ Prior to the issuance of the proposal, the SAG discussed the topic of related parties at meetings on September 8–9, 2004, June 21, 2007, and October 14–15, 2009. See the SAG Meeting Archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>.

²⁰² See Staff Audit Practice Alert No. 5 (April 7, 2010).

As part of its considerations, the Board considered whether AU sec. 334 could be amended to include new specific procedures. The Board determined that the nature and extent of revisions necessary, including changes to align a revised AU sec. 334 with the risk assessment standards, would essentially result in a new standard. Thus, the Board determined that it was appropriate to propose a new standard regarding related parties, rather than amend the existing standard.

In considering how to address the other types of relationships and transactions that the Board had identified as posing similar risks – significant unusual transactions and a company's financial relationships and transactions with executive officers – the Board determined that issuing staff guidance could not make the changes that were necessary to strengthen the existing audit requirements to address the risks that had been identified in these areas. However, the Board determined that new stand-alone standards were not necessary but that appropriate improvements in audit quality could be achieved by amendments to its existing audit requirements in those areas.

As the Board considered the types and extent of changes to make in its existing standards, it considered several alternatives, including some discussed with its SAG.²⁰³ Some alternatives considered included:

Consideration of Related Party Transactions as Fraud Risk: In view of the potential for increased risks of material misstatement arising from these critical areas, the Board considered whether relationships and transactions with related parties should be presumed to be a fraud risk. Under existing auditing standards, this approach would require auditors to devote considerable

²⁰³ See the SAG Meeting Archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>, for the October 14–15, 2009 SAG meeting.

audit effort to identifying and evaluating relationships and transactions with related parties, in all instances. However, the Board recognizes that many related party transactions might not, in fact, represent fraud risks or other significant risks, a view that was further informed by discussions with the SAG.²⁰⁴ Accordingly, as such an alternative could have resulted in potentially unnecessary audit effort, the Board determined to take a targeted approach that would focus on the auditor obtaining sufficient information to identify, assess, and respond to transactions that pose increased risks of material misstatement, while, at the same time aligning the new requirements with the risk assessment standards.

Consideration of Relationships and Transactions Posing Similar Risks: The Board also considered whether to address relationships and transactions that might fall outside the definition of a "related party" but that might pose similar risks. After obtaining input from the SAG regarding this approach,²⁰⁵ the Board decided that the auditor should consider transactions that might pose similar risks, such as a company's significant unusual transactions, because these transactions not only may involve related parties previously undisclosed to the auditor but also could pose increased risks of material misstatement. Additionally, the Board concluded that linking the auditor's efforts regarding related parties and significant unusual transactions should help auditors "connect the dots" between these areas.

The Board's Approach and Choices Considered in Developing the Board's Standard and Amendments

The following discussion describes key policy choices considered by the Board as it developed the standard and amendments, and as the Board moved from its proposal to its

²⁰⁴ See SAG Meeting Archive for the October 14-15, 2009 SAG meeting.

²⁰⁵ Id.

reproposal and then to the adoption of the standard and amendments. In developing the standard and amendments, the Board determined to develop an audit approach that would promote heightened scrutiny in the critical areas, but that would also provide opportunity for efficient implementation. Key policy choices included:

Aligning with the Risk Assessment Standards: In the Board's view, its overall risk assessment approach promotes a cohesive audit, with opportunities to integrate audit effort where appropriate, and positions the auditor to identify areas in which there may be increased risks of material misstatement in company financial statements. Such an approach could also serve to minimize audit costs. The Board, thus, determined that its new requirements should be explicitly aligned with its risk assessment standards. In response to comments on its proposal, the Board took steps in its reproposal to more closely align the reproposed standard and amendments with its risk assessment standards. Those who commented on this aspect of the reproposal generally agreed that the revisions improved the alignment with the risk assessment standards. This risk assessment focus is retained in the standard and amendments being adopted by the Board.

Providing Opportunity for a Scaled Approach: Similar to the risk assessment standards, the Board determined that the standard should reflect a scaled approach, which establishes basic required procedures that are supplemented by more in-depth procedures that are commensurate with the company's facts and circumstances. Such facts and circumstances may include the size or complexity of the transaction, the nature of the company's relationships or transactions with its related parties, and the related risk of material misstatements in the financial statements.

Most commenters, including several large audit firms, agreed that the reproposed standards and amendments provide a scaled approach, permitting the auditor to vary the level of

audit work in proportion to the nature and number of a company's relationships and transactions with related parties and significant unusual transactions. Some of these commenters supported the Board's view that the level of audit effort will vary in proportion to the number and nature of a company's related party relationships and transactions, its significant unusual transactions, its financial relationships and transactions with executive officers, and the company's process to identify such matters. Another commenter stated that an audit approach that begins with basic procedures, and supplements them with more in-depth procedures as needed, is a scalable approach that allows the auditor to focus on the significant risks, regardless of the size or nature (e.g., broker or dealer or EGC) of the issuer. A few commenters, however, objected to the concept of basic required procedures and advocated for an approach that would leave the determination of the procedures necessary to the auditor's judgment.

The Board considered commenter views and determined that requiring the auditor to perform basic procedures in areas that could pose increased risks of material misstatement would heighten attention by the auditor to such areas and also provide a basis for the auditor to identify red flags that require further attention. However, as discussed below, the Board did revise certain aspects of its proposal to permit additional auditor judgment in certain areas of the audit that it determined appropriate.

Addressing Complementary Audit Areas: The Board determined that the standard and amendments should include linkages that would address risks of material misstatement arising from complementary areas of the audit. For example, the auditor's work in identifying and evaluating significant unusual transactions could assist the auditor in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor by management. This linked approach encourages the auditor to "connect the dots" between

different aspects of the audit, which could improve audit effectiveness, as well as provide opportunities for efficient implementation. In its reproposal, the Board made revisions to improve the linkages between the reproposed standard and amendments. This approach is retained in the standard and amendments being adopted by the Board.

Using Existing Concepts and Procedures: The Board determined to include some existing auditing concepts and procedures in its proposal. This approach was intended to permit audit firms to build on existing methodologies and training. Further, this approach could minimize the costs of implementing the standard and amendments. In its reproposal, the Board sought comment on such issues. Several audit firms who commented on the reproposal indicated that they would be able to update their methodologies and train staff to apply the standard and amendments in a short period, suggesting that the implementation of the standard and amendments would not be unduly burdensome.

Additionally, commenters raised a variety of policy choices for consideration by the Board, including the following:²⁰⁶

Expanding Auditor Judgment: In response to comments, the Board made some changes to allow for additional auditor judgment than originally provided for in the proposal. For example, in its proposal, any related party relationships or transactions not previously disclosed to the auditor would have been considered to be a significant risk and would have required the auditor to perform specific procedures in response. Some commenters stated that an undisclosed related party transaction could be inconsequential in nature and, in such circumstances, treating the transaction as a significant risk and performing all of the procedures set forth in the proposed

²⁰⁶ Additionally, see Appendix 4 of the reproposing release for discussion more generally of the Board's response to significant comments received on the Board's February 28, 2012 proposal.

standard would be unnecessary. Other commenters suggested it might be appropriate to perform some, but not all, of the related procedures in the proposed standard. After consideration of comments, the Board removed the proposed requirement that the auditor always treat undisclosed related party transactions as a significant risk. Instead, the additional procedures would only be required in circumstances where previously undisclosed transactions were determined by the auditor to require disclosure in the financial statements or consideration as a significant risk. This change, which is being retained in the standard being adopted by the Board, could eliminate potentially unnecessary audit work.

Clarifying the Auditor's Responsibilities to Identify a Company's Related Parties: In response to comments, the Board made clarifications to the proposed standard to emphasize that the auditor's efforts to identify a company's related parties and relationships and transactions with its related parties begins with management's work. The clarified approach taken in the Board's reproposal recognizes that the company is responsible, in the first instance, for the preparation of its financial statements, including the identification of the company's related parties, and that the auditor begins the audit with information obtained from the company. This approach has been retained in the standard being adopted by the Board. Additionally, in response to other comments made regarding the repropoed standard, several other clarifying changes have been made in this area. Those changes include emphasizing more prominently the auditor's responsibility to perform procedures to test the accuracy and completeness of the company's identification of its related parties, and that in doing so, the auditor takes into account the information gathered during the audit.

Clarifying the Requirements Regarding a Company's Financial Relationships and Transactions with Its Executive Officers: The Board made two key policy choices relating to the

amendments pertaining to a company's financial relationships and transactions with its executive officers: (i) the relationship of the amendments to the risk assessment process; and (ii) the appropriate scope of the population for the auditor's required procedures.

As discussed previously, the Board determined to supplement its existing risk assessment requirements regarding a company's financial relationships and transactions with its executive officers. As proposed, the other amendments provided that the auditor should perform procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers. While some commenters were fully supportive of this requirement and recognized that it did not represent a radical departure from existing standards, other commenters expressed concern that this would require the auditor to make an assessment regarding the appropriateness or reasonableness of executive compensation arrangements. In its reproposal, the Board clarified that these procedures would be performed as part of the risk assessment process and explicitly stated that its amendment does not require the auditor to make any determination regarding the appropriateness or reasonableness of the company's compensation arrangements with its executive officers. Commenters who addressed this area of the Board's reproposal generally indicated that the revisions were appropriate. The amendments being adopted by the Board retain the approach taken in its reproposal.

Additionally, the Board also considered the appropriate population for the auditor's consideration of financial relationships and transactions. The Board determined that the auditor's consideration of a company's financial relationships and transactions need not extend to the company's entire senior management population, but that a focus on a potentially smaller group within that population – executive officers – was appropriate. This focus is appropriate because a

company's executive officers generally are in a unique position to determine the company's accounting and financial statement disclosures.

In considering the appropriate population for the auditor's consideration, the Board took note of a range of diverse comments, including those from commenters who advocated that the auditor's procedures should include a broader group than the company's executive officers; others who stated that the auditor's focus on a company's executive officers was the most appropriate group; and another who argued for a narrower group, for example, a company's "named executive officers," ("NEOs"). Under SEC rules, NEOs generally consist of five individuals — the principal executive officer, the principal financial officer, and the next three most highly paid executive officers of a company as of the end of the most recently completed fiscal year.²⁰⁷ The Board considered the use of the NEO approach, but determined that it might focus the auditor's attention on highly paid individuals (with high compensation due to activity unrelated to financial reporting), rather than individuals with more direct involvement in the financial reporting process.

After considering these comments, the Board determined that a company's executive officers is the most appropriate population for the auditor's efforts.²⁰⁸ In the Board's view, this targeted approach could serve to limit potentially unnecessary audit effort and related costs.

The Economic Impacts of the Standard and Amendments, Including Benefits and Costs

²⁰⁷ See Item 402(a)(3) of Regulation S-K.

²⁰⁸ In considering the appropriate population for the auditor's inquiry, the Board took note of a study that indicated that the median number of "executive officers" for the Standard and Poor's 500 is 8 (the mean is 8.71), and the median number of executive officers for the Russell 2000 is 5 (the mean is 6.12). See Broc Romanek, *Study: Benchmarking the Number of Executive Officers*, The Corporate Counsel.net and LogixData (March 2, 2011).

This section contains a discussion of the economic impacts considered as the standard and amendments were developed, including consideration of likely benefits and costs.

At present, there is limited data and research available regarding the economic impact of discrete changes to auditing standards.²⁰⁹ As a result, many of the benefits and costs discussed below are difficult to quantify reliably. The resulting benefits to investors, markets, and others from more reliable financial reporting are complex and not capable of reliable quantification at this time. Likewise, limited, if any, public data exists to forecast the costs of performing additional audit procedures in the critical areas or the spillover effect on companies. Therefore, the economic discussion below is qualitative in nature.

The Board's consideration of the impacts of the standard and amendments, as with all aspects of the Board's standard-setting process, takes into account commenters' views.²¹⁰ As part of the standard-setting process, the Board asked commenters to provide information, as well as empirical data, regarding both benefits and costs, and other effects related to the repropoed standard and amendments. In response, commenters provided views regarding whether the standard and amendments would improve audit quality, as well as their views regarding potential audit costs and implementation issues. However, commenters did not provide empirical data.²¹¹

²⁰⁹ The Board established a Center for Economic Analysis to, among other things, promote and encourage academic research relating to the role of the audit in capital formation and investor protection. *See PCAOB Announces Center for Economic Analysis*, (November 6, 2013) http://pcaobus.org/News/Releases/Pages/11062013_CenterEconomicAnalysis.aspx.

²¹⁰ The comment letters are available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038Comments.aspx>.

²¹¹ Additionally, Section C provides detail regarding the Board's consideration of significant comments received relating to the specific requirements of the standard and amendments.

In general, commenters largely supported the Board's standard-setting efforts, and agreed that the existing standards should be improved in the critical areas. Commenters also generally agreed that the standard and amendments could benefit audit quality. Some commenters also noted the standard and amendments could result in improvements in the auditor's: (i) identification of material misstatements; (ii) risk assessment for the audit; and (iii) application of professional skepticism. In addition, benefits noted also included improvements to audit committee communications and company financial statement disclosures.

Commenters who addressed potential costs provided qualitative information that was generally consistent with the discussion of potential costs in the reproposing release. While commenters noted that there would be some increased costs, they did not provide data regarding the extent of such costs. However, commenters generally agreed that the standard and amendments were appropriate and should apply to audits of companies of all types and sizes.

Commenters also provided views on issues relating to scalability and costs. For example, one commenter stated that the reproposed standard and amendments would not require significant incremental management or auditor resources, but the amount of resources required could be meaningfully greater for companies with a significant number of related party transactions or significant unusual transactions. In general, the Board would not expect there to be significant cost implications for audits of companies that do not have complex or extensive: (i) relationships or transactions with related parties; (ii) significant unusual transactions; or (iii) financial relationships and transactions with the company's executive officers.

The following sections include a description of the Board's consideration of: Benefits; Costs; Smaller Audit Firms and Smaller Companies; and Other Economic Considerations.

Benefits

The Board believes that the standard and amendments will benefit investors by requiring auditors to focus appropriate auditing effort on areas that represent increased risks and, thus, warrant heightened scrutiny during the audit. As noted previously, to the extent that the standard and amendments improve the likelihood that the auditor will detect material misstatements in the financial statements, audit quality will be improved in ways that should also improve financial statement accounting and disclosures, which should in turn reduce the information asymmetry between investors and company management.

The standard and amendments take a targeted approach that is intended to focus the auditor's attention on accounting and disclosures relating to potentially complex and risky relationships and transactions that historically have been associated with cases involving fraudulent financial reporting. The magnitude and number of such cases, which have resulted in significant losses to investors, underscore the benefits to investors of strengthening the existing auditing requirements in these areas.²¹² Increased focus on the critical areas by auditors should increase the probability of auditors detecting potential fraudulent or erroneous financial reporting²¹² and should also deter fraudulent financial reporting because management will be aware that auditors are likely to expend additional effort assessing the economic substance of transactions in the critical areas.

Existing auditing standards addressing the critical areas largely provide guidance and examples of procedures, rather than requiring specific procedures. This can result in inadequate and inconsistent application of existing standards, as well as the auditor's failure to perform sufficient procedures in the critical areas, which warrant heightened scrutiny. Rather than providing examples of procedures that may not be required in every audit, the standard and

²¹² See Mark Zimbelman, *The Effects of SAS No. 82 on Auditors Planning Decisions*, 35 *Journal of Accounting Research*, 75 passim (1997).

amendments require the auditor to perform specific procedures. The new specific requirements in the standard and amendments are designed to assist the auditor in identifying red flags that warrant heightened scrutiny. The performance of basic required procedures should increase the probability of the auditor uncovering events that impact investors, such as fraud and material errors, and provide investors with increased confidence regarding the reliability of the audited financial statements.

Additionally, the standard and amendments take a wholistic view of the audit by requiring the auditor to consider the links and relationships between a company's related party transactions and significant unusual transactions. For example, the auditor's work in identifying and evaluating significant unusual transactions should assist the auditor in identifying and evaluating related parties, or transactions with related parties previously undisclosed to the auditor. Emphasizing the complementary nature of the auditor's efforts regarding these areas should help the auditor to "connect the dots" between different aspects of the audit. The complementary approach is intended to enhance audit efficiency as well as audit effectiveness in that it may increase the probability of the auditor's uncovering potential material fraud or error in a company's financial statements.

Likewise, the standard and amendments are aligned with the Board's risk assessment standards and, thus, should enhance the auditor's overall risk assessment more generally by making the auditor more effective in identifying and assessing risks of material misstatement in the critical areas, and in designing and performing better audit procedures to address such risks. Additionally, the standard and amendments feature a scaled approach that requires the auditor to supplement the basic required procedures with more in-depth procedures in response to risks identified. Alignment with the risk assessment standards and the use of a scaled approach

promotes a cohesive audit approach that should contribute to improved audit quality and provide opportunities for efficient implementation.

The auditor's heightened attention to transactions in the critical areas also could result in the auditor obtaining more information about the company's financial position. For example, the standards and amendments emphasize the auditor's understanding of the business purpose (or the lack thereof) of transactions in the critical areas. A better understanding of the business purpose should better position the auditor to understand and address such transactions, which often pose difficult measurement and recognition issues, due to factors such as transaction structure, complexity, and/or relationship to company financial targets. Such an approach should promote audit quality by providing the auditor with more insight into the nature of transactions in the critical areas, which could allow the auditor to better evaluate whether the financial statements are fairly stated.

The auditor's increased attention to the critical areas also may result in increased attention by companies to their accounting and disclosures, which could result in higher quality financial reporting. Higher quality financial reporting improves the quality of information available to the market and reduces information asymmetry between investors and company management. Improving the quality of financial reporting can reduce investors' uncertainty about the information being provided in company financial statements, foster increased public confidence in the financial markets, and enhance capital formation and the efficiency of capital allocation decisions. Research shows that decreasing the level of information asymmetry reduces the cost of capital for issuers.²¹³ In addition, if management produces more accurate disclosures, research shows that this increased quality of disclosures to financial statement users also reduces the cost

²¹³ See David Easley and Maureen O'Hara, 2004. Information and the Cost of Capital. *The Journal of Finance* 59 (4): 1553-1583.

of capital.²¹⁴

Further, new audit committee communication requirements would promote communications regarding, and improve the auditor's understanding of, the critical areas. For example, the auditor's understanding of related party transactions would be informed by an initial audit committee communication during the risk assessment that is intended to help the auditor identify the company's significant related party transactions, as well as to inform the auditor of any concerns audit committee members may have regarding the company's relationships or transactions with its related parties. Later in the audit, the auditor is required to discuss with the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of, the company's related party transactions, including any that were previously undisclosed to the auditor. In addition, improving the auditor's understanding of: (i) the business purpose (or the lack thereof) of a company's significant unusual transactions and (ii) a company's financial relationships and transactions with its executive officers, can enhance already existing required audit committee communications related to significant unusual transactions and significant risks.

These improved communication requirements should result in both auditors and audit committees becoming better informed and thus better equipped to fulfill their respective roles in the company's financial reporting. Through these communications, the auditor becomes better informed about the company, enabling the auditor to be more effective in identifying and addressing risks of material misstatement in the company's financial statements. A better informed audit committee can contribute to management oversight, which may lead management

²¹⁴ See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, 2012. Information Asymmetry, Information Precision, and the Cost of Capital. *Review of Finance* 16 (1): 1-29.

to improve the company's financial reporting. As noted above, research has indicated that improving the quality of financial reporting reduces investors' uncertainty about the information being provided in companies' financial reports and, thus, increases efficiency in capital allocation and fosters capital formation. For example, increased level and/or quality of financial reporting has been found to decrease the cost of equity, decrease the cost of debt, and decrease bid-ask spreads.²¹⁵

Commenters largely agreed with the Board that the standard and amendments could improve audit quality. In addition, specific benefits suggested by commenters included: (i) higher quality financial statement disclosures; (ii) improving investors' confidence in audited financial statements; (iii) improving the audit's effectiveness and informational value; (iv) more relevant consideration of issues facing the company; (v) increasing audit committee knowledge; and (vi) improving the audit committees' abilities to fulfill their duties. Additionally, another commenter stated that management may be more attentive to written procedures and responsibilities for related party transactions as a result of the repropoed standard. Specific comments in each area include:

- *Relationships and Transactions with Related Parties*: Many commenters stated that the repropoed standard would improve the auditor's overall understanding of a company's relationships and transactions with its related parties. Some commenters suggested that obtaining such an understanding would: (i) assist the auditor in obtaining sufficient appropriate audit evidence and increase the likelihood of

²¹⁵ See Christine A. Botosan, and Marlene A. Plumlee. 2002. *A Re-examination of Disclosure Level and the Expected Cost of Equity Capital*, 40 *Journal of Accounting Research* 21-40, (2002), Partha Sengupta, *Corporate Disclosure Quality and the Cost of Debt*, 73 *The Accounting Review* 459-474, (1998), and Michael Welker, *Disclosure Policy, Information Asymmetry, and Liquidity in Equity Markets*, 11 *Contemporary Accounting Research* 801-827 (1995), respectively.

- identifying material misstatements; and (ii) enhance the exercise of professional skepticism in the performance of the audit.
- *Significant Unusual Transactions*: A few commenters suggested that requiring procedures to improve the auditor's identification and evaluation of a company's significant unusual transactions could improve audit quality by: (i) increasing the likelihood of identifying material misstatements; (ii) promoting the exercise of professional skepticism; (iii) improving financial statement disclosures; and (iv) improving audit committees' abilities to fulfill their duties.
 - *Financial Relationships and Transactions with Executive Officers*: Commenters providing views on audit quality issues indicated that obtaining an understanding of a company's financial relationships and transactions with its executive officers could improve audit quality by: (i) improving the auditor's identification of risks of material misstatement; (ii) resulting in more relevant audit testing; and (iii) improving the auditor's assessment of fraud risk.

With respect to the baseline, the Board notes that, as described previously, some firms may perform procedures that go beyond existing requirements. Consequently, the application of the standard and amendments should generate greater benefits to audits of companies whose auditors are not currently performing a comprehensive risk-based audit or are performing only the most cursory of procedures under AU sec. 334. Benefits also include promoting consistency in audit practices among audit firms by establishing auditor performance requirements.

Costs

In general, the Board recognizes that imposing new requirements will involve some additional audit effort and related costs, both to audit firms and companies.

The Board anticipates costs include direct compliance costs to auditors that will reflect changes necessary to address the introduction of new requirements. The Board anticipates initial and ongoing costs for audit firms will include costs for updating and maintaining methodologies and audit programs, implementation, and staff training. Additionally, depending on the degree of effort currently expended by audit firms, there may be increased costs in terms of incremental audit effort, including increased audit partner time, and potential costs for the time of specialists to review complex transactions.

The increased audit effort and resulting costs may be limited as the standard and amendments are based on the Board's existing risk assessment standards and retain many existing auditing concepts and procedures that are common in practice today. For example, AU sec. 334 suggests procedures for the auditor's consideration, certain of which have been incorporated into the standard as specific required procedures. To the extent that audit firms have already incorporated these procedures into their current practices, those firms should incur lower costs in updating their methodologies. As a result, costs should be greater where auditors are not currently performing a comprehensive risk-based audit or are performing only the most cursory of procedures under AU sec. 334. In general, audit firms that audit companies of all sizes were supportive of the Board's efforts to improve audit quality in the critical areas and did not raise concerns regarding costs or provide data regarding the extent of such costs for the Board's consideration.

To the extent that there are increased costs for auditors as a result of the application of the standard and amendments, such costs may be passed on, in whole, or part (or not at all), to

companies and their investors in the form of higher audit fees.²¹⁶ The Board is aware, however, that there may be increased costs for companies whose auditors must change their methodologies and practices to address the new requirements. These potential costs to companies include increased audit fees and costs for the additional time and expense of responding to auditor inquiries.

Additionally, other costs could include costs associated with enhanced audit committee communications, to the extent the areas addressed by the standard and amendments are not already discussed. Company audit committees may require additional time and expense to participate in new audit committee communication relating to related party transactions and also may require expanded discussions relating to significant unusual transactions. While companies may need additional time or resources to conduct the new audit committee communications, the standard and amendments build on, and work in concert with, the approach taken in Auditing Standard No. 16. Thus, the new requirements in this area provide additional substance for an integrated meeting with the audit committee. This should not add significantly to the time or resources companies spend with respect to audit committee communications.

The Board also considered potential unintended consequences in conjunction with its consideration of costs. For example, the Board considered whether, to the extent that potential

²¹⁶ It is not clear to what extent the increased auditor performance requirements would result in increased audit fees. The Board is aware of public reports that have analyzed historical and aggregate data on audit fees, and which suggest that audit fees generally have remained stable in recent years, notwithstanding the fact that the Board and other auditing standard-setters have issued new standards during that period. *See, e.g., Audit Analytics Audit Fees and Non-Audit Fees: An Eleven Year Trend* (July 2013). Because amendments to, and adoption of, new Board standards typically involve discrete parts of an audit, which is not accounted for, or priced, on a standard-by-standard basis, it is difficult to obtain data that isolates the costs of particular new audit standards, and that would be comparable between firms. In its reproposal, the Board sought data that might provide information or insight into such costs. As noted above, commenters did not provide data regarding the extent of such costs.

costs stemming from the standard and amendments increase audit costs related to transactions with related parties, this could serve as a deterrent against their use. In such cases, any cost advantage a company may have from engaging in related party transactions during its normal course of operations could be reduced by higher audit-related costs.

Two commenters provided their views that the repropoed standard and amendments could serve as a deterrent against the use of related party transactions. One commenter suggested that requiring auditors to obtain evidence supporting management's arm's-length assertion regarding a related party transaction had corresponding negative economic consequences, such as, management avoiding the use of related party transactions. Another commenter that stated that the increased audit effort will result in a pass through of marginally higher audit costs to companies also noted that there could be changed behavior in structuring transactions so that they are not related party transactions.

The Board considered these comments and acknowledges that, as noted in the repropoal, potential costs stemming from the standard and amendments could increase audit costs related to transactions with related parties, which could conceivably serve as a deterrent against their use. While the Board recognizes this potential, the Board notes that companies are already required to disclose material related party transactions in their financial statements, and auditors already should be performing some procedures, under the existing standards, with respect to these transactions and related disclosures. Additionally, in considering these comments, the Board notes that the requirement in the standard for auditors to obtain evidence supporting management's arm's-length assertion regarding a related party transaction is consistent with the requirement in AU sec. 334.12, as applicable financial reporting frameworks only permit an

arm's-length assertion regarding a related party transaction to be included in the financial statements when supported by evidence.

In general, the Board's assessment of the impact of the adoption of the standard and amendments relative to costs was informed by the fact that commenters did not raise issues regarding costs that were inconsistent with those described by the Board in its reproposal. Additionally, while some commenters noted that there would be some increased costs to audit firms and companies, they did not provide data regarding the extent of such costs. A number of commenters suggested that the costs of the standard and amendments were appropriate. For example, one commenter stated that the benefits of the repropose standard and amendments would outweigh the associated costs. Another commenter stated that the repropose standard and amendments benefit users without placing too high a burden on preparers or auditors. However, a few commenters indicated that the costs associated with the standard and amendments may be difficult to measure prior to implementation.

One commenter stated that the repropose standard and amendments would not require significant incremental management or auditor resources, but resources required could be meaningfully greater for companies with a significant number of related party transactions or significant unusual transactions. Several other commenters also indicated that smaller audit firms might be disproportionately impacted by the Board's reproposal. However, commenters in general noted that the standard and amendments were appropriate for, and should apply to, audits of companies of all types and sizes, including broker-dealers and EGCs. As noted above, the Board received comments from a wide spectrum of commenters, including firms that audit companies of various sizes. Further discussion of the potential impact on smaller audit firms and smaller companies is discussed below.

Smaller Audit Firms and Smaller Companies

The Board recognizes that the adoption of the standard and amendments may impose disproportionately greater costs on smaller audit firms than on larger audit firms. For example, the one-time costs to update audit methodologies and training may represent a relatively larger share of audit costs for smaller audit firms compared to larger audit firms. Further, to the extent that a smaller audit firm has not already incorporated procedures suggested by AU sec. 334 into its current practices, such a firm would likely incur higher incremental costs to comply with the standard and amendments.

As described above, the costs incurred by the auditor to comply with the standard and amendments may be passed on, in whole, or in part (or not at all), to companies and their investors in the form of increased audit fees. To the extent this occurs, it may particularly affect smaller companies that rely on related party transactions as part of their business model. This point also was asserted by some commenters on the proposal and reproposal, many of whom also noted the particular risks posed by related party transactions engaged in by smaller companies. Increasing the costs of audits for smaller companies could negatively impact their profitability.

In considering this potential impact, the Board also has taken note of its oversight findings, which indicate that the audits of smaller companies are more frequently the subject of inspection findings and enforcement actions that involve related party transactions. Additionally, the Board notes that there is likely less information available regarding smaller companies (e.g., they have fewer brokerage research analysts, and less press coverage). Thus, while there is the potential for greater cost impact on smaller companies arising from the standard and amendments, there is also the potential that investors in such companies would accrue relatively larger benefits from the standard and amendments, such as a lower cost of capital.

As noted above, the Board believes that any additional audit costs would likely vary based on the size and complexity of the company's transactions in the critical areas, and would be commensurate with the risk of material misstatement arising out of such transactions. As noted in the reproposing release, a company that has extensive relationships and transactions with related parties or significant unusual transactions, or that has financial relationships and transactions with executive officers that give rise to risks of material misstatement, could anticipate a greater increase in audit-related costs than a company without such relationships or transactions.²¹⁷ Thus, the Board would not expect there to be a significant increase in audit fees for a company that does not have complex or extensive: (i) relationships or transactions with related parties; (ii) significant unusual transactions; or (iii) financial relationships and transactions with the company's executive officers. In addition, to the extent that some auditors are already performing procedures similar to those in the standard and amendments, there would be a lesser impact. However, if the auditor identifies related parties or relationships or transactions with related parties that were previously undisclosed to the auditor, there would be incremental costs, as well as benefits, associated with the auditor's response to the increased risks of material misstatement.

Other Economic Considerations

As noted above, commenters generally supported the Board's efforts to promote audit quality in the areas addressed by the standard and amendments. However, a few expressed concerns. For example, one commenter acknowledged that the Board had reproposed the standard and amendments to obtain more information regarding economic considerations generally, but the commenter was nonetheless critical of the Board's economic analysis in its

²¹⁷ See page A4-97 of the reproposing release.

reproposal. This commenter stated that the Board had failed to provide adequate specifics in its reproposal supporting the need for the standard and stated that the reproposal did not adequately address potential alternatives to the proposed requirements, including any rationale for not choosing to converge with the IAASB and ASB standards, which, in that commenter's view, introduced unnecessary complexity and cost. This same commenter also asked why the Board thought it necessary to adopt new requirements after the issuance of Staff Audit Practice Alert No. 5.

The Board considered the issues raised by this commenter and believes that the need for the standard and amendments, and the alternatives considered by the Board, have been fully described in the Board's proposals and throughout this release. The standards and amendments being adopted represent a targeted approach that appropriately responds to areas of the audit that have historically represented risks of material misstatement in company financial statements. In the Board's view, the need to improve the Board's existing standards addressing the critical areas, including alignment with the Board's risk assessment standards, cannot be adequately addressed through staff interpretations of existing standards. More specific requirements are warranted to promote heightened scrutiny in the critical areas. While the new auditor performance requirements will involve some additional effort and related costs in some cases, to avoid unnecessary audit efforts and costs, the Board developed the standard to align with existing audit procedures that the auditor already is required to perform as part of the auditor's risk assessment and requires the auditor to perform procedures that are commensurate with the risks of material misstatement.

The Board also considered the comment that the Board did not set forth a rationale for not choosing to converge the proposed auditing requirements with the standards of the IAASB

and the ASB. As a matter of practice, the Board regularly considers the work of other standard-setters, such as the IAASB and the ASB, for insights as it develops its standards. In developing the standard and amendments, the Board considered the analogous standards of the IAASB and the ASB and incorporated a number of similar audit procedures and requirements that the Board believed were useful and appropriate.²¹⁸

The Board, however, has determined that the critical areas require heightened scrutiny and, thus, the standard and amendments contain auditing requirements that are not reflected in the analogous standards of the IAASB and the ASB. For example, the standard and amendments contain requirements for the auditor to focus heightened audit attention on the business purpose (or the lack thereof) of a company's related party transactions.²¹⁹ Also, in view of the importance of the audit committee's role in the oversight of the company's financial reporting, the standard requires the auditor to make inquiries of the audit committee (or its chair) regarding the audit committee's understanding of the company's related parties and transactions, as well as regarding whether any member of the audit committee has concerns regarding such matters. Additionally, the other amendments require the auditor to perform risk assessment procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers.

²¹⁸ For example, paragraph 5 of the standard being adopted by the Board contains similar requirements to paragraph 13 of ISA 550 (and paragraph 14 of AU-C 550), which require the auditor to inquire of management regarding: the identity of the entity's related parties, including changes from the prior period; the nature of the relationships between the entity and these related parties; and whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

²¹⁹ See, e.g., paragraphs 5.d., 12.a., and 19.e. of the standard.

Two commenters raised concerns regarding economic considerations of a more general nature, suggesting that the Board develop a specific framework for considering costs and benefits more generally. The Board has addressed these matters separately.²²⁰

Finally, in its reproposal, the Board specifically asked for comment regarding any considerations relating to efficiency, competition and capital formation that the Board should take into account with respect to the reproposed standard and amendments. Other than the general comments described above, the Board did not receive comments noting specific concerns regarding efficiency, competition and capital formation in response to its request.

In summary, after considering these factors and public comments, the Board believes that its new requirements reflect a reasoned approach that considers and is intended to limit unnecessary audit effort and related costs.

Economic Considerations Pertaining to Audits of EGCs, Including Efficiency, Competition, and Capital Formation

The PCAOB has been monitoring implementation of the JOBS Act in order to understand the characteristics of EGCs²²¹ and inform the Board's considerations regarding whether it should

²²⁰ See, e.g., *PCAOB Strategic Plan: Improving the Quality of the Audit for the Protection and Benefit of Investors 2013 – 2017* (November 26, 2103) at 5 and 13, and *PCAOB Releases Staff Guidance on Economic Analysis in PCAOB Standard Setting* (May 15, 2014) http://pcaobus.org/News/Releases/Pages/05152014_Economic_Analysis.aspx.

²²¹ Pursuant to the JOBS Act, an EGC is defined in Section 3(a)(80) of the Exchange Act. In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than \$1 billion during its most recently completed fiscal year (and its first sale of common equity securities pursuant to an effective Securities Act of 1933 (the "Securities Act") registration statement did not occur on or before December 8, 2011). See JOBS Act Section 101(a), (b), and (d). Once an issuer is an EGC, the entity retains its EGC status until the earliest of: (i) the first year after it has total annual gross revenue of \$1 billion or more (as indexed for inflation every five years by the SEC); (ii) the end of the fiscal year after the fifth anniversary of its first sale of common equity securities under an effective Securities Act registration statement; (iii) the date on which the company issues more than \$1 billion in non-convertible debt during the prior three year period; or (iv) the date on which it is deemed to be a "large accelerated filer" under the

recommend that the SEC apply the standard and amendments to audits of EGCs. To assist the SEC, the Board is providing the following information regarding EGCs that it has compiled from public sources.²²²

Characteristics of Self-Identified EGCs

As of November 20, 2013, based on the PCAOB's research, 1,227 SEC registrants had identified themselves as EGCs in SEC filings. These companies operate in diverse industries. The five most common Standard Industrial Classification ("SIC") codes applicable to these companies are codes for: (i) blank check companies; (ii) pharmaceutical preparations; (iii) real estate investment trusts; (iv) prepackaged software services; and (v) computer processing/data preparations services.

The five SIC codes with the highest total assets as a percentage of the total assets of the population of EGCs are codes for: (i) federally chartered savings institutions; (ii) real estate investment trusts; (iii) national commercial banks; (iv) state commercial banks; and (v) crude petroleum or natural gas. Total assets of EGCs in these five SIC codes represent approximately 35% of the total assets of the population of EGCs. EGCs in three of these five SIC codes (federally chartered savings institutions, national commercial banks, and state commercial banks) represent financial institutions and the total assets for these three SIC codes represent approximately 22% of the total assets of the population of EGCs.

Exchange Act (generally, an entity that has been public for at least one year and has an equity float of at least \$700 million).

²²² To obtain data regarding EGCs, the PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and November 20, 2013, for disclosures by entities related to their EGC status. Only those entities that have voluntarily disclosed their EGC status have been identified. The PCAOB has not validated these entities' self-identification as EGCs. The information presented also does not include data for entities that have filed confidential registration statements and have not subsequently made a public filing.

Approximately 19% of the EGCs identified themselves in registration statements and were not previously reporting under the Exchange Act as of November 20, 2013. Approximately 64% of the companies that have identified themselves as EGCs began reporting under the Exchange Act in 2012 or later. The remaining 17% of these companies have been reporting under the Exchange Act since 2011 or earlier. Accordingly, a majority of the companies that have identified themselves as EGCs began reporting information under the securities laws since 2012.

Approximately 63% of the companies that have identified themselves as EGCs and filed an Exchange Act filing with information on smaller reporting company status indicated that they were smaller reporting companies.²²³

Approximately 32% of the companies that have identified themselves as EGCs provided a management report on internal control over financial reporting. Of those companies that provided a report, approximately 46% stated in the report that the company's internal control over financial reporting was not effective.²²⁴

²²³ The SEC adopted its current smaller reporting company rules in *Smaller Reporting Company Regulatory Relief and Simplification*, Securities Act Release No. 33-8876 (December 19, 2007). Generally, companies qualify to be smaller reporting companies ("SRCs") and, therefore, have scaled disclosure requirements if they have less than \$75 million in public equity float. Companies without a calculable public equity float will qualify if their revenues were below \$50 million in the previous year. Scaled disclosure requirements generally reduce the compliance burden of SRCs compared to other issuers. Notably, the only area in which SRC requirements may be more extensive than requirements for other issuers is with respect to the disclosure of related party transactions. The SEC justified this difference in treatment based on the importance of disclosing related party transactions, particularly for issuers with lower materiality thresholds.

²²⁴ For purposes of comparison, the PCAOB compared the data compiled with respect to the population of companies that identified themselves as EGCs with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The Russell 3000 was chosen for comparative purposes because it is intended to measure the performance of the largest 3,000 U.S. companies representing approximately 98%

Audited financial statements were available for nearly all of the companies that identified themselves as EGCs.²²⁵ For those companies for which audited financial statements were available and based on information included in the most recent audited financial statements filed as of November 20, 2013:

- The reported assets ranged from zero to approximately \$18.2 billion. The average and median reported assets were approximately \$184.4 million and \$0.4 million, respectively.²²⁶
- The reported revenue ranged from zero to approximately \$962.9 million. The average and median reported revenue were approximately \$59.6 million and \$3 thousand, respectively.
- The average and median reported assets among companies that reported revenue greater than zero were approximately \$359.5 million and \$68.1 million, respectively.

The average and median reported revenue among these companies that reported

of the investable U.S. equity market (as marketed on the Russell website). To contrast, approximately 95% of the companies in the Russell 3000 Index provided a management report on internal control over financial reporting. Of those companies that provided a management report, approximately 4% stated in the report that the company's internal control over financial reporting was not effective.

²²⁵ Audited financial statements were available for 1,216 of the 1,227 self-identified EGCs. Audited financial statements were not available for some EGCs that had filed registration statements that had not been declared effective by the SEC.

²²⁶ As noted above, for purposes of comparison, the PCAOB compared the data compiled with respect to the population of companies that identified themselves as EGCs with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The average and median reported assets of issuers in the Russell 3000 were approximately \$12.2 billion and approximately \$1.6 billion, respectively. The average and median reported revenue from the most recent audited financial statements filed as of November 20, 2013 of issuers in the Russell 3000 were approximately \$4.6 billion and \$725.8 million, respectively.

revenue greater than zero were approximately \$116.2 million and \$20.7 million, respectively.

- Approximately 49% identified themselves as "development stage entities" in their financial statements.²²⁷
- Approximately 54% had an explanatory paragraph included in the auditor's report describing that there is substantial doubt about the company's ability to continue as a going concern.²²⁸
- Approximately 38% were audited by firms that are annually inspected by the PCAOB (that is, firms that have issued auditor's reports for more than 100 public company audit clients in a given year) or are affiliates of annually inspected firms.

Approximately 62% were audited by triennially inspected firms (that is, firms that have issued auditor's reports for 100 or fewer public company audit clients in a given year) that are not affiliates of annually inspected firms.

The PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and November 20, 2013, for related party disclosures by EGCs. An analysis of 1,103 of the most recent audited financial statements filed through November 20, 2013 of the 1,227 self-identified EGCs indicates

²²⁷ According to the Financial Accounting Standards Board ("FASB") standards, development stage entities are entities devoting substantially all of their efforts to establishing a new business and for which either of the following conditions exists: (i) planned principal operations have not commenced or (ii) planned principal operations have commenced, but there has been no significant revenue from operations. See FASB Accounting Standards Codification Subtopic 915-10, *Development Stage Entities—Overall*.

²²⁸ Approximately 1% of the population of companies in the Russell 3000 Index have an explanatory paragraph describing that there is substantial doubt about the company's ability to continue as a going concern.

that approximately 68% of these companies disclosed at least one related party relationship or transaction.²²⁹

Economic Considerations Pertaining to Audits of EGCs, Including Comments Received

The Board's analysis of the potential economic impacts on EGCs is based on the EGC data described above, which has been collected and analyzed by the Board's staff. The Board's analysis is also informed by the Board's oversight activities, as well as by the other considerations described herein and the release more generally. Additionally, the Board's analysis has been informed by information provided by commenters. The Board's discussion of potential economic impacts on EGCs follows.

Based on the data outlined above, a majority of EGCs are smaller public companies. EGCs also appear to be companies that are relatively new to the SEC reporting process. This indicates that there is less information available to investors regarding such companies relative to the broader population of public companies. It is generally acknowledged that investors are less informed about companies that are smaller and newer, suggesting there is a higher degree of information asymmetry for smaller and newer companies.

Self-identified EGCs disclosed related party relationships or transactions at a significantly higher rate as compared to companies in the Russell 3000 Index. The data also suggests that EGCs are more likely than the population of companies in the Russell 3000 Index to have a management report on internal control over financial reporting stating that the company's internal control over financial reporting was not effective. The higher propensity of

²²⁹ A similar analysis of SEC filings for the population of companies in the Russell 3000 Index found that approximately 45% of those companies have disclosed at least one related party relationship or transaction.

EGCs to engage in related party transactions coupled with an increased likelihood for control deficiencies suggests that applying the standard in audits of EGCs is particularly relevant.

Given the characteristics of EGCs as newer and smaller companies, some might assume that EGCs would have operations that are less complex. However, this may not be true for many EGCs. Audits of EGCs appear to reflect a wide range of complexity and risk. For example, 580 of the 1,227 companies that have identified themselves as EGCs did not recognize revenue in the most recently filed financial statements. Financial institutions represent at least 22% of the total assets of EGCs. Given the nature of the operations of financial institutions, these EGCs could engage in transactions that involve complex accounting and financial statement disclosure issues.

Further, the data presented above indicates that for 54% of the EGCs the auditor's report on the most recent audited financial statements includes an explanatory paragraph describing that there is substantial doubt about the company's ability to continue as a going concern, as compared to 1% for the population of companies in the Russell 3000 Index.

Thus, applying the standard and amendments to the audits of EGCs may be particularly pertinent because of the characteristics of EGCs described above (e.g., potential for higher rates of material weaknesses in internal control, use of related party transactions, and substantial doubt about the company's ability to continue as a going concern).

In the reproposal, the Board specifically sought comment on the application of the repropose standard and amendments to audits of EGCs. Commenters generally considered the requirements of the standard to be applicable and appropriate to companies of varying sizes and industries. All those who commented on the applicability of the standard and amendments to EGCs stated that the repropose standard and amendments should be applicable to audits of EGCs. Those commenters provided various reasons, including that the risks regarding related

parties, significant unusual transactions and financial relationships and transactions with executive officers are the same, if not greater at EGCs and that EGCs may enter into such matters more frequently than non-EGCs.

No commenters stated that the repropose standard and amendments should not apply to audits of EGCs. One commenter, however, was concerned that the reproposal did not contain a substantive analysis of the economic impacts of the proposed requirements on EGCs. This commenter acknowledged, however, that after the enactment of the JOBS Act, the Board repropose the standard and amendments to seek comment and obtain additional information regarding the economic impacts on EGCs.

Some commenters stated that the repropose standard is scalable for application to audits of EGCs. One commenter stated that firm implementation costs should not differ when implementing the repropose standard for audits of EGCs or other issuers; however, increased recurring costs may fall relatively disproportionately on EGCs. One commenter stated that the implementation and training costs that a firm would incur would not depend upon whether the repropose standard is applicable to EGCs and there should be little or no additional costs to apply the repropose standard to EGCs. Another commenter noted that although smaller companies (some of which may be EGCs) may engage in more related party transactions compared to other companies, which will result in higher audit costs, the costs are commensurate with the risks of material misstatement.

Some commenters noted that regardless of the applicability to audits of EGCs, firms would perform the same procedures for all audits. One commenter suggested that it would be more costly not to apply the repropose standard and amendments to audits of EGCs as this would, in the commenter's view, require firms to maintain two methodologies. One commenter

stated that it would perform the same procedures for audits of EGCs, regardless of the applicability of the repropoed standard and amendments to audits of EGCs, as the cost to develop and maintain two separate methodologies and the related training would be cost-prohibitive. One commenter, representing a committee, stated that the standard should be applicable to audits of EGCs. However, that commenter also noted that its committee members had a mixed response; some believed the standard ought to be universally applicable, as a "carve-out" for EGCs would be more costly, but a minority believed that a carve out would be easy to implement. One commenter suggested that applying different rules to financial statement audits performed in accordance with PCAOB standards could be confusing to investors and other stakeholders.

The standard and amendments are designed to improve the auditor's efforts regarding a company's relationships and transactions with its related parties, significant unusual transactions and financial relationships and transactions with its executive officers. As previously discussed, a significant number of the Board's oversight findings from its inspections and enforcement programs regarding related party transactions involve smaller public companies, which have characteristics that are similar to EGCs.

Thus, enhanced auditor consideration of the areas addressed in the standard and amendments may be particularly important to investors in EGCs given that: (i) information asymmetry may be more pronounced at EGCs; (ii) there is the potential for greater reliance by EGCs on related party transactions; and (iii) there is a significant number of findings regarding related party transactions in audits of financial statements of smaller companies identified through PCAOB oversight activities.

Improving the auditor's efforts in the areas addressed in the standard and amendments should promote audit quality in ways that also should improve financial statement accounting and disclosure, which in turn should improve financial reporting, reduce information asymmetry, and reduce the company's cost of capital. These benefits should accrue to all types of companies, including EGCs.

EGCs will incur some incremental costs in connection with auditor compliance with the standard and amendments. As noted earlier, these costs may be disproportionately higher for smaller companies, including EGCs, relative to the broader population of public companies. The additional audit-related costs, as discussed above, could conceivably serve as a deterrent against the use of related party transactions by EGCs. Likewise, additional audit-related costs may deter certain EGCs from entering public markets, if those costs weigh heavily on their potential profitability. To the extent that EGCs tend to be smaller and newer companies, the enhanced audit performance requirements may place a disproportionately higher burden on them, which may impact their profitability and competitiveness. As noted above, however, no commenter stated that the repropose standard and amendments should not apply to audits of EGCs and no commenter discussed the impact on competitiveness of EGCs.

The standard and amendments are designed to mitigate cost impacts by aligning the auditor's efforts with the risk assessment standards and providing opportunities for a scaled approach. This allows auditors to integrate the audit to avoid unnecessary audit effort.

Additionally, in its reproposal, the Board specifically asked for comment regarding any considerations regarding efficiency, competition and capital formation that the Board should take into account when determining whether to recommend to the SEC the application of the repropose standard and amendments to audits of EGCs. No commenter expressed concerns

regarding efficiency, competition and capital formation with respect to the application of the repropose standard and amendments to audits of EGCs.

Recommendation

The Board believes that the standard and amendments will advance investor protection and promote audit quality. In addition, more effective audits and more informed communications between the auditor and the audit committee should enhance the quality of a company's financial reporting.

Additionally, the Board believes that its new requirements reflect a reasoned approach to considering and limiting unnecessary audit effort and related costs. Many commenters agreed that the repropose standard and amendments would lead to improvements in audit quality, with many commenters stating that the requirements of the repropose standard and amendments should be applicable to, and were appropriate for, companies of different sizes and industries.

The JOBS Act was enacted after the Board issued its proposing release. Subsequently, the Board issued a reproposal, in part to request comment specifically on matters relating to the application of the standard and amendments to audits of EGCs. A variety of commenters noted particular risks posed by related party transactions pertinent to small companies, including EGCs. In addition, all those commenters who commented with respect to the applicability of the standard and amendments to EGCs stated that the standard and amendments should be applicable to audits of EGCs.

Based on data available to the Board regarding EGCs, it appears that a wide range of entities, of differing sizes and industries, identify themselves as EGCs. One key difference between EGCs and the broader population of public companies would appear to be the length of time that EGCs have been subject to Exchange Act reporting requirements. Based on the

information available to the Board, while there may be additional costs and potential competitive impacts on EGCs, there also may be additional benefits from enhanced scrutiny in the areas addressed by the standard and amendments. Given these considerations, there does not appear to be a compelling reason to treat audits of EGCs differently from the audits of other companies.

For the reasons explained above, the Board believes that the standard and amendments are in the public interest and, after considering the protection of investors and the promotion of efficiency, competition, and capital formation, recommends that the standard and amendments should apply to audits of EGCs. Accordingly, the Board recommends that the Commission determine that it is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation, to apply the standard and amendments to audits of EGCs. The Board stands ready to assist the Commission in considering any comments the Commission receives on these matters during the Commission's public comment process.

III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents, the Commission will:

- (A) by order approve or disapprove such proposed rules; or
- (B) institute proceedings to determine whether the proposed rules should be

disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rules are consistent with the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/pcaob.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number PCAOB-2014-01 on the subject line.

Paper comments:

- Send paper comments in triplicate to Kevin M. O'Neill, Deputy Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number PCAOB-2014-01. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/pcaob.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rules that are filed with the Commission, and all written communications relating to the proposed rules between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549-1090, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without charge; we do not edit personal identifying information from submissions. You should submit only information that you wish to

make available publicly. All submissions should refer to File Number PCAOB-2014-01 and should be submitted on or before [insert 21 days from publication in the Federal Register].

By the Commission.

Kevin M. O'Neill
Deputy Secretary



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PROPOSED AUDITING STANDARD –)
)
RELATED PARTIES)
)
PROPOSED AMENDMENTS TO CERTAIN)
PCAOB AUDITING STANDARDS REGARDING)
SIGNIFICANT UNUSUAL TRANSACTIONS)
)
AND OTHER PROPOSED AMENDMENTS TO)
PCAOB AUDITING STANDARDS)
)
)

PCAOB Release No. 2012-001
February 28, 2012

PCAOB Rulemaking
Docket Matter No. 038

Summary: The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is proposing an auditing standard, *Related Parties*, amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other amendments to PCAOB auditing standards. The proposed standard would supersede the Board's interim standard AU sec. 334, *Related Parties*. The proposed auditing standard and proposed amendments would be applicable to all audits conducted in accordance with PCAOB standards.

Public
Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 038 in the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on May 15, 2012.

Board
Contacts: Greg Scates, Deputy Chief Auditor (202/207-9114, scatesg@pcaobus.org), Brian F. Degano, Associate Chief Auditor (202/207-9113, deganob@pcaobus.org), and Nicholas Grillo, Assistant Chief Auditor (202/207-9104, grillon@pcaobus.org).



RELEASE

I. Introduction

The auditor's evaluation of a company's identification of, accounting for, and disclosure about its relationships and transactions with related parties is important to the protection of the interests of investors and to the preparation of informative, accurate, and independent audit reports. Transactions with related parties can pose significant risks of material misstatement, as their substance might differ materially from their form. Related party transactions not only may involve difficult measurement and recognition issues that can lead to errors in financial statements but also, in some instances, related party transactions have been used to engage in financial statement fraud and asset misappropriation.

The importance to investors of auditing disclosures regarding related parties is recognized by Section 10A of the Securities Exchange Act of 1934 ("Exchange Act"), which requires each audit of an issuer to include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."^{1/}

Likewise, significant transactions that are outside the normal course of business or that otherwise appear to be unusual due to their timing, size, or nature ("significant unusual transactions") can create complex accounting and financial statement disclosure issues and, in some instances, have been used to engage in fraudulent financial reporting. For example, significant unusual transactions, especially those close to period end that pose difficult "substance-over-form" questions, might have been entered into to engage in fraudulent financial reporting or to obscure financial position or operating results. In such instances, management might place more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction.

In addition, 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).

^{1/} See Section 10A(a)(2) of the Exchange Act, 15 U.S.C. §78j-1(a)(2).



RELEASE

The Board is proposing a new auditing standard, *Related Parties* (the "proposed standard"), amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other proposed amendments to PCAOB auditing standards. The proposed amendments regarding significant unusual transactions and the other proposed amendments to PCAOB auditing standards are collectively referred to as the "proposed amendments" in this release. The proposed standard would supersede the Board's existing standard AU sec. 334, *Related Parties*.

The proposed standard and proposed amendments address the following areas for auditors:

1. Evaluating a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties;^{2/}
2. Identifying and evaluating a company's accounting and disclosure of its significant unusual transactions; and
3. Obtaining an understanding of a company's financial relationships and transactions with its executive officers that is sufficient to identify risks of material misstatement.^{3/}

^{2/} The auditor should look to the requirements of the U.S. Securities and Exchange Commission ("SEC" or "Commission") for the company under audit with respect to the accounting principles applicable to that company, including the definition of "related parties" and the financial statement disclosure requirements with respect to related parties. Also, SEC rules require additional disclosure of information regarding executive compensation and related persons in the issuer's annual report. See Items 402 and 404 of SEC Regulation S-K and Items 6.B. and 7.B. of Form 20-F.

^{3/} The term "executive officer" included in the proposed amendments to other PCAOB auditing standards is based on the definition contained in Rule 3b-7 under the Exchange Act, 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 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. For brokers and dealers, the term "executive officer" is based on a list in Schedule A of Form BD, which includes



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The proposed amendments regarding significant unusual transactions are being exposed for public comment with the proposed standard because these amendments complement the proposed standard. For example, enhancing the auditor's identification and evaluation of significant unusual transactions might assist the auditor in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor. However, not all related party transactions are significant unusual transactions, and not all significant unusual transactions involve related parties.

The other proposed amendments to PCAOB auditing standards would further complement the improvements in the proposed standard and proposed amendments regarding significant unusual transactions. Among other things, the other proposed amendments to PCAOB auditing standards would require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. Obtaining such an understanding could assist the auditor in identifying incentives and pressures that could cause management to use related party transactions or significant unusual transactions to obscure a company's financial position or operating results. In addition, performing such procedures also might assist the auditor in identifying related party transactions previously undisclosed to the auditor.

II. Overview of the Proposed Standard and Proposed Amendments

Appendices 1-3 to this release contain the text of the proposed standard, the proposed amendments regarding significant unusual transactions, and the other proposed amendments to PCAOB auditing standards, respectively. Appendix 4 to this release contains additional discussion on specific aspects of the proposed standard and proposed amendments, and describes how the proposed standard and proposed amendments would change existing requirements. Appendix 4 also contains questions for which the Board seeks specific comment. Appendix 5 to this release includes a comparison of the objectives and requirements of the proposed standard and proposed amendments with the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA"). In developing the proposed standard

a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions.



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and proposed amendments, the Board considered the requirements of the analogous standards of the IAASB and the ASB.

A. Proposed Auditing Standard, *Related Parties*

AU sec. 334 and other PCAOB auditing standards describe procedures for the auditor's evaluation of a company's relationships and transactions with its related parties.^{4/} An underlying premise of AU sec. 334 is that management is required by applicable accounting principles to identify a company's related parties and to disclose material related party transactions. AU sec. 334 describes procedures to assist the auditor in determining the existence of related parties, identifying transactions with related parties, examining the substance of identified related party transactions, and evaluating financial statement disclosures.

The proposed standard would strengthen existing audit procedures for identifying, assessing, and responding to the risks of material misstatement associated with a company's related party transactions. Among other things, the proposed standard would:

- Align with and build upon the foundational requirements in the Board's standards on risk assessment;^{5/}
- Require the auditor to perform procedures to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes of the types of transactions involving related parties;
- Require the auditor to perform specific procedures for each related party transaction, or type of related party transaction, that is either required to be disclosed or determined to be a significant risk;

^{4/} See, for example, Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

^{5/} See PCAOB Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (August 5, 2010).



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- Require the auditor to evaluate whether information that comes to the auditor's attention during the audit indicates that undisclosed related parties or relationships or transactions with related parties might exist;
- Require the auditor to perform specific procedures if the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist; and
- Require the auditor to communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.

B. Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

Existing standards describe procedures for the auditor to perform as part of the auditor's evaluation of significant unusual transactions. For example, existing standards require that the auditor gain an understanding of the business rationale for significant unusual transactions and evaluate whether that rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.^{6/}

The Board is proposing amendments to AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and other auditing standards to strengthen the auditor's evaluation of significant unusual transactions. Among other things, the proposed amendments regarding significant unusual transactions would:

- Require the auditor to perform specific procedures to identify significant unusual transactions;

^{6/} See, for example, AU secs. 316.66-.67 and paragraph 14 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Certain requirements from these and other standards are compiled in Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010), available at: http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf.



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- Require the auditor to perform specific procedures to obtain an understanding of the business purpose (or the lack thereof) of identified significant unusual transactions;
- Enhance the auditor's evaluation of the business purpose of significant unusual transactions; and
- Require the auditor to evaluate whether significant unusual transactions have been appropriately accounted for and adequately disclosed.

C. Other Proposed Amendments to PCAOB Auditing Standards

The Board also is proposing other amendments to PCAOB auditing standards designed to further complement its proposals with respect to related parties and significant unusual transactions. One such amendment would address the auditor's consideration of a company's financial relationships and transactions with its executive officers. Executive officers are in a unique position to commit financial statement fraud or asset misappropriation through their ability to manipulate accounting records and present fraudulent financial information (e.g., through override of controls).^{7/} Further, a company's financial relationships and transactions with its executive officers might create incentives and pressures that could create risks of material misstatement of the financial statements.

The other proposed amendments to PCAOB auditing standards would, among other things:

- Require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers as part of its risk assessment;
- Require the auditor to obtain representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor;

^{7/} See AU sec. 316.08.



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- Emphasize the auditor's existing responsibilities to communicate possible fraud to management, the audit committee and, under certain conditions, the U.S. Securities and Exchange Commission and others;^{8/} and
- Amend other PCAOB auditing standards to conform to the proposed standard and proposed amendments regarding significant unusual transactions.

III. Considerations in Developing the Proposed Standard and the Proposed Amendments

The Board has developed the proposed standard and proposed amendments in light of the magnitude and number of financial reporting frauds involving public companies' relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers. The Board's proposals also have been informed by observations from the PCAOB's oversight activities, discussions with the Board's Standing Advisory Group ("SAG"), and international developments.

These factors, as described further in this section, collectively indicate a need for the consideration of improvements to certain existing standards. Consequently, the Board is proposing specific requirements regarding the auditor's evaluation of a company's relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with its executive officers. The proposed requirements are designed to benefit investors by focusing the auditor's efforts on those areas that pose an increased risk of material misstatement to the financial statements and the auditor's responses to those risks.

In addition, as described in Section I. of Appendix 4 to this release, the proposed standard and proposed amendments are designed to align with and build upon the foundational requirements in the Board's standards on risk assessment, including the consideration of fraud in a financial statement audit. This alignment with the risk assessment process could provide opportunities for the auditor to implement the standard in an efficient way. The Board requests comments on the foregoing.

^{8/} See Section 10A(b)(3) of the Exchange Act, 15 U.S.C. §78j-1(b)(3).



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A. Financial Reporting Frauds Involving Relationships and Transactions with Related Parties, Significant Unusual Transactions, and Financial Relationships and Transactions with Executive Officers

Relationships and transactions with related parties have been a contributing factor in prominent corporate scandals, as discussed in the SEC study of five years of enforcement actions^{9/} and in major enforcement cases, such as Enron Corporation, Tyco International, Ltd., and Refco, Inc.^{10/} Likewise, significant unusual transactions reportedly have been considered to be a contributing factor in attempts to mislead investors about companies' financial conditions. Such transactions could occur when management places more emphasis on the need for a particular accounting treatment than on accounting that reflects the underlying economic substance of the transaction. For example, in studies conducted pursuant to the Act, the SEC staff noted that "deliberate attempts to work around the intent of accounting standards have contributed to many of the largest financial reporting failures."^{11/}

^{9/} Section 704 of the Sarbanes-Oxley Act of 2002 (the "Act") directed the SEC to study enforcement actions over the five years preceding its enactment "to identify areas of issuer financial reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management." As part of the study the SEC examined 227 enforcement matters and found that 23 cases included the failure to disclose related party transactions. See *Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002* (January 24, 2003), at page 6, available at: <http://sec.gov/news/studies/sox704report.pdf>.

^{10/} See also the report of the Quality Control Inquiry Committee of the AICPA's SEC Practice Section, which analyzed more than 200 audit failures from December 1997 to October 2002 and recommended that, among other things, "required audit procedures be broadened to help ensure the auditor gains a more complete understanding of related-party transactions, including the business aspects of the transactions." See, AICPA SEC Practice Section, *Memo To Managing Partners of SECPS Member Firms, "Recommendations for the Profession Based on Lessons Learned from Litigation"* (October 2002).

^{11/} See SEC *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (June 15, 2005), page 99, available at: <http://sec.gov/news/studies/soxoffbalancerept.pdf>.



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In addition, the *Report Prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs* noted that "some U.S. financial institutions and public companies have been misusing structured finance vehicles...to carry out sham transactions that have no legitimate business purpose and mislead investors, analysts, and regulators about companies' activities, tax obligations, and true financial condition."^{12/} Significant unusual transactions in which the substance of the transactions might differ materially from their form, or in which the transactions might represent "window dressing," also have raised concerns regarding the possible lack of transparency in financial statements.^{13/}

Recent corporate scandals also illustrate that a company's financial relationships and transactions with its executive officers can create incentives and pressures that can

^{12/} 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 Exchange Act 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>.

^{13/} Phrases such as "window dressing" or "dressing up" have been used to describe transactions entered into at or close to period end that improve the appearance of a company's financial statements, but which are unwound shortly after period end. Concerns over "window dressing" have been described in the report of 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>. See also Securities Act Release No. 33-9144, *Commission Guidance on Presentation of Liquidity and Capital Resources in Management's Discussion and Analysis* (September 17, 2010), available at: <http://www.sec.gov/rules/interp/2010/33-9144.pdf>.



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result in risks of material misstatement, including fraud risks.^{14/} Notably, a May 2010 academic study that examined in detail SEC accounting and auditing enforcement releases from 1997 to 2008 noted that either the chief executive officer or chief financial officer was named in 89 percent of the enforcement actions involving fraudulent financial reporting.^{15/} That study also noted that the SEC's most commonly cited motivations for fraud included the need to meet internal or external earnings expectations, an attempt to conceal the company's deteriorating financial condition, the need to increase the stock price, the need to bolster financial performance for pending equity or debt financing, or the desire to increase management compensation based on financial results.^{16/}

Investor and regulatory concerns about a company's financial relationships and transactions with management (e.g., compensation) remain prevalent today.^{17/} Certain risks resulting from compensation policies are now required to be disclosed in SEC filings. For example, in 2009, the SEC adopted new rules that require a company to disclose compensation policies and practices that are reasonably likely to have a material adverse effect on the company.^{18/} Understanding the structure of compensation arrangements for executive officers can assist the auditor in identifying conditions and events that could represent fraud risk factors and, individually, or in conjunction with other fraud risk factors, could represent fraud risks.

^{14/} 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>.

^{15/} 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.

^{16/} *Id* at pages 5 and 33.

^{17/} 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>.

^{18/} See Securities Act Release No. 33-9089, *Proxy Disclosure Enhancements* (December 16, 2009), available at: <http://www.sec.gov/rules/final/2009/33-9089.pdf>.



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B. Observations from PCAOB Oversight Activities

The PCAOB's Inspections program has identified deficiencies regarding the auditing of related party transactions.^{19/} For example, inspection findings indicate that some auditors are not giving adequate consideration to the risks of material misstatement of financial statements resulting from related party transactions.^{20/} In addition, PCAOB inspectors have sometimes observed deficiencies in firms' audit procedures related to off-balance sheet structures (e.g., consideration of implicit or informal guarantees or other arrangements to provide financial support between some financial services' issuers prior to the time such guarantees or arrangements became explicit during the economic crisis).^{21/}

^{19/} Deficiencies cited in inspection reports do not necessarily warrant revision of the relevant standard. The Board considers inspection findings and other information from the PCAOB's inspections program in connection with other relevant information and data in determining whether or how to revise its rules and standards.

^{20/} See page 7 of PCAOB Release No. 2007-010, *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms* (October 22, 2007), available at: http://pcaobus.org/Inspections/Documents/2007_10-22_4010_Report.pdf, which states, in part:

Inspection teams have observed deficiencies related to firms' failures to identify and address the lack of disclosure of related party transactions. They also have identified deficiencies relating to the effectiveness of firms' testing of the nature, economic substance, and business purpose of transactions with related parties. For example, firms have failed to sufficiently test (a) the validity and classification of expenditures made by a controlling shareholder on behalf of an issuer, (b) the collectability of receivables due from entities owned or controlled by officers of an issuer, (c) the validity and accuracy of payables owed to related parties, and (d) the appropriateness of the accounting for the extinguishment of a note receivable from an officer of an issuer.

^{21/} See PCAOB Release 2010-006, *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis* (September 29, 2010), available at: http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf.



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Additionally, certain of the Board's disciplinary actions have involved auditors' failures to perform sufficient procedures regarding transactions with related parties and significant unusual transactions, including, for example, the failure to perform sufficient procedures regarding identified related party transactions and transactions with related parties previously undisclosed to the auditor.^{22/}

C. Standing Advisory Group Discussions

The PCAOB requested input from the SAG with respect to relationships and transactions with related parties on several occasions.^{23/}

Many SAG members support the Board's efforts to enhance its standards regarding the auditing of related party transactions. Several SAG members indicated that related party transactions represent an area of increased audit risk and require heightened scrutiny. Some SAG members also noted that auditors often view related party transactions primarily as a disclosure issue, rather than an issue requiring increased focus on whether the accounting is appropriate in light of the transaction's

^{22/} See PCAOB Release No. 2005-022, Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA, Respondents (November 22, 2005); PCAOB Release No. 105-2007-1, Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Williams & Webster, P.S., Kevin J. Williams, CPA, and John G. Webster, CPA, Respondents (June 12, 2007); PCAOB Release No. 2006-010, Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Turner Stone & Company, LLP and Edward Turner, CPA, Respondents (December 19, 2006); PCAOB Release No. 105-2007-004, Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Timothy L. Steers, CPA, LLC, and Timothy L. Steers, CPA, Respondents (November 14, 2007); and PCAOB Release No. 2008-004, Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Jaspers and Hall, PC, Thomas M. Jaspers, CPA, and Patrick A. Hall, CPA, Respondents (October 21, 2008).

^{23/} See SAG briefing papers: "Related Party Transactions" (September 8, 2004), "Related Parties" (June 21, 2007), and "Related Parties" (October 14, 2009). Copies of these SAG briefing papers and webcast archives are available at: <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>.



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business purpose. Some SAG members noted that often the issue is not the identification of a related party transaction but, rather, the extent of substantive procedures applied by an auditor (i.e., relying too heavily on management representations). Some SAG members did, however, express concern regarding whether imposing additional requirements for the auditor to perform procedures to identify related party relationships and transactions previously undisclosed to the auditor would result in unduly increased audit costs.

Moreover, some SAG members noted that there are risks associated with a company's financial relationships and transactions with management and that these relationships should be considered during the audit. However, other SAG members noted the need for specific guidance to address this issue, and expressed concern that, without specific guidance for the auditor, the auditor's efforts regarding financial relationships and transactions with management could become excessive.

D. International Developments

Other regulators have noted a need for an improved focus on both related party and significant unusual transactions. For example, the United Kingdom's Financial Services Authority noted that auditors did not always appear to be willing to challenge key accounting judgments made by management that were fundamental to transactions structured to achieve a particular accounting treatment.^{24/} Foreign securities regulators have issued communications regarding a need for better disclosures of related party transactions and relationships.^{25/}

^{24/} See, for example, Financial Services Authority & Financial Reporting Council Discussion Paper 10/3, *Enhancing the auditor's contribution to prudential regulation* (June 2010), available at:

http://www.fsa.gov.uk/pubs/discussion/dp10_03.pdf. In addition, the Audit Inspection Unit of the United Kingdom's Professional Oversight Board, part of the Financial Reporting Council, has identified deficiencies regarding the identification and testing of related party transactions by auditors. Those public reports are available at: <http://www.frc.org.uk/pob/audit/firmreports1011.cfm>.

^{25/} For example, in March 2011, the European Corporate Governance Forum of the European Commission issued a statement highlighting the importance of related party transactions to shareholders. See *Statement of the European Corporate Governance Forum on Related Party Transactions for Listed Entities* (10 March 2011),



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The risk of material misstatement associated with related party relationships and transactions applies not only to U.S. companies, but also to the foreign operations of U.S. companies and foreign private issuers.^{26/} For example, the Organisation for Economic Co-Operation and Development, *Guide on Fighting Abusive Related Party Transactions in Asia*, noted that:

The complexity of group structures and the inter-connectedness of enterprises (most notably under the 'complicated network ownership' structure) means auditors face significant challenges in being sceptical of material information on related party transactions in Asia. The fact that, for the most part, external auditors are reliant on information provided by management magnifies this challenge.^{27/}

A report published by the Asia-Pacific Office of the Chartered Financial Analysts ("CFA") Institute's Centre for Financial Market Integrity also expressed similar concerns stating, "[r]elated-party transactions are a constant corporate governance risk in Asia. Although the concept is identical to its meaning in the West, the practice differs as a result of the ownership structure characteristic to the region."^{28/}

available at:

http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf_related_party_transactions_en.pdf. Additionally, in March 2010, the Commissione Nazionale per le Società e la Borsa ("CONSOB") in Italy approved new regulations regarding related party transactions. See

http://www.consob.it/mainen/press_release/comunicato_20100312.htm.

^{26/} See Rule 3b-4 under the Exchange Act for the definition of the term "foreign private issuer."

^{27/} Organisation for Economic Co-Operation and Development, Corporate Governance Series, *Guide on Fighting Abusive Related Party Transactions in Asia* (September 2009), available at: <http://www.oecd.org/dataoecd/39/57/43626507.pdf>.

^{28/} See Asia-Pacific Office of the CFA Institute Centre for Financial Market Integrity, *Related Party Transactions Cautionary Tales for Investors in Asia* (2009), available at: <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2009.n1.1>.



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In addition, in July 2008, the IAASB revised its auditing standard on related parties with the issuance of International Standard on Auditing No. 550, *Related Parties* ("ISA 550"). The IAASB emphasized that a new standard was warranted given the public focus on the accounting and auditing of related party relationships and transactions after recent major corporate scandals.^{29/} The ASB also has revised its auditing standard on related parties with the issuance of AU-C Section 550, *Related Parties*, contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification*, in October 2011.

IV. Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act^{30/} ("Dodd-Frank Act") gave the Board oversight of the audits of brokers and dealers registered with the SEC. In September 2010, the Commission issued interpretive guidance clarifying that the "references in Commission rules and staff guidance and in the federal securities laws to [Generally Accepted Auditing Standards] GAAS or to specific standards under GAAS, as they relate to non-issuer brokers or dealers, should continue to be understood to mean" the auditing and attestation standards established by the AICPA. The guidance noted that the Commission intended to revisit this interpretation in connection with a Commission rulemaking project to update the audit and attestation requirements for brokers and dealers in light of the Dodd-Frank Act.^{31/}

On June 15, 2011, the SEC proposed to amend its rules to require, among other things, that audits of brokers' and dealers' financial statements and examinations of reports regarding compliance with Commission requirements be performed in accordance with the standards of the PCAOB.^{32/} If the SEC adopts its proposed

^{29/} See IAASB Exposure Draft, *Related Parties* (December 2005).

^{30/} See Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

^{31/} See Exchange Act Release No. 34-62991, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers* (September 24, 2010).

^{32/} See Exchange Act Release No. 34-64676, *Broker-Dealer Reports* (June 15, 2011).



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amendments to SEC Rule 17a-5 or provides other direction that auditors of brokers and dealers are to comply with PCAOB professional standards, the Board's auditing, attestation, quality control, and, where applicable, independence standards would then apply to audits of brokers and dealers required by Section 17 of the Exchange Act and SEC Rule 17a-5. The proposed standard and the proposed amendments would be applicable for all audits performed in accordance with PCAOB standards. The Board therefore requests comments from auditors of brokers and dealers and others on the proposed standard and the proposed amendments.

V. Effective Date of the Proposed Standard and Amendments

Given the importance of the proposed standard and proposed amendments to improved audits and greater investor protection, the Board anticipates that the proposed standard and proposed amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2012. The Board seeks comment regarding the feasibility of this date.

VI. Opportunity for Public Comment

The Board is seeking comment on the proposed standard, proposed amendments regarding significant unusual transactions, and proposed amendments to other PCAOB standards. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington DC 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's Web site at: www.pcaobus.org. All comments should refer to the PCAOB Rulemaking Docket Matter No. 038 on the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on May 15, 2012.

The Board will consider carefully all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are rules of the Board under the Act.

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On the 28th day of February, in the year 2012, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

February 28, 2012

APPENDIX 1 – *Proposed Standard – Related Parties*

APPENDIX 2 – *Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions*

APPENDIX 3 – *Other Proposed Amendments to PCAOB Auditing Standards*

APPENDIX 4 – *Additional Discussion of the Proposed Standard and Proposed Amendments and Questions for Public Comment*

APPENDIX 5 – *Comparison of the Objectives and Requirements of the Proposed Standard and Proposed Amendments with the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants*



APPENDIX 1

Proposed Standard, *Related Parties*

Introduction

1. This standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.^{1/}

Objective

2. The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.^{2/}

Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties

3. The auditor should perform procedures to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes (or the lack thereof) of the types of transactions involving related parties.^{3/} The procedures performed should be designed to identify likely sources of potential material misstatements in the financial

^{1/} The auditor should look to the requirements of the U.S. Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company, including the definition of "related parties" and the financial statement disclosure requirements with respect to related parties.

^{2/} See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*. See also paragraph .04(c)-(d) of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, and Rule 4-01 of Regulation S-X.

^{3/} Paragraph 16 of Auditing Standard No. 9, *Audit Planning*, states that the auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.



statements that may arise from the company's relationships and transactions with related parties, including related parties or relationships or transactions with related parties previously undisclosed to the auditor.^{4/}

Note: For purposes of this standard, the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes (1) related parties that were not disclosed to the auditor or (2) relationships or transactions with known or previously unknown related parties that were not disclosed to the auditor.

4. In identifying related parties and obtaining an understanding of relationships and transactions with related parties, the auditor should take into account information obtained from the performance of risk assessment procedures (e.g., obtaining an understanding of the company and its environment, performing analytical procedures, and conducting a discussion among engagement team members regarding the risks of material misstatement) required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

Obtaining an Understanding of Internal Control over Financial Reporting

5. The auditor should obtain an understanding of the controls that management has established to:

- a. Identify related parties and relationships and transactions with related parties;
- b. Authorize and approve transactions with related parties; and
- c. Account for and disclose relationships and transactions with related parties in the financial statements.

^{4/} Paragraph 7 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, requires the auditor to evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. Paragraph 7 states that lesser amounts of misstatements could influence the judgment of a reasonable investor because of qualitative factors, e.g., because of the sensitivity of circumstances surrounding misstatements, such as conflicts of interest in related party transactions.



Performing Inquiries

6. The auditor should inquire of management regarding:
 - a. The names of the company's related parties during the period under audit, including changes from the prior period;
 - b. Background information concerning the related parties (e.g., physical location, industry, number of employees);
 - c. The nature of any relationships, including ownership structure, between the company and each related party;
 - d. The types of transactions entered into with each related party during the period under audit and the terms and business purposes (or the lack thereof) of each type of transaction;
 - e. The business reasons for entering into a transaction with a related party versus an unrelated party; and
 - f. Any significant related party transactions (i) 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 and (ii) for which exceptions to the company's established policies or procedures were granted.

7. The auditor should inquire of others within the company regarding the matters identified in paragraph 6 of this standard. The auditor should identify others within the company to whom inquiries should be directed and determine the extent of such inquiries by considering whether such individuals are likely to have additional knowledge regarding (i) the company's related parties or relationships or transactions with related parties and (ii) the company's controls over relationships or transactions with related parties. The auditor also should consider whether such individuals are likely to have knowledge of related parties, or relationships or transactions with related parties previously undisclosed to the auditor. Examples of such individuals include, but are not limited to:
 - a. Personnel in a position to initiate, process, or record transactions with related parties and those who supervise or monitor such personnel;
 - b. Internal auditors;
 - c. In-house legal counsel;



- d. The chief compliance/ethics officer or person in equivalent position; and
 - e. The human resource director or person in equivalent position.
8. The auditor should inquire of the audit committee, or its chair, regarding:^{5/}
- a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
 - b. Whether any member of the audit committee has particular concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

Communications with the Audit Engagement Team and Other Auditors

9. The auditor should communicate to engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.^{6/}

10. 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 related parties and the nature of the company's relationships and transactions with those related parties.^{7/} The auditor also should inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.

^{5/} In addition to this inquiry, paragraph 8 of the proposed auditing standard, *Communications with Audit Committees*, requires the auditor to make certain inquiries of the audit committee. Appendix A to the proposed auditing standard, *Communications with Audit Committees*, contains the definition of audit committee. See PCAOB Release No. 2011-008 (December 20, 2011).

^{6/} See Auditing Standard No. 10, *Supervision of the Audit Engagement*, which establishes requirements regarding supervision of the audit engagement, including supervising the work of engagement team members.

^{7/} See AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements.



Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor

11. The auditor should evaluate whether information that comes to the auditor's attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Identifying and Assessing Risks of Material Misstatement

12. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level.^{8/} This includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties.

Responding to the Risks of Material Misstatement

13. The auditor must design and implement audit responses that address the assessed risks of material misstatement.^{9/} 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.

Note: The auditor also should look to the requirements in proposed paragraphs.66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, for related party transactions that are also significant unusual transactions (e.g., significant related party transactions outside the normal course of business).

14. The auditor should perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or That are a Significant Risk

^{8/} See paragraph 59 of Auditing Standard No. 12.

^{9/} See paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.



15. For each related party transaction, or type of related party transaction, that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:

- a. Read the underlying documentation and determine whether the terms and business purpose (or the lack thereof) of the transaction are consistent with explanations from inquiries and from other audit evidence;
- b. Determine (i) 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 and (ii) whether any exceptions to those established policies or procedures were granted;^{10/}
- c. Evaluate the financial capability of the related parties with respect to significant uncollected balances, guarantees, and other obligations, if any;^{11/} and
- d. Perform other procedures as appropriate, depending on the nature of the related party transaction and the related risks of material misstatement, to meet the objective of this standard.

Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor

16. If the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform procedures to determine whether previously

^{10/} Information obtained from gaining an understanding of the company also might assist the auditor in identifying agreements prohibiting or restricting related party transactions (e.g., loans or advances to related parties).

^{11/} Examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.



undisclosed relationships or transactions with related parties, in fact, exist.^{12/} These procedures should extend beyond inquiry of management.

Note: Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

17. If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Determine why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;^{13/}
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationships or transactions with the related party;
- d. Assess the need to perform procedures to identify additional relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 15 of this standard, treating the related party transaction as a significant risk;

^{12/} See paragraph 29 of Auditing Standard No. 15, *Audit Evidence*, which states that if audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

^{13/} See paragraph .04 of AU sec. 333, *Management Representations*, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.



- f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
- g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
- h. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor determines that it is likely that an illegal act has or may have occurred, the auditor should perform the appropriate procedures, including those required by AU sec. 316, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

Evaluating Financial Statement Accounting and Disclosures

18. The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.^{14/} This includes evaluating whether the financial statements contain the information regarding related party transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions

19. If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.^{15/}

^{14/} See paragraph 30 of Auditing Standard No. 14, *Evaluating Audit Results*.

^{15/} See the proposed amendments to AU sec. 333, which would require the auditor to obtain written representations from management if the financial statements include such an assertion. Representations from management alone are not sufficient appropriate audit evidence. See also paragraphs .35-.36 of AU sec. 508, *Reports on Audited Financial Statements*.



Note: Transactions with related parties might not be conducted on terms equivalent to those prevailing in arm's-length transactions (e.g., a company may receive services from a related party without cost). Except for routine transactions, it may not be possible for management to determine whether a particular transaction would have taken place, or what the terms and manner of settlement would have been, if the parties had not been related. Accordingly, it may be difficult for the auditor to obtain sufficient appropriate audit evidence to substantiate management's assertions that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. A preface to a statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

Communications with the Audit Committee

20. The auditor should communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. The auditor also should communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- b. The identification of significant related party transactions (i) that have not been authorized or approved in accordance with the company's established policies or procedures and (ii) for which exceptions to the company's established policies or procedures were granted;
- c. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support such assertions; and
- d. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

Note: An auditor may communicate significant matters to only the audit committee chair if done in order to communicate these matters in a timely manner during the audit. The auditor, however, should communicate significant matters to the full audit committee prior to the issuance of the auditor's report.



APPENDIX A – Examples of Information and Sources of Information That Could Indicate That Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor Might Exist

A1. This appendix contains examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Specifically, paragraph A2 of this appendix contains examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, and paragraph A3, similarly, contains examples of sources that could contain such information. The examples contained in this Appendix are not intended to represent a comprehensive listing.

A2. The following are examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Buying or selling goods or services at prices that differ significantly from prevailing market prices;
- Sales transactions with unusual terms, including unusual rights of return or extended payment terms generally not offered to customers;
- "Bill and hold" type transactions;
- Borrowing or lending on an interest-free basis or with no fixed repayment terms;
- Occupying premises or receiving other assets or rendering or receiving management services when no consideration is exchanged;
- Engaging in a nonmonetary transaction that lacks commercial substance;
- Sales without economic substance (e.g., funding the other party to the transaction to facilitate collection of the sales price, or entering into a transaction shortly prior to period end and unwinding that transaction shortly after period end);
- Loans to parties that, at the time of the loan transaction, do not have the ability to repay and possess insufficient or no collateral;
- Loans made without prior consideration of the ability of the party to repay;
- A subsequent repurchase of goods that indicates that at the time of sale an implicit obligation to repurchase may have existed that would have precluded revenue recognition or sales treatment;



- Advancing company funds that are used directly or indirectly to pay what would otherwise be an uncollectible loan or receivable;
- Sales at below market rates to an intermediary whose involvement serves no apparent business purpose and who, in turn, sells to the ultimate customer at a higher price, with the intermediary (and ultimately its principals) retaining the difference;
- Guarantees and guarantor relationships outside the normal course of business; or
- Transactions between two or more entities in which each party provides and receives the same or similar amounts of consideration (e.g., round-trip transactions).

A3. The following are examples of sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Minutes of meetings of the board of directors;
- Periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies;
- Confirmation responses and responses to inquiries of the company's lawyers;
- Tax filings;
- Invoices and correspondence received from the company's professional advisors, for example, attorneys and consulting firms;
- Relevant internal auditors' reports;
- Conflicts-of-interest statements from management and others;
- Shareholder registers that identify the company's principal shareholders;
- Life insurance policies purchased by the company;
- Records of the company's investments, pension plans, and other trusts established for the benefit of employees, including the names of the officers and trustees of such investments, pension plans, and other trusts;
- Contracts or other agreements (including side agreements or other arrangements) with management;
- Contracts and other agreements representing significant unusual transactions;



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- Significant contracts renegotiated by the company during the period under audit;
- Records from a management, audit committee, or board of directors' whistleblower program;
- Expense reimbursement documentation for executive officers; or
- The company's organizational charts.



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APPENDIX 2 – Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

A. Identifying Significant Unusual Transactions (Section II.A. of Appendix 4) Auditing Standard No. 5, "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements"

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, as amended, is amended as follows:

a. In paragraph 14:

- The first bullet point is replaced with:

Controls over significant unusual transactions, particularly those that result in late or unusual journal entries;^{10A/} and

- Footnote 10A is added at the end of the first bullet:

^{10A/} See paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

Auditing Standard No. 9, "Audit Planning"

Auditing Standard No. 9, *Audit Planning*, is amended as follows:

a. In paragraph 12, item a. is replaced with:

The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, e.g., significant unusual transactions executed at the location or business unit.^{14/}



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Auditing Standard No. 12, "Identifying and Assessing Risks of Material Misstatement"

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

a. In paragraph 13:

- The fifth bullet point is replaced with:

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");^{7A/} and

- Footnote 7A is added after the semicolon (;) in the fifth bullet:

^{7A/} See AU secs. 316.66-.67A.

b. In paragraph 56.a.:

- In item (6), delete the word "and" at the end of the item.
- In item (7), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
- Add Item (8) and footnote 31A at the end of item (8):

(8) Whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties.^{31A/}

^{31A/} See AU secs. 316.66-.67A.

c. In paragraph 56.b.:

- In item (3), delete the word "and" at the end of the item.
- In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.



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- Add item (5):
 - (5) Whether the company has entered into any significant unusual transactions.
- d. In paragraph 56.c.:
 - In item (3), delete the word "and" at the end of the item.
 - In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add item (5):
 - (5) Whether the company has entered into any significant unusual transactions.
- e. In paragraph 57, the third bullet point is replaced with:

Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements, a significant unusual transaction, or a significant related party transaction;
and
- f. Paragraph 71.g., is replaced with:

Whether the risk involves significant unusual transactions.
- g. Paragraph 73A is added after paragraph 73:

73A. The auditor should obtain an understanding of the controls that management has established to identify, authorize and approve, and account for and disclose significant unusual transactions in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18-40 and 72-73 of this standard.



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Auditing Standard No. 13, "The Auditor's Responses to the Risks of Material Misstatement"

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, is amended as follows:

- a. The second sentence of footnote 3 to paragraph 5.d. is replaced with:

See also paragraphs .66-.67A of AU sec. 316, Consideration of Fraud in a Financial Statement Audit, and paragraphs .04 and .06 of AU sec. 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.

- b. Paragraph 15.c. is replaced with:

Evaluating whether the business purpose for significant unusual transactions indicates that the transactions may have been entered into to engage in fraudulent financial reporting or misappropriation of assets. (AU secs. 316.66-.67A).

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. The first item in paragraph .85.A.2, section a., under "Opportunities" is replaced with the following two items:
- Related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business)
 - Significant transactions with related parties whose financial statements are not audited or are audited by another firm
- b. The fourth item, in paragraph .85.A.2, section a., under "Opportunities" is replaced with:



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- Significant or highly complex transactions or significant unusual transactions, especially those close to period end, that pose difficult "substance-over-form" questions
- c. The following item is added as the last item to paragraph .85.A.2, section a., under "Opportunities":
 - Contractual arrangements lacking a business purpose

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

- a. In paragraph .55, paragraph B1., the tenth bullet is replaced with:
 - The occurrence of infrequent or significant unusual transactions

B. Evaluating Significant Unusual Transactions (Section II.B. of Appendix 4)

Auditing Standard No. 13, "The Auditor's Responses to the Risks of Material Misstatement"

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, is amended as follows:

- a. Paragraph 11A is added after paragraph 11:
 - 11A. Responding to Risks Associated with Significant Unusual Transactions. Paragraph 71.g. of Auditing Standard No. 12 indicates that one of the factors to be evaluated in determining significant risks is whether the risk involves significant unusual transactions. Also, AU secs. 316.66-67A establish requirements for performing procedures to respond to fraud risks regarding significant unusual transactions. Because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-67A.



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AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. Paragraph .66 is replaced with:

.66 Evaluating whether the business purpose for significant unusual transactions indicates that the transactions may have been entered into to engage in fraud. 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 misappropriation of assets.

Note: The auditor's identification of significant unusual transactions should take into account information obtained from: (a) the risk assessment procedures required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial reporting) and (b) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

- b. Paragraph .66A is added after paragraph .66:

.66A The auditor should design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction. The procedures should include:

a. Reading the underlying documentation and determining whether the terms and business purpose (or the lack thereof) of the transaction are consistent with explanations from inquiries and other audit evidence;



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- b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, guarantees, and other obligations, if any;^{24A/} and
- d. Performing other procedures as appropriate, depending on the nature of the transaction and the risks of material misstatement, to obtain an understanding of the business purpose (or the lack thereof) of the significant unusual transaction.

Note: Paragraph 11A of Auditing Standard No. 13 requires the auditor to take into account the types of misstatements that could result from significant unusual transactions in designing and performing further audit procedures.

^{24A/} Examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

- c. Paragraph .67 is replaced with:

.67 The auditor should evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. In making that evaluation, the auditor should evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);
- The transaction involves unconsolidated related parties, including variable interest entities;



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- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor;^{25A/}
- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company;
- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);
- 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 other, more clearly independent, parties on an arm's-length basis;
- The company's accounting for the transaction enables the company to achieve certain financial targets;
- 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); and
- Management has discussed the nature and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Note: Paragraphs 20-23 of Auditing Standard No. 14, *Evaluating Audit Results*, provide additional requirements regarding the auditor's evaluation of whether identified misstatements might be indicative of fraud. In addition, the auditor considers management's disclosure (or the lack thereof) regarding significant unusual transactions in other parts of the company's Securities and Exchange



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Commission filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

- d. Footnote 25A is added at the end of the third bullet in paragraph .67:

25A/

Related parties or relationships or transactions with related parties previously undisclosed to the auditor includes: (1) related parties that were not disclosed to the auditor or (2) relationships or transactions with known or previously unknown related parties that were not disclosed to the auditor. The proposed auditing standard, *Related Parties*, requires the auditor to perform certain procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

- e. Paragraph .67A is added after paragraph 67:

.67A Paragraph 30 of Auditing Standard No. 14 requires the auditor to evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. This includes evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework.



APPENDIX 3 –Other Proposed Amendments to PCAOB Auditing Standards

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

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

a. Paragraph 10A is added after paragraph 10:

10A. The auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements). The procedures should be designed to identify risks of material misstatement and should include, but are not limited to (1) reading employment and compensation contracts and (2) reading proxy statements and other relevant company filings with the Securities and Exchange Commission and other regulatory agencies that relate to the company's financial relationships and transactions with its **executive officers**.

b. In paragraph 11:

- The third bullet is replaced with:

Obtaining an understanding of compensation arrangements with senior management other than executive officers referred to in paragraph 10A, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses;

- In the fourth bullet, remove the word "and" at the end of the bullet.

- Add a fifth bullet:

Inquiring of the chair of the compensation committee, or its equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and

- Add a sixth bullet:



Obtaining an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

- c. In Appendix A, paragraph A3A is added after paragraph A3:

A3A. Executive officer – The president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policy-making functions for the company. (See Rule 3b-7 under the Exchange Act.) For brokers and dealers, the term "executive officer" includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions. (See Schedule A of Form BD.)

AU sec. 315, "Communications Between Predecessor and Successor Auditors" (Section III.B. of Appendix 4)

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows:

- a. The following bullet is added to the end of paragraph .09:
- The predecessor auditor's understanding of the company's relationships and transactions with related parties and significant unusual transactions.^{fn 5A}
- b. Add the following footnote to the end of paragraph .09:
- ^{fn 5A} Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, describes significant unusual transactions.
- c. For paragraph .11:
- Replace the fifth sentence with:

The predecessor auditor should ordinarily permit the successor auditor to review working papers, including documentation of planning, internal



control, audit results, and other matters of continuing accounting and auditing significance, such as the working papers containing an analysis of balance sheet accounts, those relating to contingencies, those related to relationships and transactions with related parties, and those related to significant unusual transactions.

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit" (Section III.C. of Appendix 4)

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. The title before paragraph .79 is replaced with:

Communication about Possible Fraud to Management, the Audit Committee, the Securities and Exchange Commission, and Others ^{fn 37}

- b. Paragraph .81A is added after paragraph .81:

.81A The auditor has a responsibility, under certain conditions, to disclose possible fraud to the Securities and Exchange Commission to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change and the fraud or related risk factors constitute a reportable event or are the source of a disagreement, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required pursuant to Section 10A(b)(3) of the Securities Exchange Act of 1934 relating to an illegal act that the auditor concludes has a material effect on the financial statements.

- c. For paragraph .82:

- The paragraph and footnotes 39 and 41 are replaced with:

.82 The auditor also may have a duty to disclose the existence of possible fraud to parties outside the entity in the following circumstances:



- a. To a successor auditor when the successor makes inquiries in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors*.^{fn 40}
- b. In response to a subpoena.
- c. To a funding agency or other specified agency in accordance with requirements for the audits of companies that receive governmental financial assistance.
- d. The following item is added to paragraph .85.A.2, section b., under "Opportunities":
 - The exertion of dominant influence by or over a related party

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), as amended, is amended as follows:

- a. Footnote 2 to paragraph .27 is replaced with:

Proposed Auditing Standard, *Related Parties*, establishes requirements regarding the auditor's evaluation of relationships and transactions between the company and its related parties.

AU sec. 333, "Management Representations" (Section III.D. of Appendix 4)

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

- a. The third sentence of paragraph .03 is replaced with:

For example, after the auditor performs the procedures described in Proposed Auditing Standard, *Related Parties*, the auditor should obtain a written representation that management has no knowledge of any relationships and transactions with related parties that have not been properly accounted for and adequately disclosed. The auditor should obtain this written representation even if the results of those procedures indicate that relationships and transactions with related parties have been properly accounted for and adequately disclosed.



- b. In paragraph .06:
- Subparagraph c. is replaced with:

Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
 - Subparagraph f. is replaced with:

Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.
 - Subparagraph l. is replaced with:

Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.^{fn9}
- c. Footnote 9 to paragraph .06 is replaced with:

See Proposed Auditing Standard, Related Parties.
- d. Paragraph .11A is added after paragraph 11:

.11A If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should obtain written representation from management regarding that assertion in the financial statements.
- e. The second sentence in paragraph 4 of Appendix A is replaced with:

Examples are fraud, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in Proposed Auditing Standard, *Related Parties*.
- f. In paragraph 6 of Appendix A:
- Item 2.a. is replaced with:



Financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Item 11.d. is added:

Side agreements or other arrangements (either written or oral) that have not been disclosed to you.

AU sec. 334, "Related Parties"

SAS No. 45, Omnibus Statement on Auditing Standards — 1983 (AU sec. 334, "Related Parties"), as amended, is superseded.

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," as amended, is superseded.

AU sec. 336, "Using the Work of a Specialist"

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336, "Using the Work of a Specialist"), as amended, is amended as follows:

- a. Footnote 6 of paragraph .10 is replaced with:

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.

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543" (Section III.E. of Appendix 4)

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543," as amended, is amended as follows:

- a. Paragraph .05 is replaced with:

Interpretation—Before issuing his or her report, the other auditor should inquire of the principal auditor as to matters significant to the audit. Those matters include relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.



AU sec. 722, "Interim Financial Information" (Section III.F. of Appendix 4)

SAS No. 100, as amended, Interim Financial Information (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

- a. In paragraph .24:
 - Subparagraph g. is replaced with:

Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
 - Subparagraph j. is replaced with:

Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.
 - Subparagraph m. is replaced with:

Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.
- b. The second sentence of item C5 of paragraph .56 is replaced with:

Examples are fraud, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in Proposed Auditing Standard, *Related Parties*.
- c. Within the second illustrative representation letter (2.) for a review of interim financial information (statements) contained in paragraph C6 of paragraph .56:
 - Item 2.a. is replaced with:

All financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
 - Item 12.d. is added:



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Side agreements or other arrangements (either written or oral) that have not been disclosed to you.



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Appendix 4 – Additional Discussion of the Proposed Standard and Proposed Amendments and Questions for Public Comment

This appendix discusses the proposed standard, *Related Parties* (the "proposed standard") in Appendix 1, the proposed amendments regarding significant unusual transactions in Appendix 2, and other proposed amendments to PCAOB auditing standards in Appendix 3. The proposed amendments regarding significant unusual transactions and the other proposed amendments to PCAOB auditing standards are collectively referred to as the "proposed amendments" in this appendix. This appendix provides additional background information regarding certain of the proposed requirements in the proposed standard and proposed amendments, discusses the basis for the proposals, and requests comment on specific questions as well as on the proposals in general.

I. Proposed Auditing Standard, *Related Parties*

The proposed standard would enhance the existing requirements for identifying, assessing, and responding to the risks of material misstatement associated with a company's relationships and transactions with related parties.

The proposed standard is designed to align with and build upon the foundational requirements contained in the Board's standards on risk assessment.^{1/} Due to the increased risk of material misstatement to the financial statements associated with a company's related party transactions, as described in the release, the proposed requirements are contained in a separate auditing standard; however, the proposed standard is aligned with and refers to the standards on risk assessment.

In general, the proposed standard establishes procedures for the auditor to obtain from management, and others as appropriate, the names of the company's related parties and relevant information about relationships and transactions with those parties. Under the proposed standard, the auditor inquires whether any member of the audit committee has particular concerns regarding the company's relationships or transactions with related parties and, if so, the substance of those concerns. The auditor performs procedures regarding the identified relationships and transactions with related parties, and evaluates whether information that comes to the auditor's attention during

^{1/} See PCAOB Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (August 5, 2010).



the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. If the auditor identifies a related party or relationship or transaction with a related party previously undisclosed to the auditor, the proposed standard requires the auditor to perform specific audit procedures. The proposed standard also requires the auditor to communicate to the audit committee, in a timely manner and prior to the issuance of their audit report, its evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. The auditor also communicates significant matters arising during the audit regarding the company's related parties or relationships or transactions with related parties.

The discussion in this section describes the major topic areas of the proposed standard, as set forth below,^{2/} including how the requirements in the proposed standard align with and build upon the Board's risk assessment standards and other considerations:

- Introduction (paragraph 1);
- Objective (paragraph 2);
- Identifying related parties and obtaining an understanding of relationships and transactions with related parties (paragraphs 3 – 11);
- Identifying and assessing risks of material misstatement (paragraph 12);
- Responding to the risks of material misstatement (paragraphs 13 – 17);
- Evaluating financial statement accounting and disclosures (paragraphs 18 – 19);
- Communications with the audit committee (paragraph 20); and
- Other considerations.

^{2/} The paragraph references in this section relate to provisions in the proposed standard contained in Appendix 1.



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A. Introduction (paragraph 1 of Appendix 1)

The introduction of the proposed standard states that it establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. The existing standard, AU sec. 334, *Related Parties*, incorporates the U.S. generally accepted accounting principles ("U.S. GAAP") definition of a related party.^{3/}

The proposed standard requires the auditor to look to the requirements of the U.S. Securities and Exchange Commission ("SEC") for the company under audit with respect to the accounting principles applicable to that company, including the definition of related parties and the financial statement disclosure requirements with respect to related parties.^{4/} The proposed standard does not define the term "related party" because applicable financial reporting frameworks may contain different definitions of the term "related party." Applicable financial reporting frameworks also may contain different disclosure requirements.

Question:

1. Is the framework neutral approach described in the introduction of the proposed standard appropriate? If not, why not?

^{3/} See AU sec. 334.02. For auditors of financial statements prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board ("IFRS") or other comprehensive set of accounting principles, see Question 4 of *Staff Questions and Answers, References to Authoritative Guidance in PCAOB Standards*, available at: http://pcaobus.org/Standards/QandA/2009-09-02_FASB_Codification.pdf.

^{4/} For SEC filings that include financial statements prepared in accordance with or reconciled to U.S. GAAP, see, for example, the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") Topic 850. For SEC filings that include financial statements prepared in accordance with International Financial Reporting Standards ("IFRS"), see, for example, International Accounting Standard No. 24, *Related Parties*.



B. Objective (paragraph 2 of Appendix 1)

AU sec. 334 does not identify an objective for the auditor's work regarding a company's relationships and transactions with its related parties. In contrast, paragraph 2 of the proposed standard states that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

Providing an overarching concept as an audit objective for the auditor to take into account while performing the procedures required by the proposed standard can assist the auditor in performing those procedures, including developing other procedures as required, and evaluating the results of those procedures. An overarching concept can be especially helpful when judgment is required, for example, when designing additional procedures not specifically required by the proposed standard. New auditing standards issued by the Board include an objective, and this standard is following the same format.

A broadly stated objective to guide the auditor's actions also may eliminate a mechanical approach for examining relationships and transactions with related parties, which could result in the auditor not appropriately considering all the facts and circumstances in determining and performing audit procedures. Given the increased risk of material misstatement associated with transactions with related parties, avoiding a mechanical approach could improve audit quality and potentially address concerns regarding the auditor's consideration of related party transactions.

Question:

2. Is the objective of the proposed standard appropriate? If not, why not?

C. Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties (paragraphs 3 – 11 of Appendix 1)

AU sec. 334.05 requires the auditor to obtain an understanding of management responsibilities and the relationship of each component to the total entity in determining the scope of work to be performed with respect to possible transactions with related parties. AU sec. 334.05 further requires that the auditor consider controls over management activities and the business purpose served by the various components of the entity. AU sec. 334.09 requires that, after identifying related party transactions, the



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auditor perform the procedures necessary to obtain satisfaction concerning the purpose, nature, and extent of transactions with related parties and their effect on the financial statements. AU sec. 334.09 also requires that those procedures extend beyond inquiry of management, and that until the auditor understands the business sense of material transactions, he cannot complete his audit. If the auditor lacks sufficient specialized knowledge to understand a particular transaction, the auditor should consult with persons who do have the requisite knowledge.^{5/}

The proposed standard would retain the general approach taken in AU sec. 334, and further require the auditor to perform specific procedures to identify the company's related parties and obtain an understanding of the relationships and types of transactions with related parties. Paragraphs 3 and 4 of the proposed standard introduce procedures necessary for the auditor's identification and assessment of risks of material misstatement, including fraud risks. A footnote to paragraph 3 provides that paragraph 16 of Auditing Standard No. 9, *Audit Planning*, states that the auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

The requirements in paragraphs 3 and 4 build upon the foundational risk assessment requirements contained in Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Specifically, paragraph 3 of the proposed standard requires that the auditor perform procedures to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes (or the lack thereof) of the types of transactions involving related parties. The procedures performed should be designed to identify likely sources of potential material misstatements in the financial statements that may arise from the company's relationships and transactions with related parties, including related parties or relationships or transactions with related parties previously undisclosed to the auditor. Those procedures include the procedures in paragraphs 4 through 11 of the proposed standard.

The requirements in paragraph 3 of the proposed standard apply to related party transactions, whether they are required to be disclosed or not in the financial statements, such as intercompany transactions.

A note to paragraph 3 explains that the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes (1)

^{5/} See footnote 6 to AU sec. 334.09.



related parties that were not disclosed to the auditor or (2) relationships or transactions with known or previously unknown related parties that were not disclosed to the auditor. Auditors should be alert to the potential existence of related parties or transactions with related parties (including formal or informal arrangements) that were previously undisclosed to the auditor.

An additional footnote to paragraph 3 states that paragraph 7 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, requires the auditor to evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. Paragraph 7 states that lesser amounts of misstatements could influence the judgment of a reasonable investor because of qualitative factors, e.g., because of the sensitivity of circumstances surrounding misstatements, such as conflicts of interest in related party transactions.

Paragraph 4 of the proposed standard requires the auditor to take into account information obtained from the performance of risk assessment procedures when identifying related parties and obtaining an understanding of relationships and transactions with related parties. For example, the auditor should take into account information resulting from the performance of risk assessment procedures (e.g., obtaining an understanding of the company and its environment, performing analytical procedures, and conducting a discussion among engagement team members regarding the risks of material misstatement) required by Auditing Standard No. 12. The procedures in paragraphs 5 through 11 represent incremental requirements to the risk assessment procedures described in Auditing Standard No. 12.

The auditor should understand how relationships with related parties might result in a material misstatement of the financial statements, for example, through gaining an understanding of the business purpose (or the lack thereof) of the transaction. The procedures performed should be sufficient to identify likely sources of potential material misstatements regarding related party transactions, and to identify fraud risk factors associated with related party transactions.^{6/} For example, to improve the appearance of its financial condition, a company and a related party could attempt to "dress up" the appearance of the company's balance sheet at period end by agreeing to have the

^{6/} Paragraph 26 of Auditing Standard No. 12 describes risks of material misstatement due to fraud.



company temporarily pay down its related party debt prior to the balance sheet date while having an undisclosed side agreement to subsequently borrow the same or a comparable amount shortly after period end.

Understanding the nature of relationships and transactions with related parties is important for the auditor's evaluation of the company's accounting for and disclosure of related party transactions. Further, this understanding is critical to determining whether related parties might be involved in transactions indirectly through the use of an intermediary.

Obtaining an Understanding of Internal Control over Financial Reporting (paragraph 5 of Appendix 1)

Existing standards require the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.^{7/} Paragraph 5 of the proposed standard would specifically require that the auditor obtain an understanding of the controls that management has established to:

- a. Identify related parties and relationships and transactions with related parties;
- b. Authorize and approve transactions with related parties; and
- c. Account for and disclose relationships and transactions with related parties in the financial statements.

Obtaining an understanding of internal control over financial reporting includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.^{8/}

^{7/} See paragraph 18 of Auditing Standard No. 12.

^{8/} See paragraph 20 of Auditing Standard No. 12.



Performing Inquiries (paragraphs 6 – 8 of Appendix 1)

Paragraph 6 of the proposed standard would require the auditor to inquire of management regarding: the names of the company's related parties during the period under audit, including changes from the prior period; background information concerning the related parties (e.g., physical location, industry, number of employees); the nature of any relationships, including ownership structure, between the company and each related party; the types of transactions entered into with each related party during the period under audit and the terms and business purposes (or the lack thereof) of each type of transaction; the business reasons for entering into a transaction with a related party versus an unrelated party; and any significant related party transactions (i) that have not been authorized and approved in accordance with the company's established policies and procedures regarding the authorization and approval of transactions with related parties and (ii) for which exceptions to the company's established policies or procedures were granted.

Paragraph 7 of the proposed standard would extend the inquiries in paragraph 6 to other individuals within the company. Paragraph 7 would require the auditor to identify others within the company to whom those inquiries should be directed and determine the extent of such inquiries by considering whether such individuals are likely to have additional knowledge regarding (i) the company's related parties or relationships or transactions with related parties and (ii) the company's controls over relationships or transactions with related parties. The auditor also should consider whether such individuals are likely to have knowledge of related parties or relationships or transactions with related parties previously undisclosed to the auditor. Paragraph 7 states that examples of such individuals include, but are not limited to:

- a. Personnel in a position to initiate, process, or record transactions with related parties and those who supervise or monitor such personnel;
- b. Internal auditors;
- c. In-house legal counsel;
- d. The chief compliance/ethics officer or person in equivalent position; and
- e. The human resource director or person in equivalent position.

The requirements in paragraphs 6 and 7 of the proposed standard could assist the auditor in obtaining a sufficient understanding of the company's relationships and transactions with related parties to identify and assess risks of material misstatement.



Paragraph 8 of the proposed standard would require that the auditor inquire of the audit committee, or its chair, regarding: (a) the audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company and (b) whether any member of the audit committee^{9/} has particular concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

The inquiries in paragraph 8 could be performed at the same time as the inquiries of the audit committee, or its chair, about the risks of material misstatement, including fraud risks, required by paragraphs 54 and 56.b. of Auditing Standard No. 12.^{10/} These inquiries also could provide an opportunity for the auditor to discuss the company's financial relationships and transactions with its executive officers with the audit committee, or its chair, as part of the auditor's procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers as discussed in Section III.A. of this release.

Communications with the Audit Engagement Team and Other Auditors (paragraphs 9-10 of Appendix 1)

Paragraph 9 of the proposed standard would require the auditor to communicate to the engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships with those related parties. Communicating such information might increase the engagement team's opportunity to identify related parties or relationships or transactions with related parties previously undisclosed to the auditor and to evaluate their effect on the financial statements. Effective two-way communication among the engagement team members also might highlight evidence that corroborates or contradicts information provided by management about relationships and transactions with related parties. Additionally, effective communications could enhance the auditor's understanding of the business purpose and terms of related party transactions.

^{9/} See Appendix A to the proposed auditing standard, *Communications with Audit Committees*, for the definition of audit committee; see PCAOB Release No. 2011-008 (December 20, 2011).

^{10/} Paragraph 8 of the proposed auditing standard, *Communications with Audit Committees*, also requires the auditor to make certain inquiries of the audit committee; see PCAOB Release No. 2011-008 (December 20, 2011).



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The requirement in paragraph 9 of the proposed standard would complement the requirement in paragraph 49 of Auditing Standard No. 12 that key engagement team members discuss the potential for material misstatement due to error or fraud. That discussion, in part, includes: (1) the susceptibility of the company's financial statement to material misstatement due to fraud, (2) how management could perpetrate and conceal fraudulent financial reporting, and (3) how assets of the company could be misappropriated, including the susceptibility of the financial statements to material misstatement through related party transactions.^{11/}

Examples of matters regarding related parties that the engagement team might discuss include: (a) information that could indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor, (b) sources of information that could indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor, (c) how variable-interest entities controlled by management might be used to facilitate earnings management, and (d) how transactions between the company and a known business partner of a member of management could be arranged to facilitate asset misappropriation.^{12/} Communicating information about related parties at an early stage of the audit would benefit such discussions and should continue throughout the audit.

As described in Section III.A. of this Appendix, the other proposed amendments to PCAOB auditing standards that would require the auditor to obtain an understanding of the company's financial relationships and transactions with its executive officers also could complement the discussion required by Auditing Standard No. 12.

AU sec. 334.07.g. provides that determining the existence of undisclosed related parties or related parties and related party transactions might require inquiry of other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions. AU sec. 9334.13 states that the principal auditor and other auditor should each obtain from the other the names of known related parties and that, ordinarily, the exchange should be made at an early stage of the audit.

^{11/} Paragraph 52 of Auditing Standard No. 12.

^{12/} See *also* Section II.B. of Appendix 4 of this release, for a description of transactions with a party that falls outside the definition of a related party, but where either party may be able to negotiate terms that may not be available to other, more clearly independent, parties on an arm's-length basis.



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When the auditor serves as a principal auditor, paragraph 10 of the proposed standard would require that the auditor, when using the work of another auditor, communicate to the other auditor relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties. This requirement applies regardless of whether the auditor is taking responsibility for the work of the other auditor. Paragraph 10 would also require the auditor to inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications. Exchanging relevant information can assist the principal auditor in understanding the overall nature of the company's relationships and transactions with related parties.

Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor (paragraph 11 and Appendix A of Appendix 1)

The existing auditing standard provides that the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and related party relationships that require disclosure in the financial statements.^{13/} AU sec. 334.05 states that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component of the company to the total company and consider controls over management activities. AU sec. 334.08 lists procedures for identifying undisclosed related parties or related party relationships and transactions.

Paragraph 11 of the proposed standard requires that the auditor evaluate whether information that comes to the auditor's attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Paragraph 11 further states that Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

The proposed standard includes Appendix A to assist the auditor's identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor. Specifically, paragraph A2 of Appendix A includes examples of information that could indicate that related parties or relationships or transactions with

^{13/} See AU sec. 334.04.



related parties previously undisclosed to the auditor might exist.^{14/} For example, if the auditor identifies situations where the company is buying or selling goods or services at prices that differ significantly from prevailing market prices, the auditor should evaluate whether such transactions could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Paragraph A3 of Appendix A includes examples of sources that could contain such information. The examples of sources of information in paragraph A3 include, among other things: minutes of meetings of the board of directors; periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies; and confirmation responses and responses to inquiries of the company's lawyers.

The proposed standard would not require an auditor to review each source of information referenced in Appendix A. However, an auditor may be required to perform auditing procedures with respect to certain of those sources (e.g., reading minutes of meetings of the board of directors) by other auditing standards or through the performance of auditing procedures in other areas.^{15/} Appendix A also states that the examples contained in that Appendix are not intended to represent a comprehensive listing.

Questions:

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/} As described in Section I.E., if the auditor identifies information that indicates related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, whether included in a source in Appendix A or not, the auditor should perform procedures under paragraph 16 to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Those procedures should extend beyond inquiry of management.

^{15/} See, for example, AU sec. 560, *Subsequent Events*, AU sec. 722, *Interim Financial Information*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.



4. Are the procedures for identifying related parties and obtaining an understanding of relationships and transactions with related parties appropriate?
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?

D. Identifying and Assessing Risks of Material Misstatement (paragraph 12 of Appendix 1)

Paragraph 12 of the proposed standard aligns with the foundational risk assessment requirements contained in Auditing Standard No. 12. Auditing Standard No. 12 requires that the auditor identify and assess the risks of material misstatement at the financial statement level and the assertion level.^{16/} Paragraph 12 of the proposed standard states that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties.

Due to their nature, transactions with related parties might involve difficult measurement and recognition issues that can lead to errors in financial statements. For example, related parties might buy or sell goods or services at prices that differ significantly from prevailing market prices or offer unusual rights of returns or extended payment terms. Additionally, the substance of related party transactions might differ materially from their form. Further, related parties that operate through an extensive and complex range of relationships and structures could result in an increased level of complexity.

Under existing requirements, the auditor should determine whether any of the identified and assessed risks of material misstatement are fraud risks or other significant risks.^{17/} For example, depending upon the facts and circumstances, the creation of a variable interest entity in which the company's economic interest (its obligation to absorb losses or its right to receive benefits) is disproportionately greater

^{16/} See paragraph 59 of Auditing Standard No. 12.

^{17/} See paragraph 59.f. of Auditing Standard No. 12.



than the company's stated power may represent a fraud risk or other significant risk, especially in the presence of fraud risk factors. Examples of fraud risk factors regarding related parties that individually, or in combination with other fraud risk factors, might indicate the existence of a fraud risk, include significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.^{18/}

Related parties, due to their ability to control or significantly influence, may be in a position to prevent a company from pursuing its own separate interests. The existence of dominant influence is a factor considered by auditors when assessing the risks of material misstatement. Identifying the risks of material misstatement associated with dominant influence can assist the auditor's assessment of the risks of material misstatement. Paragraph .85 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, already describes the principle of dominant influence in the example of a fraud risk factor by stating that the ineffective monitoring of management as a result of domination of management by a single person or small group, without compensating controls, provides an opportunity for management to engage in fraudulent financial reporting.

The other proposed amendments to PCAOB auditing standards contained in Appendix 3 would amend AU sec. 316.85.A.2 to include the exertion of dominant influence by or over a related party as an example of a fraud risk factor.^{19/} The other proposed amendment to AU sec. 316.85.A.2 expands that concept to encompass all related parties outside of management of the company. The proposed amendments do not define dominant influence as doing so might result in some auditors being overly focused on the definition itself instead of the "red flags" associated with dominant influence that might create risks of material misstatement at the financial statement level. Examples of factors that may signal dominant influence exerted by a related party include:

- Significant transactions are referred to the related party for approval;

^{18/} See AU sec. 316.85.A.2, section a., under "Opportunities."

^{19/} Paragraph A29 of International Standards on Auditing ("ISA") 550, *Related Parties*, also describes "dominant influence" and provides examples of indicators to assist the auditor in identifying instances of dominant influence with regard to a related party. The Auditing Standards Board of the American Institute of Certified Public Accountants also has described dominant influence.



- There is little or no debate among management and the board of directors regarding business proposals initiated by the related party; or
- The related party played a leading role in starting the company and continues to play a leading role in managing the company, even if the related party is no longer part of management or the board of directors.^{20/}

The existence of dominant influence by itself, or in the presence of other fraud risk factors (e.g., use of an intermediary whose involvement serves no apparent business purpose), might indicate the existence of a fraud risk.

Questions:

6. Is paragraph 12 of the proposed standard appropriately aligned with the existing requirements regarding the identification and assessment of risks of material misstatement?
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?
8. Are there particular related party transactions that should be deemed a fraud risk or other significant risk?

E. Responding to the Risks of Material Misstatement (paragraphs 13 – 17 of Appendix 1)

AU sec. 334.11 requires that, for each material related party transaction that requires disclosure, the auditor should consider whether he or she has obtained sufficient appropriate audit evidence to understand the related party relationship and the effects of the related party transactions on the financial statements. AU sec. 334.11 also requires the auditor to evaluate such evidence to determine whether material related party relationships and transactions have been adequately disclosed in the financial statements. Footnote 6 of AU sec. 334.09 states that "[u]ntil the auditor understands the business sense of material transactions, he cannot complete his audit." AU secs.

^{20/} See, for example, paragraph A29 of ISA 550, which contains similar examples.



334.09-.10 provide procedures for examining identified related party transactions. Those paragraphs direct the auditor to apply the procedures the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of identified related party transactions and their effect on the financial statements, noting that those procedures should extend beyond inquiry of management.

The auditor must design and implement audit responses that address the assessed risks of material misstatement.^{21/} Paragraph 13 of the proposed standard states that 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 8 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, further requires the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.

A note to paragraph 13 of the proposed standard states that the auditor also should look to the requirements in proposed paragraphs AU secs. 316.66-.67A for related party transactions that are also significant unusual transactions (e.g. significant related party transactions outside the normal course of business).

Existing standards state that the auditor should consider arranging for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.^{22/} Existing standards also state that regardless of whether the principal auditor decides to make reference to the audit of the other auditor, the principal auditor should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.^{23/}

^{21/} See paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

^{22/} See AU sec. 334.09.e.

^{23/} See paragraph .10 of AU sec. 543, *Part of Audit Performed by Other Independent Auditor*, which provides that those measures may include ascertaining



Paragraph 14 of the proposed standard would require that the auditor perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or That are a Significant Risk (paragraph 15 of Appendix 1)

Paragraph 15 of the proposed standard includes several required procedures designed to assist in the auditor's evaluation of transactions with related parties. Specifically, paragraph 15 of the proposed standard states that for each related party transaction, or type of related party transaction, that is required to be disclosed in the financial statements by the company in the financial statements or determined to be a significant risk, the auditor should:

- a. Read the underlying documentation and determine whether the terms and business purpose (or the lack thereof) of the transaction are consistent with explanations from inquiries and from other audit evidence;
- b. Determine (i) 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 and (ii) whether any exceptions to those established policies or procedures were granted;
- c. Evaluate the financial capability of the related parties with respect to significant uncollected balances, guarantees, and other obligations, if any;^{24/} and

through communication with the other auditor that a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.

^{24/} Examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.



- d. Perform other procedures as appropriate, depending on the nature of the related party transaction and the related risks of material misstatement, to meet the objective of this standard.

These procedures help the auditor evaluate whether the transaction has been properly accounted for and adequately disclosed. These procedures also are necessary to evaluate the business purpose of an identified related party transaction. A business purpose that appears inconsistent with the nature of the company's business might represent a fraud risk factor.

Paragraph 15.a. requires the auditor to read the underlying documentation and determine whether the terms and business purpose (or the lack thereof) of the transaction is consistent with explanations from inquiries and from other audit evidence. This requires the auditor to evaluate appropriate information regarding the transaction, including, for example, the executed contract and consider whether the contract and other underlying documentation is consistent with explanations from inquiries of management and others. The auditor would also consider how that information compares to other available audit evidence. For example, when evaluating the responses to inquiries of management and others, the auditor could take into account information obtained from other sources, such as SEC filings that include a description of the registrant's policies and procedures for the review, approval, or ratification of "related person" transactions or that identify any "related person" transaction where such policies and procedures did not require review, approval or ratification or where such policies and procedures were not followed.^{25/}

Existing standards require that the auditor design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.^{26/} This includes designing

^{25/} See Securities Act Release No. 33–8732A, *Executive Compensation and Related Person Disclosure* (August 29, 2006), available at: <http://www.sec.gov/rules/final/2006/33-8732afr.pdf>. For the definition of "related person," see Instruction 1 to item 404(a) of Regulation S-K. Disclosure requirements regarding "related persons" in Regulation S-K may differ from "related party" disclosures. See Section I. of the Release, at note 2.

^{26/} See paragraph 8 of Auditing Standard No. 13. Further, paragraph 17 of Auditing Standard No. 13 states that tests of controls must be performed in the audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when necessary to support the



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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. The procedures contained in paragraph 15 of the proposed standard are designed to work in conjunction with the procedures that the auditor performs during the audit to address the relevant assertions associated with each related party transaction that requires disclosure. For example, if a company makes a material purchase of property, plant and equipment from an unconsolidated related party, the auditor should obtain audit evidence that supports management's assertion regarding the existence of the asset (e.g., inspection of the asset). Further, the auditor should examine the underlying documents supporting the transfer of title and ownership to obtain audit evidence that supports management's assertion regarding its rights and obligations.

Accounting principles applicable to the company may allow the aggregation of related party transactions that require disclosure (e.g., by type of related party transaction). In these cases, the auditor would be required to test the compilation and disclosure of these transactions and the extent of the auditor's testing on the underlying transactions, consistent with the requirements of Auditing Standard No. 13, should be commensurate with the risks of material misstatement.

Existing standards require the auditor to examine identified related party transactions, and AU sec. 9334, *Related Parties: Auditing Interpretations of Section 334* notes that the higher the assessment of risk, the more extensive the audit procedures should be.^{27/} AU sec. 9334 provides that when there is a higher risk of material misstatement, the auditor may have to, among other things, refer to audited or unaudited financial statements of the related party, apply procedures at the related party or, in some cases, audit the financial statements of the related party.^{28/} Existing standards further state that the auditor should be aware that the substance of a particular related party transaction could be significantly different from its form and that

auditor's reliance on the accuracy and completeness of financial information used in performing other audit procedures.

^{27/} See paragraph .19 of AU sec. 9334.

^{28/} *Id.*



financial statements should recognize the substance of particular transactions rather than merely their legal form.^{29/}

Paragraph 15.d. of the proposed standard would require auditors perform other procedures as appropriate to meet the objective of the proposed standard. This requires the auditor to make a determination about what procedures are needed to evaluate the accounting and disclosure of the related party transactions. For example, related party transactions might pose valuation and measurement issues that are not present in arm's-length transactions. Consequently, the auditor's tests regarding valuation of a receivable from an entity under common control might be more extensive than for a trade receivable of the same amount from an unrelated party because the common parent may be motivated to obscure the substance of the transaction.

The economic substance of a related party transaction also may differ materially from its form. As described in Section I.F. of Appendix 4, paragraph .06 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, requires that the auditor consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. The procedures performed pursuant to paragraph 15.d. should be designed to address concerns about whether the substance of a related party transaction differs materially from its form. For example, evaluating the collectability of receivables due from companies owned or controlled by officers of the company under audit might include questions beyond evaluating the financial capability of the related party to pay.

Examples of other procedures that might be appropriate for the auditor to perform, depending on the nature of the transaction and the risks of material misstatement of the financial statements, include:

- Inquiring directly of the related party regarding the business purpose of the transaction;
- Inspecting information in the possession of the related party or other parties to the transaction, if available;
- Reading public information regarding the related party and the transaction, if any;

^{29/} See AU sec. 334.02.



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- Reading the financial statements or other relevant financial information obtained from the related party, if available, to understand how the related party accounted for the transaction;
- Confirming the terms of the transaction with other parties with knowledge of the transaction (e.g., banks, guarantors, agents, or attorneys), if any;
- Confirming whether there are any side agreements or other arrangements (either written or oral) with the related party;
- Evaluating the transferability and value of collateral provided by the related party, if any; and
- Performing procedures at the related party, if possible.

Questions:

9. Is paragraph 13 of the proposed standard appropriately aligned with the existing requirements regarding responding to the risks 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?

Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor (paragraphs 16-17 and Appendix A of Appendix 1)

Existing standards describe procedures that could assist the auditor to identify undisclosed related parties or relationships and transactions with related parties. For example, AU sec. 334.07 lists the following procedures for determining the existence of related parties:

- Reviewing filings by the reporting entity with the SEC and other regulatory agencies for the names of related parties and for other businesses in which officers and directors occupy directorship or management positions.
- Determining the names of all pension and other trusts established for the benefit of employees and the names of their officers and trustees.



- Reviewing stockholder listings of closely held companies to identify principal stockholders.

Further, AU sec. 334.08 provides the following examples of procedures for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships:

- Reviewing the minutes of meetings of the board of directors and executive or operating committees for information about material transactions authorized or discussed at their meetings.
- Reviewing proxy and other material filed with the SEC and comparable data filed with other regulatory agencies for information about material transactions with related parties.
- Reviewing conflict-of-interests statements obtained by the company from its management.
- Reviewing confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.
- Reviewing confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.
- Reviewing invoices from law firms that have performed regular or special services for the company for indications of the existence of related parties or related party transactions.

As described in paragraph 13 of the proposed standard, the auditor should perform procedures to respond to identified and assessed risks of related parties or relationships or transactions with related parties previously undisclosed to the auditor. Information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist might be found in evidence that is normally obtained during the course of an audit. As described earlier, to assist auditors in identifying information that could indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor, examples of information and sources contained in the existing standard have been included in Appendix A to the proposed standard. For example, Appendix A lists the following sources of information that could indicate that related parties or



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

- Minutes of meetings of the board of directors.
- Periodic and current reports, proxy statements and other relevant company filings with the SEC and other regulatory agencies.
- Conflicts-of-interests statements from management and others.
- Confirmation responses and responses to inquiries of the company's lawyers.
- Invoices and correspondence received from the company's professional advisors, for example, attorneys and consulting firms.
- Records of the company's investments, pension plans and other trusts established for the benefit of employees, including the names of the officers and trustees of such investments, pension plans, and other trusts.
- Shareholder registers that identify the company's principal shareholders.

Existing standards require that the auditor respond to the assessed risks of material misstatement due to related parties or relationships or transactions with related parties previously undisclosed to the auditor, including significant risks.^{30/} Existing standards also describe procedures that could identify undisclosed related parties or relationships and transactions with related parties.^{31/}

Paragraph 3 of the proposed standard requires the auditor to identify likely sources of material misstatement in the financial statements that may arise from the company's relationships and transactions with related parties, including related parties or relationships or transactions with related parties previously undisclosed to the auditor. Consistent with the requirements of Auditing Standard No. 13, the extent of the auditor's response should be commensurate with the risks of material misstatement. Based upon the auditor's assessment, the auditor should design and perform

^{30/} See paragraph 3 of Auditing Standard No. 13.

^{31/} See, for example, AU secs. 334.07-.08.



procedures to identify information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

The determination that either related parties or relationships or transactions with related parties previously undisclosed to the auditor exist may have a significant impact on other areas of the audit, including the auditor's evaluation of the integrity of management and the company's internal control over financial reporting.

Paragraph 16 requires that if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform procedures to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Paragraph 16 also requires that these procedures should extend beyond inquiry of management. A footnote to paragraph 16 refers the auditor to paragraph 29 of Auditing Standard No. 15, *Audit Evidence*, which states that if audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, paragraph 17 of the proposed standard would require the auditor to, among other things: (1) inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor, including regarding the possible existence of other transactions with the related party previously undisclosed to the auditor; (2) determine why the related party or relationship or transaction with the related party was not previously disclosed to the auditor; (3) promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationships or transactions with the related party; (4) assess the need to perform additional procedures to identify additional relationships or transactions with the related party previously undisclosed to the auditor; and (5) perform the procedures required by paragraph 15 of the proposed standard, treating the related party transaction as a significant risk.

Additionally, paragraph 17 of the proposed standard requires the auditor to: (1) evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable; (2) reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and (3) evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud



or an illegal act may have occurred. Paragraph 17 further states that if the auditor determines that it is likely that an illegal act has or may have occurred, the auditor should perform the procedures required by AU sec. 316, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934 ("Exchange Act").^{32/}

Questions:

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?

F. Evaluating Financial Statement Accounting and Disclosures (paragraphs 18-19 of Appendix 1)

AU sec. 334.11 requires the auditor to consider whether sufficient appropriate evidence has been obtained to understand each related party relationship, as well as the effect on the financial statements of each material related party transaction. AU sec. 334.02 states that "the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form." The existing standard further states that the auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure.^{33/}

Paragraph 18 of the proposed standard states that Auditing Standard No. 14 requires the auditor to evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. This includes evaluating whether the financial statements contain the information regarding related party transactions essential for a fair presentation in conformity with the applicable financial reporting framework. A footnote to paragraph 18 states that

^{32/} See 15 U.S.C. §78j-1(b).

^{33/} See AU sec. 334.02.



there is an existing requirement in Auditing Standard No. 14 regarding the auditor's evaluation of the company's financial statement accounting and disclosures regarding related parties and relationships and transactions with related parties. The auditor's evaluation under paragraph 18 would apply to each related party transaction that requires disclosure. In addition, the auditor would evaluate the results of audit procedures performed on intercompany account balances pursuant to paragraph 14 of the proposed standard.

Transactions with related parties, like all transactions, are subject to the requirements contained in paragraph .06 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. That standard requires that the auditor consider whether the substance of the transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. The proposed standard does not include a separate requirement to evaluate whether the substance of a related party transaction differs materially from its form because that evaluation is part of the auditor's evaluation of whether the financial statements have been presented fairly in conformity with the applicable financial reporting framework.

Question:

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?

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (paragraph 19 of Appendix 1)

Financial reporting frameworks allow management to assert that a related party transaction was consummated on terms equivalent to those prevailing in arm's-length transactions only when management can substantiate that assertion.^{34/} However, those financial reporting frameworks do not discuss what information is required to substantiate such an assertion or how management is to determine the terms and

^{34/} See FASB ASC paragraph 850-10-50-5. Paragraph 23 of IAS 24 also states that disclosures "that related party transactions were made on terms equivalent to those that prevail in arm's length transactions are made only if such terms can be substantiated."



conditions that would prevail in an arm's-length exchange, including for example, whether there would be a guarantee or an extension of credit.

Paragraph 19 of the proposed standard requires that the auditor determine whether the evidence obtained supports or contradicts management's assertion. Paragraph 19 also states that if the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.^{35/}

A note to paragraph 19 informs auditors that, except for routine transactions, it may not be possible for management to determine whether a particular transaction would have taken place, or what the terms and manner of settlement would have been, if the parties had not been related. Accordingly, it may be difficult for the auditor to obtain sufficient appropriate audit evidence to substantiate management's assertions that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. The note to paragraph 19 also retains the discussion contained in AU secs. 9334.22-.23 that a preface to an assertion such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities to substantiate representations that the transaction terms are equivalent to terms in arms-length transactions.

Appendix 3 of this release contains proposed amendments to AU sec. 333, *Management Representations*, which also would require the auditor to obtain written representations from management when management has asserted that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

Question:

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?

^{35/} A decision by management to remove, at the auditor's request, such an assertion from the financial statements due to management's inability to provide the auditor with sufficient appropriate audit evidence might impact the auditor's assessment of internal control over financial reporting.



G. Communications with the Audit Committee (paragraph 20 of Appendix 1)

Paragraph 20 of the proposed standard would require that the auditor communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. Paragraph 20 also would require the auditor to communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties, including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- b. The identification of significant related party transactions (i) that have not been authorized or approved in accordance with the company's established policies or procedures and (ii) for which exceptions to the company's established policies or procedures were granted;
- c. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support such assertions; and
- d. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

A note to paragraph 20 states that an auditor may communicate significant matters to only the audit committee chair if done in order to communicate these matters in a timely manner during the audit. It also states that the auditor, however, should communicate significant matters to the full audit committee prior to the issuance of the auditor's report.^{36/}

Paragraph 8 of the proposed standard would require the auditor to inquire of the audit committee, or its chair regarding: (a) the audit committee's understanding of the company's relationships and transactions that are significant to the company and (b) whether any member of the audit committee has particular concerns regarding relationships and transactions with related parties, and, if so, the substance of those

^{36/} This is consistent with paragraph 25 of proposed auditing standard, *Communications with Audit Committees*, see PCAOB Release 2011-008 (December 20, 2011).



concerns. The communication required by paragraph 20 of the proposed standard would provide an opportunity for the auditor to communicate information obtained during the audit relevant to those matters. For example, the auditor might discuss relationships or transactions with related parties that are significant to the company that were not previously discussed with the audit committee, or its chair.

The auditor also would communicate significant matters to the audit committee if the auditor encountered these matters during the review of interim financial information.^{37/}

Question:

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?

H. Other Considerations

Paragraph .19 of AU sec. 508, *Reports on Audited Financial Statements*, describes situations in which the auditor may emphasize a matter regarding the financial statements in a separate paragraph of the auditor's report. AU sec. 508.19 provides the example "[t]hat the entity has had significant transactions with related parties" as a matter that an auditor might wish to emphasize.^{38/} The proposed standard would not change the auditor's responsibilities regarding the auditor's report.

Question:

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

^{37/} See AU sec. 722.34.

^{38/} Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, requires the auditor to consider the need to disclose changes in the reporting entity in the auditor's report.



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II. Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

As discussed in Section III.A. of the release, significant financial reporting frauds have demonstrated that companies may use significant unusual transactions such as transactions in which 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 transactions), to materially misstate their financial statements. Existing auditing standards require the auditor to consider significant unusual transactions as part of the auditor's overall consideration of fraud in an audit of financial statements.^{39/}

The proposed amendments regarding significant unusual transactions to AU sec. 316.66 would describe significant unusual transactions as significant transactions outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature. The proposed amendments regarding significant unusual transactions would align the description contained in AU sec. 316.66 with the factor listed in paragraph 71.g. of Auditing Standard No. 12 for the auditor's evaluation in identifying whether an assessed risk of material misstatement is a significant risk. A significant unusual transaction does not necessarily need to occur infrequently. For example, a significant unusual transaction could occur quarterly or more frequently. Whether a transaction constitutes a significant unusual transaction should be based upon the specific facts and circumstances.

This section highlights the proposed amendments regarding significant unusual transactions included in Appendix 2 of this release. Both Appendix 2 and this section

^{39/} See AU secs. 316.66-.67. These requirements were responsive to recommendations contained in *The Panel on Audit Effectiveness Report and Recommendations* (the "PAE Report") (August 31, 2000). The PAE Report noted that "a number of cases of fraudulent financial reporting have involved...[disclosure of significant accounting policies], and the disclosed accounting policies inaccurately portrayed the entity's actual accounting policies. Accounting policy disclosures often related to industry practices or matters unique to the specific entity." See Chapter 3, "Earnings Management and Fraud" of the PAE Report, and *Public Oversight Board Staff Status Report: The Recommendations of the Panel on Audit Effectiveness, as of February 15, 2002*, available at: <http://www.pobauditpanel.org/downloads/chapter3.pdf>, and <http://www.publicoversightboard.org/StatusReport.pdf>, respectively.



have been organized as follows: (a) identifying significant unusual transactions and (b) evaluating significant unusual transactions.

A. Identifying Significant Unusual Transactions (Section A of Appendix 2)

The proposed amendments regarding significant unusual transactions would add a note to AU sec. 316.66 stating that the auditor's identification of significant unusual transactions should take into account information obtained from: (a) the risk assessment procedures required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial reporting) and (b) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

Inquiring of Management and Others (paragraph 56 of Auditing Standard No. 12)^{40/}

Existing standards require that the auditor make inquiries of management, the audit committee, and internal auditor regarding fraud risks.^{41/} Existing standards also note examples of other individuals to whom the auditor can direct inquiries regarding fraud risks.^{42/} The proposed amendments regarding significant unusual transactions to paragraph 56.a. of Auditing Standard No. 12 would require that the auditor inquire whether the company has entered into any significant unusual transactions, and, if so, the nature, terms and business purpose (or the lack thereof) of those transactions and whether related parties are involved. The proposed amendments regarding significant unusual transactions to paragraphs 56.b. and 56.c. of Auditing Standard No. 12 also would require the auditor to inquire of the audit committee and internal audit personnel (if applicable), respectively, regarding their knowledge of whether the company has entered into any significant unusual transactions.

^{40/} The paragraph references in this section relate to the provisions of the proposed amendments contained in Appendix 2.

^{41/} See paragraph 56 of Auditing Standard No. 12.

^{42/} See paragraph 57 of Auditing Standard No. 12.



Obtaining an Understanding of the Methods Used to Account for Significant Unusual Transactions (paragraph 13 of Auditing Standard No. 12)

Existing standards also require the auditor to obtain an understanding of the company and its environment, including the company's selection and application of accounting principles, including related disclosures.^{43/} Existing standards note that the methods the company uses to account for significant and unusual transactions are relevant to the necessary understanding of the company's selection and application of accounting principles, including related disclosures.^{44/} The proposed amendments regarding significant unusual transactions to paragraph 13 of Auditing Standard No. 12 would replace the reference to "significant and unusual transactions" with a reference to "significant unusual transactions" as used in AU secs. 316.66-.67A.

Obtaining an Understanding of Internal Control over Financial Reporting (paragraph 73A of Auditing Standard No. 12)

Existing standards require that the auditor obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.^{45/}

The proposed amendments regarding significant unusual transactions would add paragraph 73A to Auditing Standard No. 12 and would require the auditor to obtain an understanding of the controls that management has established to identify, authorize and approve, and account for and disclose, significant unusual transactions. Obtaining an understanding of internal control over financial reporting includes evaluating the design of controls relevant to the audit and determining whether those controls have been implemented.^{46/}

In addition, the proposed amendments regarding significant unusual transactions to Auditing Standard No. 5, *An Audit of Internal Control That Is Integrated with An Audit*

^{43/} See paragraph 7.c. of Auditing Standard No. 12.

^{44/} See paragraph 13 of Auditing Standard No. 12.

^{45/} See paragraph 18 of Auditing Standard No. 12.

^{46/} See paragraph 20 of Auditing Standard No. 12.



of *Financial Statements*, would replace the reference to "significant, unusual transactions" with a reference to "significant unusual transactions" as used in AU secs. 316.66-.67A.

Other Information Obtained During the Audit

As described above, the proposed amendments regarding significant unusual transactions would add a note to AU sec. 316.66 which states that the auditor's identification of significant unusual transactions should take into account information obtained through risk assessment and other procedures performed during an audit. Examples of those procedures include:

- a. Reading minutes of meetings of the board of directors and its committees;^{47/}
- b. Reading periodic and current reports, including Forms 8-K, and other relevant company filings with the SEC and other regulatory agencies;^{48/}
- c. Inspecting confirmation responses and responses to inquiries of the company's lawyers;^{49/}
- d. Obtaining an understanding of the company's selection and application of accounting principles, including related disclosures (e.g., reading accounting policy manuals and technical memoranda prepared by or for management);^{50/}
- e. Performing analytical procedures during the audit;^{51/} and

^{47/} See AU sec. 560.12.c and AU sec. 722.18.a.

^{48/} See paragraph 11 of Auditing Standard No. 12 which requires the auditor to consider reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements as part of obtaining an understanding of the company.

^{49/} See paragraph .06 of AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

^{50/} See paragraph 7.c. of Auditing Standard No. 12.

^{51/} See paragraphs 46-48 of Auditing Standard No. 12.



- f. Performing journal entry testing, including inquiring of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments as required by existing standards.^{52/}

Also, the auditor might identify significant unusual transactions when performing other audit procedures. For example, an auditor might identify a significant unusual transaction by scanning a population of invoices for unusual items when determining a sample of items to be tested. By doing so, the auditor might identify an unusual item in terms of dollar amount, the date on which the item was shipped (e.g., on a Sunday when the shipping department is closed), or the unusually high concentration of transactions during a given time period.

As described in section I.C. of this Appendix, Appendix A to the proposed standard includes examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. These examples could also be helpful in identifying significant unusual transactions.

In addition, the proposed amendments regarding significant unusual transactions would amend certain examples of fraud risk factors contained in AU sec. 316 that are relevant to significant unusual transactions. For example, AU sec. 316 notes that the nature of the industry or the company's operations provides opportunities to engage in fraudulent financial reporting that can arise from significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm. The proposed amendments to AU sec. 316.85 regarding significant unusual transactions would amend that example to consist of two separate examples: (1) related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business) and (2) significant transactions with related parties whose financial statements are not audited or are audited by another firm.

As discussed in Section III.A. of this Appendix, the Board also has proposed an amendment to AU sec. 315, *Communications Between Predecessor and Successor Auditors*, that would require inquiry of the predecessor auditor regarding significant unusual transactions and indicate that the successor auditor's review of documentation includes documentation regarding significant unusual transactions.

^{52/} See AU secs. 316.58-.62.



Question:

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

B. Evaluating Significant Unusual Transactions (Section B of Appendix 2)

Existing standards recognize that during an audit, the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment. In such circumstances, AU sec. 316.66 requires the auditor to gain an understanding of the business rationale for such transactions and whether that rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. AU sec. 316.67 identifies several matters that the auditor should consider in understanding the business rationale for those transactions, including whether:

- The form of such transactions is overly complex;
- Management has discussed the nature of and recording of such transactions with the audit committee or board of directors;
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction;
- Transactions that involve unconsolidated related parties, including special purpose entities, have been properly reviewed and approved by the audit committee or board of directors; and
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

The proposed amendments regarding significant unusual transactions would build on the existing requirements of AU secs. 316.66-.67 to enhance the auditor's evaluation of significant unusual transactions. The proposed amendments regarding significant unusual transactions are designed to address the unique nature of such transactions. The proposed amendments regarding significant unusual transactions include a new paragraph .66A to AU sec. 316 that would require the auditor to design and perform procedures that are specifically responsive to and address the assessed



risks of material misstatement associated with significant unusual transactions.^{53/} This amendment would require that the auditor design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction by performing the following procedures:

- a. Reading the underlying documentation and determining whether the terms and business purpose (or the lack thereof) of the transaction are consistent with explanations from inquiries and other audit evidence;
- b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, guarantees, and other obligations, if any; and
- d. Performing other procedures as appropriate, depending on the nature of the transaction and the risks of material misstatement, to obtain an understanding of the business purpose (or the lack thereof) of the significant unusual transaction.

As described in Section I.E. of this Appendix, existing standards require that the auditor design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.^{54/} This includes designing and performing audit procedures in a manner that addresses the assessed risks of material misstatement associated with significant unusual transactions. The procedures contained in proposed AU sec. 316.66A are designed to work in conjunction with the procedures that the auditor performs during the audit to address the relevant assertions associated with each significant unusual transaction.

The proposed amendments regarding significant unusual transactions also would require auditors to design and perform any additional procedures that are appropriate to obtain an understanding of the business purpose (or the lack thereof) of the significant unusual transaction. Those procedures would be based on the facts and circumstances regarding the significant unusual transaction. These additional procedures should: (1)

^{53/} See paragraph 3 of Auditing Standard No. 13.

^{54/} See paragraph 8 of Auditing Standard No. 13.



address the assessed risks of material misstatement; (2) provide an understanding of the business purpose (or the lack thereof) that is sufficient to evaluate whether the transaction was entered into to commit fraudulent financial reporting or misappropriate assets; and (3) provide the auditor with sufficient audit evidence to evaluate whether the financial statement accounting and disclosure requirements have been met.

Examples of other procedures that might be appropriate depending on the nature of the significant unusual transaction and the risks of material misstatement of the financial statements include:

- Inquiring directly of the other party regarding the business purpose of the transaction;
- Reading public information regarding the transaction and the parties to the transaction, if available;
- Reading the financial statements or other relevant financial information obtained from other parties involved in the transaction, if available, to understand how the other party accounted for the transaction;
- Evaluating the transferability and value of collateral provided by the other party, if any;
- Confirming the terms of the transaction with other parties with knowledge of the transaction (e.g., banks, guarantors, agents, or attorneys), if any; and
- Confirming whether there are any side agreements or other arrangements (either written or oral) with the other party.

The proposed amendments regarding significant unusual transactions to AU sec. 316.67 require the auditor to evaluate certain matters when determining whether the business purpose (or the lack thereof) of a significant unusual transaction suggests that the transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriations of assets. The proposed amendments to AU sec 316.67, however, include additional matters that the auditor should evaluate, including whether:

- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end).



- 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 other, more clearly independent, parties on an arm's-length basis.^{55/}
- The company's accounting for the transaction enables the company to achieve certain financial targets.

These additional matters have been added to assist in the auditor's evaluation of whether the business purpose (or the lack thereof) indicates that the transaction may have been entered into to commit fraudulent financial reporting or misappropriate assets. These additional matters also represent areas that may be relevant to the auditor's evaluation of whether the financial statements contain the information regarding the significant unusual transaction essential for a fair presentation in conformity with the applicable financial reporting framework.

Including these additional matters in the auditor's evaluation of a significant unusual transaction can also assist the auditor in the identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor because it focuses the auditor on the substance of the relationship or transaction. For

^{55/} In December 2001, certain member firms of the accounting profession petitioned the SEC for rulemaking and requested required disclosure in the Management's Discussion and Analysis ("MD&A") section of SEC filings of relationships that fall outside the definition of a related party but represent non-arm's-length transactions. See *Petition to U.S. Securities and Exchange Commission for Issuance of Interpretive Release* (December 31, 2001) available at: <http://www.sec.gov/rules/petitions/petndiscl-12312001.htm>. The petition noted the "lack of transparent disclosure about transactions with unconsolidated entities and other parties where that information appeared necessary to understand how significant aspects of the business were conducted." In response, the SEC issued *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations*, which generally requires companies to consider the need for disclosure in the MD&A of arrangements and relationships that fall outside of the definition of "related parties," but with whom the company has a relationship that enables either party to negotiate terms of material transactions that may not be available for other, more clearly independent, parties on an arm's-length basis. See Securities Act Release No. 33-8056 (January 22, 2002), available at: <http://www.sec.gov/rules/other/33-8056.htm>.



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example, relationships such as those with entities managed by former officers, interlocking directors/ownership, significant customers and suppliers, competitors, strategic alliances or partnerships, or collaborative arrangements could represent matters that involve related parties or relationships or transactions with related parties previously undisclosed to the auditor. Further, a related party could be involved in a significant unusual transaction either directly or indirectly, through the use of an intermediary whose involvement in the transaction appears to serve no apparent business purpose.

Paragraph .67A of the proposed amendments regarding significant unusual transactions to AU sec. 316 states that according to paragraph 30 of Auditing Standard No. 14 the auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. This includes evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

Because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of misstatements that could result from significant unusual transactions in designing and performing the procedures, including procedures performed pursuant to the proposed amendments to AU secs. 316.66-67A. The proposed amendments regarding significant unusual transactions would also amend Auditing Standard No. 13 by adding paragraph 11A to remind auditors of this when responding to risks associated with significant unusual transactions.

The Board has proposed an auditing standard, *Communications with Audit Committees*, that would supersede the existing standard AU sec. 380, *Communication with Audit Committees*.^{56/} If adopted by the Board and approved by the Commission, that proposed standard would include a requirement for the auditor to communicate to the audit committee significant transactions, of which the auditor is aware, 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, including the auditor's understanding of the business rationale for such transactions. This proposed communication addresses the auditor's existing requirements in AU secs. 316.66-.67. The proposed amendments regarding significant unusual transactions would amend AU secs. 316.66-.67. The Board anticipates that if, at the conclusion of rulemaking regarding significant unusual

^{56/} See PCAOB Release No. 2011-008 (December 20, 2011).



transactions, the Board adopts, and the Commission approves, the proposed amendments regarding significant unusual transactions, those amendments would include any corresponding changes to the proposed standard, *Communications with Audit Committees*, that may be appropriate to match the communication requirements with the underlying procedures.

Question:

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

III. Other Proposed Amendments to PCAOB Auditing Standards

The following sections describe certain of the other proposed amendments to PCAOB Auditing Standards included in Appendix 3. The headings in this section correspond to the headings in Appendix 3.

A. *Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Appendix 3)*

Understanding the financial relationships and transactions that a company has with its executive officers, including executive compensation, perquisites, and other arrangements, can assist the auditor in identifying conditions (including incentives and pressures) that could result in risks of material misstatement, including fraud risks.^{57/} Further, obtaining an understanding of a company's financial relationships and transactions with its executive officers can assist in the identification of information that indicates the existence of related party relationships or transactions previously undisclosed to the auditor.

^{57/} See AU sec. 316.85, which 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 (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.



Existing standards require the auditor to consider risks of material misstatement associated with a company's financial relationship with its senior management. Paragraph 11 of Auditing Standard No. 12 states that as part of obtaining an understanding of the company the auditor should consider obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements and special bonuses. The proposed amendments would enhance existing requirements by requiring the auditor to perform certain procedures necessary to obtain an understanding of the company's financial relationships and transactions with its executive officers.

Paragraph 10A of the proposed amendments to Auditing Standard No. 12 would require the auditor to obtain an understanding of the company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements). Paragraph 10A would require the auditor to perform procedures designed to identify risks of material misstatement related to the company's financial relationships and transactions with its executive officers. Those procedures should be sufficient to identify whether these financial relationships and transactions could create conditions (e.g., incentives and pressures) that result in risks of material misstatement, including fraud risks. The auditor should perform procedures that include, but are not limited to:

- Reading employment and compensation contracts; and
- Reading proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.^{58/}

The proposed amendments would define the term "executive officer" in Appendix A to Auditing Standard No. 12. The proposed definition is based on the SEC definition of an executive officer in Rule 3b-7 under the Exchange Act and a list in Schedule A of Form BD. The proposed amendments to Auditing Standard No. 12 would define an executive officer as:

^{58/} The auditor also might read the company's proxy statements and other relevant SEC company filings in meeting the requirements of paragraph 11 of Auditing Standard No. 12, which requires that the auditor consider reading public information regarding the company.



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The president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policy-making functions for the company. (See Rule 3b-7 under the Exchange Act.) For brokers and dealers, the term "executive officer" includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions. (See Schedule A of Form BD.)

The proposed amendments would not change the existing requirement to consider obtaining an understanding of compensation arrangements with senior management. The population for the proposed procedures required by paragraph 10A is the list of executive officers disclosed in the securities filing or the executive officers included on Schedule A of Form BD.^{59/} The existing requirement in paragraph 11 of Auditing Standard No. 12 applies to a larger population than just a company's executive officers.

Understanding how a company has structured its compensation for executive officers can assist the auditor in understanding whether such compensation arrangements affect the assessment of the risks of material misstatement.^{60/} 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 that boost its compensation. This understanding could also assist the auditor in determining areas where management bias might occur (e.g., certain accounting estimates, including fair value measurements.) The auditor could inquire of the audit committee, or its chair, regarding its views on executive officer

^{59/} See Item 401(b) of Regulation S-K and Schedule A of Form BD.

^{60/} According to a May 2010 academic study that examined in detail SEC accounting and auditing enforcement releases from 1997 to 2008, the chief executive officer or chief financial officer was named in 89 percent of the enforcement actions involving fraudulent financial reporting. 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.



compensation at the same time the auditor makes inquiries regarding how the audit committee exercises oversight of the company's assessment of fraud risks and the establishment of controls to address fraud risks as required by paragraph 56.b.(4) of Auditing Standard No. 12.

Obtaining an understanding of how the company has structured its compensation for its executive officers can assist the auditor in identifying fraud risks. Paragraph 7 of the proposed standard directs the auditor to identify others within the company to whom inquiries could be made regarding related parties. Paragraph 7.e. of the proposed standard states that the human resource director or person in an equivalent position, is an example of an individual likely to have knowledge of the company's related parties or relationships and transactions with related parties or the company's controls over relationships or transactions with related parties. This inquiry also could provide an opportunity for the auditor to obtain an understanding of the company's financial relationship and transactions with its executive officers and how that relationship could create conditions that could result in risks of material misstatement, including fraud risks.

In some circumstances, a company's financial relationships and transactions with its executive officers can create risks of material misstatement that relate pervasively to the financial statements. The information obtained regarding a company's financial relationships and transactions with its executive officers, in conjunction with other information obtained during the risk assessment process (e.g., information about company performance measures), could be used to identify account balances that are likely to be affected and that could have a significant effect on the financial statements. That information could be used by the auditor to identify and assess risks of material misstatement due to fraud and to design appropriate audit responses.

Obtaining an understanding of a company's financial relationships and transactions with its executive officers also would complement the requirement in paragraph 52 of Auditing Standard No. 12 that key engagement team members discuss the potential for material misstatement due to fraud, including consideration of the known external and internal factors affecting the company that might create incentives or pressures for management and others to commit fraud.

The proposed amendment also would amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider inquiring of the chair of the compensation committee, or its equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers. An auditor performing this inquiry could take into



account other available audit evidence, such as disclosures in SEC filings that (1) describe the company's compensation policies and practices that present material risks to the company^{61/} and (2) disclose fees paid to compensation consultants, in certain circumstances.^{62/}

The proposed amendments also would amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider obtaining an understanding of controls over the authorization and approval of executive officer expense reimbursements, and its effect on the risk of material misstatement of the financial statements. Based on the auditor's assessment of risk, the auditor might determine that additional procedures are necessary. For example, the auditor might read available reports from the internal audit function that contain an evaluation of the expense report process. In other cases, the auditor might determine that it is necessary for the auditor to inspect executive officer expense reimbursement documentation for unusual items.

These proposed audit 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 associated with a company's financial relationships and transactions with its executive officers, including unrecognized compensation, illegal acts, or other matters (e.g., self-dealing or other conflicts of interest). If present, these conditions may call into question the integrity of the management representations or represent violations of the company's established policies and procedures. In addition, these procedures could identify potential instances of management override of internal controls that could inform the auditor whether others in the company are willing to challenge management or whether management might be dominating others in the company.

B. AU sec. 315, *Communications Between Predecessor and Successor Auditors* (Appendix 3)

Existing standards note that determining the existence of relationships with related parties requires the application of audit procedures which may include inquiring of predecessor, principal, or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in

^{61/} See Securities Act Release No. 33-9089, *Proxy Disclosure Enhancements* (December 16, 2009), available at: <http://www.sec.gov/rules/final/2009/33-9089.pdf>.

^{62/} See Item 407(e)(3)(iii) of Regulation S-K.



material transactions.^{63/} The proposed standard would amend paragraph .09 of AU sec. 315 to require inquiry of the predecessor auditor's understanding of the company's regarding relationships and transactions with related parties and significant unusual transactions. The proposed standard also would amend paragraph .11 to include in the successor auditor's review of the predecessor auditor's working papers documentation regarding relationships and transactions with related parties and significant unusual transactions.

C. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (Appendix 3)

Emphasizing the auditor's identification and evaluation of significant unusual transactions could lead to more instances of auditors becoming aware of indications that fraud or another illegal act has or may have occurred. The proposed amendments would amend AU sec. 316 by expanding the discussion in the standard regarding certain requirements contained in Section 10A of the Exchange Act. The proposed amendments would emphasize the auditor's responsibility to investigate and disclose possible fraud to management, the audit committee and, upon the satisfaction of certain conditions, the SEC, consistent with the auditor's responsibility under Section 10A of the Exchange Act.

D. AU sec. 333, *Management Representations* (Appendix 3)

AU sec. 333, *Management Representations*, requires auditors to obtain written representations from management for the periods covered by the auditor's report. That standard addresses representations covering financial statements; completeness of information; recognition, measurement and disclosure; and subsequent events. AU sec. 333 requires the auditor to obtain a representation regarding the recognition, measurement, and disclosure of related party transactions.

The proposed standard would amend AU sec. 333.06 to require that the auditor obtain written representations from management indicating that management has disclosed to the auditor the names of all of the company's related parties and all relationships and transactions with related parties. The proposed standard also would amend AU sec. 333.06 to require the auditor to obtain a written representation from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor.

^{63/} See AU sec. 334.07.g. and AU secs. 9334.12-.13.



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Side agreements or other arrangements (either written or oral) undisclosed to the auditor could represent a risk of material misstatement of the financial statements for both related party and significant unusual transactions. For example, the lack of an arm's-length relationship in related party transactions can raise questions about whether all transaction terms have been disclosed to the auditor. Similarly, significant unusual transactions occurring close to the end of the period that pose difficult substance over form questions also could involve side agreements or other arrangements undisclosed to the auditor. The existence of implicit or informal understandings (either written or oral) could have a significant impact on the financial accounting and disclosure of relationships and transactions with related parties and significant unusual transactions.

In addition, the proposed standard also would amend AU sec. 333 to require that the auditor obtain written representations from management in situations in which the financial statements include an assertion by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction. This proposed requirement would complement the auditor's evaluation, required by paragraph 19 of the proposed standard, when management has asserted that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

E. AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543* (Appendix 3)

Existing standards note that determining the existence of relationships with related parties requires the application of audit procedures which may include inquiring of predecessor, principal, or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions.^{64/} The other proposed amendments to PCAOB auditing standards would amend paragraph .05 of AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543*, to remove the reference to AU sec. 334 and require that, before issuing his or her report, the other auditor inquire of the principal auditor as to matters significant to the audit. Those matters include relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties. This proposed amendment would align the requirements in AU sec. 9543 with similar requirements for a principal auditor included in paragraph 11 of the proposed standard.

^{64/} *Id.*



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F. AU sec. 722, *Interim Financial Information* (Appendix 3)

AU sec. 722, *Interim Financial Information*, requires the auditor to inquire of management that has responsibility for financial and accounting matters concerning unusual or complex matters that might have an effect on the interim financial information. The proposed amendments would amend AU sec. 722 to be consistent with the proposed amendments to AU sec. 333 and would require the auditor to obtain written representations each interim period (i) that management has disclosed to the auditor the names of the company's related parties and all relationships and transactions with related parties and (ii) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. In addition, the proposed amendments would require the auditor to obtain written representations for any assertion by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction.

Questions:

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

IV. Audits of Brokers and Dealers

As described in section IV of the release, the Dodd-Frank Wall Street Reform and Consumer Protection Act gave the Board oversight of the audits of brokers and dealers registered with the SEC. The proposed standard and the proposed amendments would be applicable for all audits performed in accordance with PCAOB standards. The Board requests comments from auditors of brokers and dealers and others on the proposed standard and the proposed amendments.

Questions:

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?



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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.

V. Effective Date

The proposed standard and proposed amendments are intended to improve the conduct of audits in areas of increased risk in order to provide greater investor protection. Given the importance of the proposed standard and proposed amendments to improved audits and greater investor protection, the Board anticipates that the proposed standard and proposed amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2012. The Board requests comments on the feasibility of this date.

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?



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Appendix 5 – Comparison of the Objectives and Requirements of the Proposed Standard and Proposed Amendments with the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

This appendix compares the objectives and certain key requirements of the proposed standard and proposed amendments with the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA").

The analogous standards of the IAASB discussed in this comparison include:

- International Standard on Auditing 550, *Related Parties* ("ISA 550");
- International Standard on Auditing 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* ("ISA 240");
- International Standard on Auditing 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* ("ISA 315");
- International Standard on Auditing 510, *Initial Audit Engagements—Opening Balances* ("ISA 510");
- International Standard on Auditing 580, *Written Representations* ("ISA 580");
- International Standard on Auditing 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* ("ISA 600"); and
- International Standard on Review Engagements 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*, ("ISRE 2410").

The analogous standards of the ASB discussed in this comparison include:

- AU-C Section 550, *Related Parties* ("AU-C Section 550");
- AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit* ("AU-C Section 240");
- AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* ("AU-C Section 315");
- AU-C Section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements* ("AU-C Section 510");
- AU-C Section 580, *Written Representations* ("AU-C Section 580");



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- AU-C Section 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* ("AU-C Section 600"); and
- AU-C Section 930, *Interim Financial Information* ("AU-C Section 930").^{1/}

This comparison is organized in the following sections: (1) the proposed standard, (2) the proposed amendments regarding significant unusual transactions, and (3) the other proposed amendments to PCAOB auditing standards.^{2/} This comparison does not cover the application and explanatory material in the analogous standards of the IAASB or ASB.^{3/}

This appendix is provided for informational purposes only. It is not a summary of or substitute for the proposed standard in Appendix 1 or the proposed amendments in

^{1/} These AU-C Sections are contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification* ("SAS No. 122"). In October 2011, the ASB adopted SAS No. 122, which contains 39 clarified SASs with "AU-C" section numbers for each clarified SAS. The "AU-C" is a temporary identifier to avoid confusion with references to existing "AU" sections in AICPA Professional Standards. See <http://www.aicpa.org/InterestAreas/FRC/AuditAttest/Pages/DescriptionofClarifiedSASs.aspx>.

^{2/} This comparison does not cover the foundational requirements contained in the Board's risk assessment standards. Appendix 11 of PCAOB Release 2010-004, *Auditing Standards Related to Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, contains a comparison of the objectives and requirements of those standards with the analogous standards of the IAASB and the ASB.

^{3/} Paragraph A59 of International Standard on Auditing 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, states that the Application and Other Explanatory Material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section."



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Appendices 2 and 3 of this release. This comparison may not represent the views of the IAASB or the ASB regarding the interpretations of their standards.

I. Proposed Auditing Standard, Related Parties (Appendix 1)

A. Introduction (paragraph 1 of Appendix 1)

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The proposed standard refers auditors to the requirements of the U.S Securities and Exchange Commission ("SEC") for the company under audit with respect to the accounting principles applicable to that company, including the definition of related parties, and the financial statement disclosure requirements with respect to related parties. The proposed standard does not include definitions that might represent accounting guidance, including a definition for an arm's-length transaction.

IAASB

Paragraph 10(b) of ISA 550 defines a related party as a party that is either:

- i. a related party as defined in the applicable financial reporting framework;
or
- ii. where the applicable financial reporting framework establishes minimal or no related party requirements:
 - a. a person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - b. another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - c. another entity that is under common control with the reporting entity through having:
 - (i) common controlling ownership;
 - (ii) owners who are close family members; or
 - (iii) common key management.



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However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

ISA 550 also defines an arm's-length transaction as a transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

ASB

AU-C Section 550 defines a related party as a related party as defined in generally accepted accounting principles. AU-C Section 550 also contains a definition of arm's-length transaction that is similar to the definition in ISA 550.

B. Objective (paragraph 2 of Appendix 1)

PCAOB

Paragraph 2 of the proposed standard states that the auditor's objective is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

IAASB

Paragraph 9 of ISA 550 states that the objectives of the auditor are:

- (a) irrespective of whether the applicable financial reporting framework establishes related party requirements to obtain an understanding of related party relationships and transactions sufficient to be able:
 - i. To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
 - ii. To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:



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- a. achieve fair presentation (for fair presentation frameworks); or
 - b. are not misleading (for compliance frameworks); and
- (b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

ASB

AU-C Section 550 contains a similar objective to the objective in ISA 550 for fair presentation frameworks.

C. Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties (paragraphs 3 – 11 of Appendix 1)

PCAOB

Paragraph 3 of the proposed standard would require the auditor to perform procedures to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes (or the lack thereof) of the types of transactions involving related parties. Paragraph 3 includes a requirement that the procedures performed should be designed to identify likely sources of potential material misstatements in the financial statements that may arise from the company's relationships and transactions with related parties, including related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Paragraph 4 of the proposed standard states that, in identifying related parties and obtaining an understanding of relationships and transactions with related parties, the auditor should take into account information obtained from the performance of risk assessment procedures (e.g., obtaining an understanding of the company and its environment, performing analytical procedures, and conducting a discussion among engagement team members regarding the risks of material misstatement) required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.



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IAASB

Paragraph 11 of ISA 550 states that as part of the risk assessment procedures and related activities required by ISA 315 and ISA 240, the auditor shall perform the audit procedures and related activities set out in paragraphs 12-17 of ISA 550 to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Performing Inquiries (paragraphs 6 – 8 of Appendix 1)

PCAOB

Paragraph 6 of the proposed standard would require the auditor to inquire of management regarding:

- a. The names of the company's related parties during the period under audit, including changes from the prior period;
- b. Background information concerning the related parties (e.g., physical location, industry, number of employees);
- c. The nature of any relationships, including ownership structure, between the company and each related party;
- d. The types of transactions entered into with each related party during the period under audit and the terms and business purposes (or the lack thereof) of each type of transaction;
- e. The business reasons for entering into a transaction with a related party versus an unrelated party; and
- f. Any significant related party transactions (i) 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 and (ii) for which exceptions to the company's established policies or procedures were granted.



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Paragraph 7 of the proposed standard would require the auditor to identify others within the company to whom inquiries regarding related parties should be directed and determine the extent of such inquiries by considering whether such individuals are likely to have additional knowledge regarding (i) the company's related parties or relationships or transactions with related parties and (ii) the company's controls over relationships and transactions with related parties. Paragraph 7 would also require the auditor to consider whether such individuals are likely to have knowledge of related parties, or relationships or transactions with related parties previously undisclosed to the auditor.

Paragraph 8 of the proposed standard would require the auditor to inquire of the audit committee, or its chair, regarding: (a) the audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and (b) whether any members of the audit committee has particular concerns regarding relationships or transactions with related parties, and, if so, the substance of those concerns.

IAASB

Paragraph 13 of ISA 550 requires the auditor to inquire of management regarding:

- (a) The identity of the entity's related parties, including changes from the prior period;
- (b) The nature of the relationships between the entity and these related parties; and
- (c) Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor (paragraph 11 and Appendix A of Appendix 1)

PCAOB

Paragraph 11 of the proposed standard requires the auditor to evaluate whether information that comes to the auditor's attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the



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auditor might exist. Appendix A of the proposed standard describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. As described in section I.C. of Appendix 4, other PCAOB auditing standards might impose requirements relating to the sources of information included in Appendix A (e.g., reading bank and legal confirmations and minutes of meetings of the board of directors of the company).

IAASB

Paragraph 15 of ISA 550 requires the auditor to remain alert, during the audit, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. Paragraph 15 of ISA 550 further requires that, in particular, the auditor inspect the following for indications of the existences of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- (a) Bank and legal confirmations obtained as part of the auditor's procedures;
- (b) Minutes of meetings of shareholders and of those charged with governance;
and
- (c) Such other records and documents as the auditor considers necessary in the circumstances of the entity.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

D. Identifying and Assessing Risks of Material Misstatement (paragraph 12 of Appendix 1)

PCAOB

Paragraph 12 of the proposed standard aligns with the existing requirements for the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 59 of Auditing Standard No. 12, requires that the auditor identify which risks are significant risks. Further, paragraph 71 of Auditing Standard No. 12 provides factors that should be evaluated by the auditor in determining which risks are significant risks. Those factors include: (1) whether the risk involves significant transactions with related parties, (2) whether the risk involves



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significant transactions that are outside the normal course of business and (3) whether the risk is a fraud risk. The proposed amendments to AU sec. 316.85.A2. state that a related party transaction that is also a significant unusual transaction (e.g., a significant related party transaction outside the normal course of business) is an example of a fraud risk factor.

IAASB and ASB

ISA 550 and AU-C Section 550 require that the auditor identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. ISA 550 and AU-C Section 550 require the auditor to treat identified significant related party transactions outside the normal course of business as giving rise to significant risks.

E. Responding to the Risks of Material Misstatement (paragraphs 13-17 of Appendix 1)

PCAOB

Paragraph 13 of the proposed standard aligns with existing requirements that the auditor must design and implement audit responses that address the assessed risks of material misstatement. Paragraph 13 states that 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.

IAASB

Paragraph 20 of ISA 550 requires that the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21-24 of ISA 550.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.



Transactions with Related Parties Required to be Disclosed in the Financial Statements or That Are a Significant Risk (Paragraph 15 of Appendix 1)

PCAOB

Paragraph 15 of the proposed standard requires that for each related party transaction, or type of related party transaction, that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:

- a. Read the underlying documentation and determine whether the terms and business purpose (or the lack thereof) of the transaction are consistent with explanations from inquiries and from other audit evidence;
- b. Determine (i) 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 and (ii) whether any exceptions to those established policies or procedures were granted;
- c. Evaluate the financial capability of the other parties with respect to significant uncollected balances, guarantees, and other obligations, if any; and
- d. Perform other procedures as appropriate, depending on the nature of the related party transaction and related risks of material misstatement, to meet the objective of this standard.

IAASB

Paragraph 23 of ISA 550 requires that for identified significant related party transactions outside the entity's normal course of business, the auditor should:

- a. Inspect the underlying contracts or agreements, if any, and evaluate whether:
 - i. The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
 - ii. The terms of the transactions are consistent with management's explanations; and



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- iii. The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- b. Obtain audit evidence that the transactions have been appropriately authorized and approved.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor (paragraphs 16 – 17 of Appendix 1)

PCAOB

Paragraph 16 of the proposed standard requires that if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform procedures to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Paragraph 16 states that those procedures should extend beyond inquiry of management.

Paragraph 17 of the proposed standard describes the required procedures that the auditor should perform if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Determine why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationships or transactions with the related party;



- d. Assess the need to perform procedures to identify additional relationships or transactions with the related parties previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 15 of this standard, treating the related party transaction as a significant risk;
- f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
- g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
- h. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor determines that it is likely that an illegal act has or may have occurred, the auditor should perform the appropriate procedures, including those required by AU sec. 316, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

IAASB

Paragraph 21 of ISA 550 requires that if the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships and transactions.

Paragraph 22 of ISA 550 requires that if the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor should:

- a. Promptly communicate the relevant information to the other members of the engagement team;
- b. Where the applicable financial reporting framework establishes related party requirements;
 - (i) request management to identify all transactions with the newly identified related parties for the auditor's further evaluation;



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- (ii) inquire why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
- c. Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions;
- d. Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor and perform additional audit procedures as necessary.
- e. Evaluate the implications for the audit if the nondisclosure by management appears intentional (and, therefore, indicative of a risk of material misstatement due to fraud).

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

F. Evaluating Financial Statement Accounting and Disclosure (paragraphs 18—19 of Appendix 1)

PCAOB

Paragraph 18 of the proposed standard aligns with the existing requirement that the auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. Paragraph 18 states that this includes evaluating whether the financial statements contain the information regarding related party transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

IAASB

Paragraph 25 of ISA 550 requires that in forming an opinion on the financial statements, the auditor shall evaluate:

- a. Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- b. Whether the effects of the related party relationships and transactions:



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- i. Prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or
- ii. Cause the financial statements to be misleading (for compliance frameworks).

ASB

AU-C Section 550 contains similar requirements to the requirements in ISA 550 for fair presentation frameworks.

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (paragraph 19 of Appendix 1)

PCAOB

Paragraph 19 of the proposed standard requires that if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.

A note to paragraph 19 of the proposed standard further states that a preface to a statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

IAASB

Paragraph 24 of ISA 550 states that if management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

**G. Communications with the Audit Committee (paragraph 20 of Appendix 1)**PCAOB

Paragraph 20 of the proposed standard requires that the auditor communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. Paragraph 20 also requires that the auditor communicate to the audit committee other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- b. The identification of significant related party transactions (i) that have not been authorized or approved in accordance with the company's established policies or procedures and (ii) for which exceptions to the company's established policies or procedures were granted;
- c. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support such assertions; and
- d. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

IAASB

Paragraph 27 of ISA 550 requires that the auditor communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties. ISA 550 states that an example of a significant related party matter includes difficulties in identifying the party that ultimately controls the entity.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.



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II. Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions (Appendix 2)

A. Identifying Significant Unusual Transactions (Section A of Appendix 2)

PCAOB

The proposed amendments to paragraph 56.a. of Auditing Standard No. 12 require the auditor to inquire of management regarding whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involve related parties. The proposed amendments to paragraph 56.b. of Auditing Standard No. 12 would require that the auditor inquire of the audit committee or equivalent, or its chair, regarding whether the company has entered into any significant unusual transactions. The proposed amendments to paragraph 56.c. of Auditing Standard No. 12 would require similar inquiries of internal audit.

IAASB and ASB

ISA 315, ISA 550, AU-C Section 315, and AU-C Section 550 do not contain similar requirements for the auditor to those in the PCAOB's proposed amendments.

B. Evaluating Significant Unusual Transactions (Section B of Appendix 2)

PCAOB

The proposed amendments to paragraph .66A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* would require the auditor to design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction. AU sec. 316.66A would require that those procedures include the following:

- a. Reading the underlying documentation and determining whether the terms and business purpose (or the lack thereof) of the transaction are consistent with explanations from inquiries and other audit evidence;
- b. Determining whether the transaction has been appropriately authorized and approved in accordance with the company's established policies and procedures;



- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, guarantees, and other obligations, if any; and
- d. Performing other procedures as appropriate, depending on the nature of the transaction and the risks of material misstatement, to obtain an understanding of the business purpose (or the lack thereof) of the significant unusual transaction.

The proposed amendments to AU sec. 316.67 would require that the auditor evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. The amendments to AU sec. 316.67 require that, in making that evaluation, the auditor evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);
- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor.
- The transaction involves other parties that do not appear to have the financial resources to support the transaction without assistance from the company;
- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);
- 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 other, more clearly independent, parties on an arm's-length basis;
- The company's accounting for the transaction enables the company to achieve certain financial targets;



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- 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); and
- Management has discussed the nature and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Further, the proposed amendments to paragraph 11A of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, would require that because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-67A.

IAASB

Paragraph 16 of ISA 550 requires that if the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required by paragraph 15 or through other audit procedures, the auditor shall inquire of management about:

- (a) The nature of these transactions; and
- (b) Whether related parties could be involved.

Paragraph 32(c) of ISA 240 requires the auditor to evaluate whether the business rationale (or the lack thereof) of a significant transaction outside the normal course of business suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. As discussed in Section I.E. of this Appendix, paragraph 23 of ISA 550 requires the auditor to perform certain procedures for identified significant related party transactions outside the entity's normal course of business.

ASB

AU-C Section 550 and AU-C Section 240 contain similar requirements to those in ISA 550 and ISA 240.



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III. Other Proposed Amendments to PCAOB Auditing Standards (Appendix 3)

A. **Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (Appendix 3)**

PCAOB

The proposed amendments to paragraph 10A of Auditing Standard No. 12 would require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements). The procedures should be designed to identify risks of material misstatement and should include, but are not limited to (a) reading employment and compensation contracts and (b) reading proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers. The proposed amendments to Auditing Standard No. 12 would also include a definition of executive officer that aligns with definitions used in SEC filings.

In addition, the other proposed amendments to PCAOB auditing standards would amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider: (1) inquiring of the chair of the compensation committee, or its equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structure of the company's compensation for executive officers, and (2) obtaining an understanding of the company's established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

IAASB and ASB

ISA 315 and AU-C Section 315 do not contain similar requirements for the auditor to those in the PCAOB's proposed amendments.

B. **AU sec. 315, *Communications Between Predecessor and Successor Auditors* (Appendix 3)**

PCAOB

The proposed amendments to other PCAOB Auditing Standards would amend AU sec. 315, *Communications Between Predecessor and Successor Auditors*, to require the auditor to inquire of the predecessor auditor regarding the company's relationships and transactions with related parties and significant unusual transactions. The proposed amendments would also require the successor auditor to review



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documentation regarding relationships and transactions with related parties and significant unusual transactions.

IAASB and ASB

ISA 510 and AU-C Section 510 do not contain similar requirements to those in the PCAOB's proposed amendments.

C. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (Appendix 3)

PCAOB

The proposed amendments to AU sec. 316.81A describe the auditor's responsibility, under certain conditions, to disclose possible fraud to the Securities and Exchange Commission to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change on Form 8-K and the fraud or related risk factors constitute a *reportable event* or are the source of a *disagreement*, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required pursuant to Section 10A(b)(3) of the Securities Exchange Act of 1934 relating to an illegal act that the auditor concludes has a material effect on the financial statements.

IAASB and ASB

ISA 240 and AU-C Section 240 do not inform the auditor of certain obligations under Section 10A of the Securities Exchange Act of 1934, which is applicable to auditors of U.S. public companies registered with the PCAOB.

D. AU sec. 333, *Management Representations* (Appendix 3)

PCAOB

The proposed amendments to AU sec. 333, *Management Representations*, would require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The proposed amendments to AU sec. 333 also would require the auditor to obtain written representation from management if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction.



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IAASB and ASB

ISA 580, ISRE 2410, AU-C Section 580, and AU-C Section 930 do not contain similar requirements to those in the PCAOB's proposed amendments.

E. AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543* (Appendix 3)

PCAOB

The proposed amendments to AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543*, would provide that before issuing his or her report, the other auditor should inquire of the principal auditor as to matters significant to the audit. Those matters include relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.

Paragraph 10 of the proposed standard requires that, when the auditor serves as a principal auditor, the auditor should inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications. Paragraph 17.c. of the proposed standard further requires that if the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist, the auditor promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transactions with the related party.

IAASB

Paragraph 40 of ISA 600 provides that the group engagement team shall request the component auditor to communicate on a timely basis related parties not previously identified by group management or the group engagement team. The group engagement team shall determine whether to identify such additional related parties to other component auditors.

ASB

ISA 600 states that the two-way communication between the group auditor and the component auditor may be initiated by the component auditor regarding matters that may be significant to the component audit.



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Paragraph 40 of AU-C Section 600 states that the group engagement team should request the component auditor to communicate on a timely basis related parties not previously identified by group management or the group engagement team. The group engagement team should identify such additional related parties to other component auditors.

F. AU sec. 722, *Interim Financial Information* (Appendix 3)

PCAOB

The proposed amendments to AU sec. 722, *Interim Financial Information*, would require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The proposed amendments to AU sec. 722 also would require the auditor to obtain written representations from management when management has made an assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in arm's-length transactions.

IAASB

ISA 550, ISA 580, and ISRE 2410 do not contain similar requirements to those in the PCAOB's proposed amendments.

ASB

AU-C Section 550, AU-C Section 580, and AU-C Section 930 do not contain similar requirements to those in the PCAOB's proposed amendments.



Exhibit 2(a)(B)

**Alphabetical List of Commenters on the Proposal in
PCAOB Release No. 2012-001**

1	American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)
2	American Federation of State, County and Municipal Employees (AFSCME)
3	Ball Corporation
4	Chris Barnard, Actuary
5	BDO USA, LLP
6	BKD, LLP
7	Center for Audit Quality (CAQ)
8	Council of Institutional Investors
9	Crowe Horwath LLP
10	Deloitte & Touche LLP
11	Eide Bailly LLP
12	Eli Lilly and Company
13	Ernst & Young LLP
14	Federation of European Accountants

15	Howard Gluckman, C.P.A.
16	Grant Thornton LLP
17	Illinois CPA Society
18	Institut der Wirtschaftsprüfer
19	The Institute of Chartered Accountants in England and Wales (ICAEW)
20	KPMG LLP
21	Lobel, Novins & Lamont LLP
22	McGladrey LLP
23	MetLife, Inc.
24	Midsized Bank Coalition of America
25	New York State Society of Certified Public Accountants
26	Nordstrom & Associates, P.C.
27	Piercy Bowler Taylor & Kern
28	Plante & Moran, PLLC
29	PricewaterhouseCoopers LLP
30	Public Citizen
31	Society of Corporate Secretaries & Governance Professionals
32	TCF Financial Corporation
33	Texas Society of Certified Public Accountants
34	U.S. Chamber of Commerce, Center for Capital Markets Competitiveness
35	UHY LLP
36	United States Government Accountability Office (GAO)
37	Gilbert F. Viets

American Federation of Labor and Congress of Industrial Organizations



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

Re: Proposed Auditing Standard on Related Parties, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards

Dear Mr. Seymour:

On behalf of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), I appreciate the opportunity to comment on proposed amendments to the Public Company Accounting Oversight Board ("PCAOB") auditing standards. The AFL-CIO is the largest labor federation in the United States and represents more than 12 million union members. Union-sponsored pension and employee benefit plans hold more than \$480 billion in assets.

The AFL-CIO supports the proposed amendments to Auditing Standard No. 12, Identifying and Assessing Risk of Material Misstatement. We agree with PCAOB Chairman James Doty that the proposed amendments will "sharpen auditors' focus and help them be more effective in their investor protection role," and "enhance the auditors' understanding of the issuers' financial arrangements with its senior officers."¹

The proposed changes use a common sense approach to strengthen the auditors' ability to evaluate the relationship between executive compensation, risk, and financial misstatements. The desire to increase management compensation based on financial results is one of the most commonly cited motivations for fraud, according to a recent study commissioned by the Committee of Sponsoring Organizations of the Treadway Commission. The study notes that

¹ Comments at PCAOB Open Board Meeting, Feb. 28, 2012.

either the chief executive officer or the chief financial officer was associated with financial statement fraud in 89 percent of cases.²

We support the proposed amendments to Auditing Standard 12 that will require the auditors to perform certain procedures, including examining employment and compensation contracts as well as the proxy statement and other relevant company filings with the Securities and Exchange Commission, to evaluate the impact of incentive compensation arrangements on the risk of financial misstatement. Because the board of directors is ultimately responsible for setting senior executive compensation, we also support requiring auditors to inquire of the chair of the compensation committee, and any compensation consultants engaged, about the structure of executive compensation.

These proposed changes are incremental and build on what is already required under Statement on Auditing Standards 99: Consideration of Fraud. SAS 99 requires auditors to scrutinize any incentives for fraud, including compensation. We suggest that the PCAOB clarify the specific information auditors should seek from board compensation committees and compensation consultants regarding executive compensation arrangements. Auditors should, in particular, pay careful attention to executive compensation that includes a heavy reliance on asymmetric incentive structures such as stock option compensation that might encourage executives to swing for the fences.

Some have argued that the proposed changes will improperly inject auditors into the executive compensation process, and that companies may have their business judgment second-guessed by their auditors. We believe these arguments lack merit for two reasons. First, current auditing standards already require auditors to gain an understanding of executive compensation arrangements—the only difference between the current standard and the proposed changes is how auditors should gain that understanding. Second, these changes will result in better audits and better internal controls that ultimately benefit both the company and investors.

We appreciate the opportunity to share our views with the PCAOB. If you need any additional information, please contact me at 202-637-3900.

Sincerely,



Brandon Rees
Acting Director
AFL-CIO Office of Investment

BJR/sdw
opeiu #2, afl-cio

² "Fraudulent Financial Reporting 1998-2007: An Analysis of U.S. Public Companies," by Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson and Terry L. Neal, 2010.



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May 29, 2012

Via Email

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

RE: PCAOB No. 2012-001, Rulemaking Docket Matter No. 38

Dear Mr. Seymour,

The American Federation of State, County and Municipal Employees (“AFSCME”) submits this letter in strong support of the Public Company Accounting Oversight Board’s (the “Board’s”) Release No. 2012-011, “Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions” (the “Release”). AFSCME is the largest union in the AFL-CIO, representing 1.6 million state and local government, health care and child care workers. AFSCME members participate in over 150 public pension systems whose assets total over \$1 trillion. In addition, the AFSCME Employees Pension Plan (the “Plan”) is a long-term shareholder that manages \$850 million in assets for its participants, who are staff of AFSCME and its affiliates.

AFSCME has a substantial track record of engagement with companies around the risks created by incentive compensation programs. We agree with the Board that poorly designed compensation plans can increase the risk of material misstatement, harming a company and its shareholders. Empirical evidence indicates that the desire to increase incentive compensation is a frequent motivation for financial statement fraud.ⁱ As well, there is support for the notion that certain compensation arrangements, such as large amounts of stock options, correlate to more large losses for shareholders.ⁱⁱ We therefore applaud the Board for issuing the Release to more specifically describe auditors’ responsibilities for evaluating the impact of incentive compensation arrangements on the risk of financial misstatement.

American Federation of State, County and Municipal Employees, AFL-CIO

TEL (202) 429-1000 FAX (202) 429-1293 TDD (202) 659-0446 WEB www.afscme.org 1625 L Street, NW, Washington, DC 20036-5687

Public Company Accounting Oversight Board
No. 2012-001, Rulemaking Docket Matter No. 38
May 29, 2012
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The changes proposed in the Release do not represent a radical departure from current standards; instead, they clarify and provide more specificity. At present, Auditing Standard No. 12, "Identifying and Assessing Risks of Material Misstatement," states that the auditor "should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement." Understanding the "nature of the company" is one of the five elements in satisfying this requirement. (Auditing Standard No. 12, section 7)

Auditing Standard No. 12 already provides that an auditor, in obtaining an understanding of the nature of the company, should "[o]btain an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses." (Auditing Standard No. 12, section 11)

The changes proposed in the Release would replace that somewhat general language with more specific procedures, including reviewing employment agreements and proxy statement disclosure. (Release, page A3-1) Thus, we do not expect that the Release's greater specificity would result in a meaningful increase in audit costs. More specific guidance would, however, enhance the quality of the audit by assisting the auditor in identifying fraud risks; thus, on balance we favor the proposed change even if a modest increase in audit costs would result.

In addition, the amendments proposed in the Release would provide that the auditor should "inquir[e] of the chair of the compensation committee, or its equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers." (Release, page A3-1) Although we believe that communication between auditors and those involved in designing and implementing compensation arrangements would be useful in enhancing auditors' understanding of those arrangements, we are concerned that the language of this proposed change—"regarding the structuring"—may be too imprecise and may not serve the Board's objective. We urge the Board to clarify the information auditors should seek from board compensation committees and compensation consultants regarding executive compensation arrangements.

Criticism of the compensation-related amendments contained in the Release has focused on the possibility that auditors will begin dictating compensation practices, and

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that companies with non-standard arrangements will risk not receiving a clean audit opinion. Those arguments fail to account for the fact that the Board's current standard already directs auditors to gain an understanding of executive compensation arrangements; we are aware of no reports of auditors demanding that companies abandon their existing practices. Those arguments also ignore the purpose of Auditing Standard No. 12—to require the auditor to assess the risk of material misstatement at a client in order to design appropriate audit procedures. More accurate assessments lead to better audits, benefiting investors such as the Plan.

We also support the measures outlined in the Release to more fully detail the measures auditors should take to identify and examine related party transactions. Related party transactions provide opportunities for insiders to extract personal benefit at the expense of investors. Although we recognize that related party transactions may have a legitimate business purpose, we agree with the Board that heightened scrutiny is necessary in the audit setting. Many high-profile corporate failures resulting in massive losses for investors, such as Enron, Adelphia and Hollinger, have involved the abuse of related party transactions. For example, at Enron, numerous related parties engaged in transactions with the company without any economic rationale, with the common objective of concealing the company's true financial condition. Once the truth came out, the company couldn't obtain financing and lost the confidence of counterparties, leading to bankruptcy. The related party transactions were used to conceal the problems, allowing them to become even larger (while benefiting insiders).ⁱⁱⁱ

The Board's own inspections provide support for the notion that auditors may still not be probing these transactions sufficiently. One-quarter of the Board's settled disciplinary orders involve failures in this area.^{iv} More specific standards and procedures will increase investor confidence in audits.

As with the compensation-related changes, the changes proposed in the Release on related party transactions build upon the auditor's existing duty to identify and analyze these transactions. We believe that requiring the auditor to understand the business rationale for related party transactions, in particular, will assist in identifying abuse. If Arthur Andersen's auditors had focused on and communicated with the board regarding the (non-existent) business rationale for the abusive related party transactions that Enron used to conceal its true financial condition, investor losses might have been significantly less.^v Similarly, the Release's proposed changes to AU 316, "Consideration of Fraud in a Financial Statement Audit," do not introduce new responsibilities, but instead clarify how

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auditors should think about (and apply professional skepticism when evaluating) the opportunities to engage in fraudulent financial reporting provided by related party transactions that are also significant unusual transactions for the company.^{vi}

* * * *

We appreciate the opportunity to share our views with the Board on these important issues. If you have any questions, or need additional information, please do not hesitate to contact Lisa Lindsley at (202) 429-1275.

Sincerely,


 GERALD W. McENTEE
 INTERNATIONAL PRESIDENT

ⁱ See Mark S. Beasley et al., "Fraudulent Financial Reporting 1998-2007: An Analysis of Public Companies," at 3 (COSO 2010) available at http://coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.

ⁱⁱ See Wm. Gerard Sanders & Donald C. Hambrick, "Swinging for the Fences: The Effects of CEO Stock Options on Company Risk-Taking and Performance," Academy of Management Journal, at 30-31 (2007) available at <http://journals.aomonline.org/InPress/pdf/done/291.pdf>; see also Wm. Gerard Sanders, "Behavioral Responses of CEOs to Stock Ownership and Stock Option Pay," Academy of Management Journal, 477 (2001) (finding that stock option CEO pay was associated with greater acquisition activity) available at <https://myweb.space.wisc.edu/czhang46/web/Executive%20compensation%20and%20risk%20taking/Sanders%202001.pdf>.

ⁱⁱⁱ Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., dated Feb. 1, 2002, available at <http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf>.

^{iv} See Statement of Steven B. Harris, Board Member, Feb. 28, 2012 available at pcaob.us.org/news/speech/pages/02282012_harrisstandard.aspx.

^v See, e.g., Report of Investigation, Special Investigative Committee of the Board of Directors of Enron Corp., Feb. 1, 2002, at 24-25 (concluding that "Andersen did not

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fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal controls over the related-party transactions" and that Andersen allowed related-party transactions to proceed that should not have been approved) available at

<http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf>.

^{vi} See AU Section 316, "Consideration of Fraud in a Financial Statement Audit," paragraph .85 available at

<http://www.aicpa.org/research/standards/auditattest/downloadabledocuments/au-00316.pdf>; Release, at A3-3.



10 Longs Peak Drive
Broomfield, Colorado

May 31, 2012

VIA EMAIL

Office of Secretary
The Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006

Dear Public Accounting Oversight Board:

Thank you for the opportunity to respond to the Public Accounting Oversight Board ("PCAOB") Proposed Auditing Standard: *Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (the "Proposed Standards"). Ball Corporation ("Ball", "the company", "we" or "our") is a U.S.-based public, Fortune 500, multi-national manufacturer of metal packaging products and of aerospace and other technologies with sales in 2011 of \$8.6 billion and total assets of \$7.3 billion. The company has chosen to respond to the Proposed Standards to highlight its concerns with the proposed changes to the auditing standards of executive compensation included in Auditing Standard 12.

The company understands the PCAOB's background for introducing this proposal as: 1) incentives and pressures for executive officers to meet financial targets can result in increased 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. Consequently, the PCAOB has introduced the proposed auditing guidance to ensure that the risks presented to the financial statements by executive compensation are incorporated into the auditor's opinion of the financial statements.

The company has reservations regarding the proposed auditing standard and the far reaching implications this standard can have on the auditors and their relationship with their publicly-traded clients. Specifically, Ball is concerned that the proposed standard will put the auditors in a position to have to opine upon the merits of a performance based compensation plan and whether there is significant risk of fraud inherent in the utilization of that plan. Ball is also concerned that the added emphasis on executive compensation could cause investors to question the independence of auditors required to assess executive compensation as currently included in the Proposed Standards.

First, we believe that the Proposed Standard puts a burden on the auditors to understand the performance based compensation arrangements of executive management and determine if those compensation arrangements pose an increased risk of material misstatement of the company's financial statements. Many executive performance based compensation arrangements are unique, complex arrangements that are structured and reviewed by consultants and board members that have extensive experience in the structuring of these types of contracts. Ball is concerned that the independent auditor firms do not have the appropriate knowledge, expertise, experience or skill sets to review these potentially complex contracts. This will in turn require the auditors to hire outside experts to review the contracts and gain

comfort with the structure of the arrangements, which will increase the time and cost related to the audit while not necessarily increasing the value of the opinion expressed at the conclusion of the audit itself.

Second, as the auditors are required to review the executive compensation arrangements and opine on the risk presented by those contracts, many companies may desire to use the audit report which includes the auditor's opinion on the compensation arrangements for purposes of supporting the reasonability of its compensation arrangements or ask the audit advisors to assist in the design of the compensation arrangements to avoid potential issues related to the auditors required audit work under the standard. The tailoring of executive compensation arrangements to comply with auditor specifications could potentially be viewed as a conflict of interest by investors and raise questions about the independence of the audit firm.

In conclusion, we would ask the PCAOB to reconsider the Proposed Standards on executive compensation and specifically exclude them from the proposals for Auditing Standard No. 12.

Please consider our comments and contact us if you have any further questions regarding our comments on the Staff Paper.

Sincerely,

A handwritten signature in blue ink, appearing to read 'SMB', with a long horizontal flourish extending to the right.

Shawn M. Barker
Vice President and Controller

Please note that the comments expressed herein are solely my personal views

Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803
United States
www.pcaobus.org

Chris Barnard
Actuary

15 May 2012

- **Release No. 2012-001**
- **PCAOB Rulemaking Docket Matter No. 038**
- **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 Sir.

Thank you for giving us the opportunity to comment on your Proposed Auditing Standard, Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards. Concerning related parties you are proposing standards that would improve the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.

I agree with you that: "The auditor's evaluation of a company's identification of, accounting for, and disclosure about its relationships and transactions with related parties is important to the protection of the interests of investors and to the preparation of informative, accurate, and independent audit reports."¹ I also support the proposed standards, which strike the right balance between principles and prescriptive requirements. I would only suggest that you could improve the completeness of section 20, which concerns "Communications with the Audit Committee".

¹ See I. Introduction, in the proposed standards.

Please note that the comments expressed herein are solely my personal views

I would specifically recommend that you add a point e. to the proposed standard, section 20, that would concern critical processes, as follows:

- e. Any judged shortfalls in processes in critical functions due to related parties or relationships or transactions with related parties that were previously undisclosed to the auditor, including governance, compliance, internal audit, risk management and legal, whether currently material or not.

I believe that this would be sufficient and complete in order that the auditor should communicate those significant matters arising from the audit regarding the company's relationships and transactions with related parties.

Yours faithfully

C.R.B.

Chris Barnard



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100 Park Avenue
New York, NY 10017

May 31, 2012

Via e-mail: comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: **PCAOB Release No. 2012-001, Rulemaking Docket Matter No. 038, *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 Members and Staff of the Public Company Accounting Oversight Board:

BDO USA, LLP welcomes this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) release, *Proposed Auditing Standard - Related Parties* (Proposed Standard), *Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (Proposed Amendments) (the Release). We support the Board's overall objective to strengthen existing audit procedures for identifying, assessing, and responding to the risks of material misstatement associated with a company's related party transactions and the auditor's evaluation of significant unusual transactions, including transactions with executive officers, as part of the risk assessment process.

After careful consideration of the Proposed Standard, the Proposed Amendments, and the explanatory material provided within the Release, we provide the following comments for your consideration as you work to strengthen the existing standards. We believe the changes we propose below will enhance the clarity and ultimately the effectiveness with which the Proposed Standard and the Proposed Amendments are implemented.

For your convenience, a reference to the relevant questions posed in the Release is shown parenthetically, where applicable.

Authority of Objective (Question 2)

The objective of the Proposed Standard explains that "the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements." While the setting of objectives has been part of the PCAOB's standard setting process since the issuance of Auditing Standard No. 7, *Engagement Quality Review*, the status and meaning of the objective within the standards has not been sufficiently explained or set out in an overall standard.



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Public Company Accounting Oversight Board
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With respect to this Proposed Standard, Appendix 4, page A4-4, explains the use of the audit objective as follows:

Providing an overarching concept as an audit objective for the auditor to take into account while performing the procedures required by the proposed standard can assist the auditor in performing those procedures, including developing other procedures as required, and evaluating the results of those procedures. An overarching concept can be especially helpful when judgment is required, for example, when designing additional procedures not specifically required by the proposed standard. New auditing standards issued by the Board include an objective, and this standard is following the same format.

While we agree with the description of the status and meaning of the objective as stated above, we believe that this description should be included in an overall standard that applies to each of the Board's standards. This would clarify how an auditor is intended to use the objective, not only in this standard, but for all of the Board's auditing standards that contain an objective. Further, while the excerpt above provides some guidance to the auditor about how the objective should be considered, we believe it is incomplete in that it does not explain how the requirements relate and support the objective. For this reason, we suggest adding guidance that explains:

1. how the requirements included within the standard are expected to provide a sufficient basis for the auditor's achievement of the objective; and
2. that since circumstances differ in each audit, it is impossible to anticipate every situation or outcome and, for this reason, the objective is provided in the standard to ensure that sufficient appropriate evidence is obtained in each circumstance.

Fraud Considerations and the Importance of the Use of Professional Skepticism

The introduction to the Release explains that transactions with related parties can pose significant risks of material misstatement, as their substance might differ materially from their form. The Release also explains that related party transactions not only may involve difficult measurement and recognition issues that can lead to errors in financial statements, but also, in some instances, related party transactions have been used to engage in financial statement fraud and asset misappropriation. To focus the auditor's attention on risks associated with related parties, specifically as they relate to the risk of fraud, we recommend including a discussion in the introduction to the Proposed Standard of these matters that would provide context to the requirements within the standard.

Moreover, as related party relationships present a greater opportunity for collusion, concealment, or manipulation by management, the ability of the auditor to detect material misstatements in this context is lessened due to the inherent limitations of an audit. For this reason, we suggest also including additional introductory guidance emphasizing the importance of the use of professional skepticism in this area, given the potential for undisclosed related party relationships and transactions.



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Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties (Questions 3 and 4)

The Proposed Standard has been written with little or no explanatory guidance included. We believe the effectiveness of the implementation of the Proposed Standard will be negatively impacted without the benefit of such material to assist in the proper and consistent application of the requirements.

For example, paragraph 3 of the Proposed Standard explains that the auditor should perform procedures to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purpose (or lack thereof) of the types of transactions involving related parties. However, by itself this requirement is vague. It is unclear whether this requirement is referring to the procedures set out in paragraphs 4 through 11 of the Proposed Standard, or whether procedures other than those set out in the Proposed Standard are contemplated. This lack of clarity increases the likelihood that the requirement will be applied inconsistently or ineffectively. For this reason, we believe the explanatory guidance in Appendix 4, page A4-5, that explains that the auditor should perform the procedures set out in paragraphs 4 through 11 should be reflected in paragraph 3.

In addition, we believe paragraph 3 should more clearly explain the relationship between the foundational risk assessment requirements, including those related to fraud risks, and the procedures included within the Proposed Standard, by referencing the risk assessment concepts discussed in Appendix 4, beginning on page A4-13, within this paragraph. We believe revising the paragraph in this way will help alleviate any perception that inquiry alone is sufficient to meet the objective of the Proposed Standard. Accordingly, we suggest modifying paragraph 3 as follows: (additions are shown in bold italics and deletions in strikethrough text)

As part of the risk assessment procedures and related activities that Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, requires ~~the auditor to perform during the audit, the auditor~~ should perform the procedures set out in paragraphs 4 through 11, to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes (or lack thereof) of the types of transactions involving related parties. The procedures performed should be designed to identify likely sources of potential material misstatements, including risks of material misstatement due to fraud, in the financial statements that may arise from the company's relationships and transactions with related parties, including related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Another area where additional explanatory material may be helpful is with respect to paragraph 4 of the Proposed Standard that requires the auditor to take into account information obtained from the performance of risks assessment procedures. The additional discussion in Appendix 4, page A4-6, explains that:



Office of the Secretary
Public Company Accounting Oversight Board
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The procedures performed should be sufficient to identify likely sources of potential material misstatements regarding related party transactions, and to identify fraud risk factors associated with related party transactions. For example, to improve the appearance of its financial condition, a company and a related party could attempt to “dress up” the appearance of the company’s balance sheet at period end by agreeing to have the company temporarily pay down its related party debt prior to the balance sheet date while having an undisclosed side agreement to subsequently borrow the same or a comparable amount shortly after period end.

Understanding the nature of relationships and transactions with related parties is important for the auditor’s evaluation of the company’s accounting for and disclosure of related party transactions. Further, this understanding is critical to determining whether related parties might be involved in transactions indirectly through the use of an intermediary.

Performing Inquiries

Paragraph 6 of the Proposed Standard requires the auditor to inquire of management regarding specific aspects of related party relationships and transactions. The first two inquiries listed in paragraph 6 both seem to relate to obtaining information about the identity of the related parties, including changes from the prior period. To allow for the use of professional judgment in determining the nature and extent of information needed in this regard, we recommend combining paragraphs 6.a. and 6.b. and revising as follows:

The auditor should inquire of management regarding:

6.a. The identity of the entity’s related parties, including changes from the prior period (e.g., names of related parties, background information concerning related parties such as physical location, industry and number of employees, etc.);

Further, to provide for the exercise of auditor judgment in determining whether inquiry of others is necessary in the circumstances, we recommend adding the phrase, “as applicable” to the end of the first sentence of paragraph 7 of the Proposed Standard. If this revision is made, the second sentence would also need to be revised as follows:

The auditor ~~should~~ *identify* others within the company to whom inquiries are to ~~should~~ be directed and determines the extent of such inquiries by considering whether such individuals are likely to have additional knowledge regarding...

Responding to the Risks of Material Misstatement (Questions 10 and 12)

Transactions with Related Parties Required to be Disclosed in the Financial Statements or That are a Significant Risk

Paragraph 15.d. of the Proposed Standard requires the auditor to perform other procedures as appropriate, depending on the nature of the related party transaction and the related risks of material misstatement, to meet the objective of this standard. While we recognize



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that the performance of other procedures, as appropriate, to obtain sufficient audit evidence is consistent with the use of the objective in the standard, we believe that the addition of examples, as described in Appendix 4, page A4-20, would provide helpful guidance in assessing when such procedures may be necessary and the nature of those other audit procedures. Accordingly, we suggest incorporating the examples from Appendix 4 into the final auditing standard as a note to paragraph 15.d.

The Exercise of Professional Judgment and Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor

The use of professional judgment is a critical and essential element to the performance of an effective audit. Due to the nature of related party relationships and transactions, the exercise of professional judgment takes on greater importance. The discussion in Appendix 4, page A4-4, emphasizes the importance of this aspect of auditor performance when it explains that “given the increased risk of material misstatement associated with transactions with related parties, avoiding a mechanical approach could improve audit quality and potentially address concerns regarding the auditor’s consideration of related party transactions.”

Accordingly, we believe that paragraph 17 of the Proposed Standard should be modified to allow for the exercise of auditor judgment in determining whether a previously undisclosed related party transaction rises to a level of significance that would warrant the performance of all the procedures detailed in paragraph 17. For example, paragraph 17.e. requires that any previously undisclosed related party relationship or transaction identified by the auditor should be treated as a significant risk, and that the auditor should perform the procedures required by paragraph 15 of the Proposed Standard. We believe there may be situations when the auditor could determine that a previously undisclosed related party transaction is not a significant risk through the performance of some, but not necessarily all, of the procedures described in paragraph 17. Emphasizing the importance of the exercise of auditor judgment in determining the most effective response to the identification of a previously undisclosed related party or relationship or transaction with a related party would align the audit response with the significance of the risk of material misstatement.

Proposed Amendments to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement

With respect to the proposed amendments to Auditing Standard No. 12 (AS 12), *Identifying and Assessing Risks of Material Misstatement*, we note that the additional paragraph proposed, paragraph 10A, requires the auditor to perform certain procedures with respect to the company’s executive officers. While the term “executive officer” is proposed to be defined in paragraph A3A, it is unclear whether the auditor is expected to determine whether the list of executive officers as set out in Rule 3b-7 under the Exchange Act or Schedule A of Form BD for brokers and dealers is complete. While we understand that the proposed amendment does not change the existing requirement to consider obtaining an understanding of compensation arrangements with senior management or that the existing requirement in AS 12, paragraph 11, applies to a larger population than just a company’s executive officers, we note that the explanatory material in Appendix 4 explains that the



Office of the Secretary
Public Company Accounting Oversight Board
Page 6 of 6

population for the proposed procedures required by paragraph 10A is the list of executive officers disclosed in the securities filing or the executive officers included on Schedule A of Form BD. To enhance clarity we suggest revising the first sentence of paragraph 10A to state:

The auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers *as disclosed in the securities filing or Schedule A of Form BD for brokers and dealers* (e.g., executive compensation, including perquisites, and any other arrangements). The procedures should be designed to identify risks of material misstatement and should include, but are not limited to (1) reading employment and compensation contracts and (2) reading proxy statements and other relevant company filings with the Securities and Exchange Commission and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.

Additional Comment

We note that paragraph 6 of the Proposed Standard requires the auditor to make certain inquiries of management relating to the period under audit. While we agree that such inquiries are appropriate, we believe that this guidance should be clarified to include inquiries during the period after the balance-sheet date to assess whether any related party transactions have occurred that may require adjustment or disclosure essential to the fair presentation of the financial statements. To address this risk, we suggest amending AU Section 560, *Subsequent Events*, paragraph 12b, to specifically address related party transactions.

We would be pleased to discuss our comments with you at your convenience. Please direct any questions to Chris Smith, Audit and Accounting Professional Practice Leader, at 310-557-8549 (chsmith@bdo.com) or Susan Lister, National Director of Auditing, at 212-885-8375 (slister@bdo.com).

Very truly yours,

/s/ BDO USA, LLP

BDO USA, LLP

May 31, 2012

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

Re: PCAOB Rulemaking Docket Matter No. 38, *Related Parties, amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other amendments to PCAOB auditing standards*

Dear Office of the Secretary:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Release No. 2012-001 on Related Parties, amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other amendments to PCAOB auditing standards ("Release"). This letter includes our views and observations on related parties as set forth in the Release.

Related Parties

We are supportive of the Board's efforts to address audit quality related to the auditor's evaluation of a company's identification of, accounting for, and disclosure about its relationships and transactions with related parties. We agree this information is important to the preparation of informative, accurate, and independent audit reports and believe it will serve to advance the Board's goal of improving audit quality. We offer the following comments to clarify the Board's meaning and suggest some additional language to allow the continued exercise of auditor professional judgment.

Paragraph 7 of the Release provides a list of others within the company that the auditor should inquire of as to knowledge of related parties. It is noted that the list is not all inclusive, but it doesn't allow for any auditor judgment to make inquiries of such individuals "as appropriate" given specific facts and circumstances. We suggest the Board consider the addition of this language.

Paragraph 15 of the Release requires auditors to perform specific procedures "For each related party transaction or type of related party transaction..." This requirement seems to imply that all transactions must be subjected to the specific procedures. It doesn't allow for auditor judgment to determine which transactions or the extent of procedures to be applied to those transactions as

Office of the Secretary
Public Company Accounting Oversight Board
Page 2
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may be appropriate given specific facts and circumstances including assessed risks of material misstatement.

Paragraph 17 of the Release requires auditors to perform specific procedures if the auditor determines that a related party relationship or transaction previously undisclosed to the auditor exists. Again, these requirements do not take into account auditor judgment to determine the extent of procedures to be applied to a transaction based on materiality, significance, or the specific facts and circumstances, including assessed risks of material misstatement.

We believe auditing standards cannot contemplate all scenarios and therefore, need to provide for auditor professional judgment. In the above examples, we believe the procedures to be performed should be commensurate with assessed risks of material misstatement and should allow for auditors to use their judgment based on the specific facts and circumstances.

Paragraph 20 of the Release relates to communications with audit committees. We suggest the Board consider the deletion of the word "full" from the note as all members of an audit committee may not be present during an audit committee meeting and attendance may not be required for an audit committee to have a quorum.

Proposed Amendments to Other Auditing Standards

In the proposed amendments to Auditing Standard No. 12, under paragraphs 10 and 11, certain procedures are listed as part of obtaining an understanding of the company's financial relationships and transactions with executive officers as well as compensation arrangements with executive officers and senior management. We suggest that the Board consider adding additional clarification that executive officers typically include those listed in filings with the Securities and Exchange Commission. We also suggest clarifying who would typically be part of senior management other than the mentioned executive officers noted.

We appreciate the opportunity to express our views for the Board's consideration. If you have any questions or would like to discuss these matters further, please contact Steve Rafferty or Jennifer George at 417.831.7283 or by email at srafferty@bkd.com or jgeorge@bkd.com.

Sincerely,



BKD, LLP



May 25, 2012

EXECUTIVE DIRECTOR

Cynthia M. Fornelli

GOVERNING BOARD

Chairman

Robert E. Moritz, Chairman and Senior Partner
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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

Re: Request for Public Comment: *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards*, PCAOB Rulemaking Docket Matter No. 038

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants (AICPA).

The CAQ appreciates the opportunity to respond and provide our views to the Public Company Accounting Oversight Board (PCAOB or the Board) on its *Proposed Auditing Standard – Related Parties* (Proposed Standard), *Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (Proposed Amendments). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

I. Related Parties Proposed Auditing Standard

We are supportive of the Board's efforts to improve audit quality through enhancements to the extant standard, AU section 334, *Related Parties*, intended to strengthen the auditor's evaluation of a company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. We have identified certain areas where we believe the Proposed Standard could be clarified; these observations are described below for the Board's consideration. In several instances we suggest the Board consider incorporating guidance or examples from the release text in Appendix 4 into the final auditing standard as we believe this may help to drive more consistent application in practice.

Identifying Related Parties and Obtaining an Understanding of Relationships

The introduction and objective in paragraphs 1 and 2 of the Proposed Standard indicate that the auditor should obtain sufficient audit evidence to evaluate whether the company has properly identified, accounted for, and disclosed its relationships and transactions with related parties. Paragraph 3 of the Proposed Standard states that, “The auditor should perform procedures to identify the company’s related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes (or the lack thereof) of the types of transactions involving related parties.” As drafted, paragraph 3 appears inconsistent with paragraphs 1 and 2 and could be read to imply a different level of auditor responsibility. We suggest the Board consider revising the first sentence in paragraph 3 to state, “The auditor should perform procedures to determine whether the company has properly identified its related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes (or the lack thereof) of the types of transactions involving related parties.” This change would result in paragraph 3 being more consistent with paragraphs 1 and 2 as well as with the nature of the audit procedures required in the remainder of the Proposed Standard.

Paragraphs 6 and 7 of the Proposed Standard require the auditor to perform inquiries of both management and others within the company regarding a variety of matters pertaining to related parties or relationships or transactions with related parties. Paragraph 6 sets forth the specific inquiries that are to be made. The CAQ suggests the Board consider adding “as appropriate” to the first sentence of both paragraphs 6 and 7 to allow for the exercise of auditor judgment in determining whether all, or only some, of the inquiries set forth in paragraph 6 should be made of management and others, as certain matters may not be relevant, given the specific facts and circumstances.

Related Party Transactions Required to be Disclosed or Deemed a Significant Risk

Paragraph 15 of the Proposed Standard states that, “For *each* related party transaction or *type* of related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should...” perform the procedures set forth therein. As drafted, the requirements in paragraph 15 could be interpreted to mean that *all* individual transactions underlying a “type” must be subjected to the procedures described, as opposed to the auditor being able to exercise judgment to determine the extent to which underlying transactions, that are all of a similar type, need to be tested. Page A4-19 of the release text provides additional discussion regarding paragraph 15:

“Accounting principles applicable to the company may allow the aggregation of related party transactions that require disclosure (e.g., by type of related party transaction). In these cases, the auditor would be required to test the compilation and disclosure of these transactions and the extent of the auditor’s testing on the underlying transactions, consistent with the requirements of Auditing Standard No. 13, should be commensurate with the risks of material misstatement.”

We suggest the Board incorporate this discussion into the final auditing standard to clarify the requirement, and more explicitly allow for the exercise of auditor judgment in determining the testing approach for a “type” of related party transaction.

Paragraph 15.d also states that the auditor should, “Perform other procedures as appropriate, depending on the nature of the related party transaction and the related risks of material misstatement, to meet the objective of this standard.” Page A4-20 of the release text provides several examples of other procedures that might be appropriate for the auditor to perform, given the facts and circumstances of the related party relationship or transaction. The CAQ believes that auditors will find these examples helpful in practice and suggests the PCAOB consider incorporating them into the final auditing standard as a supplement to paragraph 15.d.

Previously Undisclosed Related Party Transactions

Paragraph 17 of the Proposed Standard requires that the auditor perform a series of procedures, “if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists...” The CAQ believes this requirement should be modified to more explicitly allow for the exercise of auditor judgment in determining whether a previously undisclosed related party relationship or transaction rises to a level of significance that would warrant the performance of *all* the procedures detailed in paragraph 17. For example, paragraph 17.e requires that any previously undisclosed related party relationship or transaction identified by the auditor should be treated as a significant risk, and that the auditor should perform the procedures required by paragraph 15 of the Proposed Standard. The CAQ believes that in certain circumstances, the auditor might determine that a previously undisclosed related party transaction does not represent a significant risk through the performance of some, but not all of the procedures described in paragraph 17. In such circumstances, treating the transaction as a significant risk in accordance with 17.e, and performing all of the procedures set forth in paragraph 15 would be unnecessary. We believe that providing for auditor judgment in determining the necessary procedures in response to the identification of a previously undisclosed related party or relationship or transaction with a related party would encourage the auditor to perform procedures commensurate with the assessed risks of material misstatement. We believe this approach is consistent with the stated intent of the Board’s risk assessment standards.

Communications with the Audit Committee

As noted in several recent CAQ comment letters to the Board,¹ we believe the audit committee serves an essential role in the corporate governance framework and investor protection. As such, the CAQ strongly supports efforts to promote an effective, two-way dialogue between the auditor and the audit committee. We provide suggestions below for the Board’s consideration on areas where the proposed requirements related to the auditor’s communications with the audit committee could be clarified.

Paragraph 20 of the Proposed Standard states that, “the auditor should communicate to the audit committee, in a timely manner, and prior to the issuance of the auditor’s report, the auditor’s evaluation of the company’s identification of, accounting for, and disclosure of its relationships and transactions with related parties.” The CAQ suggests that the Board include a definition of the term “audit committee” in the final auditing standard consistent with that included in the PCAOB’s *Proposed Auditing Standard Related to Communications with Audit Committees* (Audit Committee Proposal).² We believe this will clarify the Board’s expectation as to whom the auditor is responsible for communicating in circumstances where the company being audited does not have a corporate governance structure that includes a board or audit committee (e.g., some smaller non-issuer brokers and dealers).

¹ See CAQ comment letters in response to *PCAOB Proposed Auditing Standard Related to Communications with Audit Committees* dated February 29, 2012; *PCAOB Concept Release on Auditor Independence and Audit Firm Rotation* dated December 14, 2011; *PCAOB Concept Release on Possible Revisions to the PCAOB Standards Related to Reports on Audited Financial Statements* dated September 30, 2011. Each of these comment letters is available at: <http://www.thecaq.org/resources/commentletters.htm>.

² Appendix A in the Board’s Audit Committee Proposal defines the audit committee as “A committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, the entire board of directors of the company. For audits of non-issuers, if no such committee or board of directors (or equivalent body) exists with respect to the company, those persons designated to oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.”

Paragraph 20 also states that the auditor should communicate to the *full* audit committee prior to the issuance of the auditor's report. Consistent with the CAQ's comment letter on the PCAOB's Audit Committee Proposal, the CAQ suggests that the Board consider removing the word "full" from the Note to paragraph 20 to recognize that not all members of the audit committee must be present in order to achieve a quorum.

II. Proposed Amendments to Auditing Standard No. 12 (AS 12), *Identifying and Assessing Risks of Material Misstatement*

The CAQ is supportive of the Board's efforts to improve audit quality through its Proposed Amendments to AS 12 intended to enhance the auditor's consideration of a company's financial relationships and transactions with its executive officers. We present for the Board's consideration suggestions on areas where we believe the Proposed Amendments could be further clarified.

Executive Officers

Paragraph 10A in the Proposed Amendments sets forth specific procedures for the auditor to perform to obtain an understanding of the company's financial relationships and transactions with its executive officers. An executive officer is defined as, "The president, any vice president of a company in charge of a principal business unit, division, or function...; any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company." We note that the PCAOB has provided additional discussion on page A4-42 of the release text regarding the requirements in paragraph 10A, stating that, "The population for the proposed procedures required by paragraph 10A is the list of executive officers disclosed [by the company] in securities filings or the executive officers included on Schedule A of Form BD." The CAQ suggests that the Board incorporate this discussion into the final amendments to AS 12, so that it is clear in the final amendments that the auditor's responsibility with respect to the procedures set forth in paragraph 10A is limited to performing the specified procedures on the list of executive officers disclosed by the company.

Senior Management

Paragraph 11 of the Proposed Amendments states that one of the procedures that the auditor should perform as part of obtaining an understanding of the company is "...obtaining an understanding of compensation arrangements with senior management other than executive officers referred to in paragraph 10A, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses." The CAQ believes that the Board should consider including in its final amendments to AS 12 a definition of senior management for the purpose of this requirement. As currently drafted, we believe the Proposed Amendments are unclear as to which additional person(s) would comprise senior management beyond the broad definition of executive officers noted above.

Expectation Gap

We have noted several statements in the financial press discussing the PCAOB's release that appear to mischaracterize the Proposed Amendments. These statements suggest that the Proposed Amendments could result in auditors influencing the company's executive pay decision-making and compensation programs based on unacceptable risks of material misstatement. To address this expectation gap, the CAQ suggests that the Board clarify in its final amendments that these new audit requirements are intended solely to enhance the auditor's ability to identify and assess financial reporting risks related to a company's financial relationships and transactions with its executive officers, and are not intended to enable, or result in the auditor having influence over the design of executive compensation programs, or to require the auditor's advance approval of such arrangements.

The CAQ supports the Board's efforts to improve audit quality through its Proposed Standard on related parties and Proposed Amendments to certain PCAOB auditing standards regarding significant unusual transactions and the financial relationships and transactions that a company has with its executive officers. We appreciate the opportunity to comment and welcome the opportunity to respond to any questions regarding the views expressed in this letter.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:

PCAOB

James R. Doty, Chairman
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
Jay D. Hanson, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor and Director of Professional Standards

SEC

Mary L. Schapiro, Chairman
Luis A. Aguilar, Commissioner
Daniel M. Gallagher, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner
James L. Kroeker, Chief Accountant
Paul A. Beswick, Deputy Chief Accountant
Brian T. Croteau, Deputy Chief Accountant
J. W. Mike Starr, Deputy Chief Accountant



CENTER FOR AUDIT QUALITY



Via Email

May 10, 2012

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

Re: Proposed Auditing Standard, Related Parties, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Amendments to PCAOB Auditing Standards (PCAOB Rulemaking Docket Matter No. 038) (Related Parties Proposal)

Dear Office of the Secretary:

I am writing on behalf of the Council of Institutional Investors (Council), a nonprofit association of public, corporate, and union employee benefit plans with combined assets of over \$3 trillion. Member funds are major shareowners with a duty to protect the retirement assets of millions of American workers.¹ The Council appreciates the opportunity to provide input to the Public Company Accounting Oversight Board's (Board) Related Parties Proposal.²

The Council supports the objective of the Related Parties Proposal to "improve the auditor's evaluation of the identification of, accounting for, and disclosure about related parties and significant unusual transactions."³ We generally agree with the Board that improvements in this area are "important to the protection of the interests of investors and to the preparation of informative, accurate, and independent audit reports."⁴

¹ For more information about the Council of Institutional Investors (Council) and its members, please visit the Council's website at <http://www.cii.org/about>.

² Proposed Auditing Standard, *Related Parties*, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Amendments to PCAOB Auditing Standards, PCAOB Release No. 2012-001, PCAOB Rulemaking Docket Matter No. 038 (Feb. 28, 2012), http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2012-001_Related_Parties.pdf [hereinafter Related Parties Proposal].

³ James R. Doty, Chairman, PCAOB, Proposed Auditing Standard on Related Parties and Proposed Amendments on Significant and Unusual Transactions 1 (Feb. 28, 2012), http://pcaobus.org/News/Speech/Pages/02282012_DotyStandard.aspx.

⁴ Related Parties Proposal, *supra* note 2, at 2.

May 10, 2012
Page 2 of 3

We are particularly supportive of the proposed enhancements to the existing requirements of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. As we understand it, those proposed enhancements would require the auditor to perform certain procedures, including the reading of compensation contracts, necessary to obtain an understanding of the company's executive compensation. We generally agree with the Board that those proposed enhancements would likely have a number of important benefits, including:

- “[A]ssist[ing] the auditor in understanding whether such compensation arrangements affect the assessment of the risks of material misstatement,”⁵ and
- “[A]ssist[ing] the auditor in identifying fraud risks.”⁶

We generally believe the proposed enhancements are aligned with the Council's membership approved policies. Those policies have long recognized that executive compensation is a critical aspect of a company's governance.⁷ That view was reaffirmed in connection with the financial crisis.⁸ In evaluating the reasons behind the financial crisis, and proposing potential reforms, the Investors Working Group concluded:

Poorly structured pay plans that rewarded short-term but unsustainable performance encouraged CEOs to pursue risky strategies that hobbled one financial institution after another and tarnished the credibility of U.S. financial markets.⁹

⁵ *Id.* at A4-42. We are reminded that in 2008 the Department of Treasury's Advisory Committee on the Auditing Profession directed two important recommendations to the Public Company Accounting Oversight Board relating to fraud detection and that neither of those recommendations have been adopted. Department of Treasury, Advisory Committee on the Auditing Profession, Final Report VII:1 & VII:13 (Oct. 6, 2008), <http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>. We continue to generally support the adoption of those recommendations.

⁶ Related Parties Proposal, *supra* note 2, at A4-43.

⁷ The Council of Institutional Investors, Corporate Governance Policies § 5.1 Introduction (Last updated Dec. 21, 2011), [http://www.cii.org/UserFiles/file/CII%20Corp%20Gov%20Policies%20Full%20and%20Current%2012-21-11%20FINAL%20\(2\).pdf](http://www.cii.org/UserFiles/file/CII%20Corp%20Gov%20Policies%20Full%20and%20Current%2012-21-11%20FINAL%20(2).pdf) (“The Council believes that executive compensation is a critical and visible aspect of a company's governance.”).

⁸ See, e.g., A Report by the Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective 22 (July 2009), [http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%27%20Working%20Group%20Report%20\(July%202009\).pdf](http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%27%20Working%20Group%20Report%20(July%202009).pdf).

⁹ *Id.*

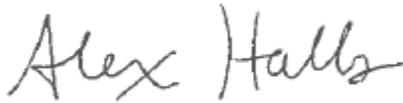
May 10, 2012

Page 3 of 3

It makes sense to us that requiring auditor's to perform additional procedures to obtain a better understanding of perhaps the most critical and visible aspect of a company's governance would, as the Board has concluded, "assist the auditor in identifying and assessing risks associated with a company's financial relationships and transactions with its executive officers, including unrecognized compensation, illegal acts, or other matters" ¹⁰ The result should be higher quality audits that better assist investors in making informed investment decisions, and that improve public confidence in the financial markets. ¹¹ We, therefore, strongly support this provision of the Related Parties Proposal.

The Council again appreciates the opportunity to comment on the Related Parties Proposal. We thank you for considering our views. Please feel free to contact me at 202.261.7088 or alex@cii.org, or the Council's General Counsel Jeff Mahoney at 202.261.7081 or jeff@cii.org with any questions.

Sincerely,



Alex Halls

¹⁰ Related Parties Proposal, *supra* note 2, at A4-44.

¹¹ See generally Council of Institutional Investors, **Statement on Financial Gatekeepers 1** (Apr. 13, 2010), <http://www.cii.org/UserFiles/file/Statement%20on%20Financial%20Gatekeepers.pdf> (noting that auditors, as financial gatekeepers, provide investors with information they need to make informed decisions, and have an impact on public confidence in the markets).



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May 30, 2012

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

**RE: PCAOB Rulemaking Docket Matter No. 038,
 Proposed Auditing Standard, *Related Parties*, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards**

Office of the Secretary:

Crowe Horwath LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) "Proposed Auditing Standard, *Related Parties*, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards" (Proposed Standard or Proposed Amendments, as applicable).

We support the PCAOB's efforts to improve audit quality by enhancing existing auditing standards, and we are pleased to provide our observations regarding possible clarifications to the Proposed Standard and Proposed Amendments.

Proposed Standard, *Related Parties*

Paragraph 15 relates to "each related party transaction, or type of related party transaction, that is either required to be disclosed in the financial statements or determined to be a significant risk"; however, the procedures listed could be interpreted to be applicable to each transaction underlying a "type". A company may engage in many related party transactions in the ordinary course of business that are required to be disclosed but do not represent a significant risk. For example, a financial institution may have numerous retail bank accounts of a given type with related parties on terms identical to the accounts of unrelated parties (and which terms are subject to specific banking regulations). We believe the standard should be more clear regarding the need for auditor judgment in determining the extent to which underlying transactions within a type of transactions must be subjected to the procedures described. Such judgment is consistent with wording contained in Appendix 4, page A4-19, as follows:

"Accounting principles applicable to the company may allow the aggregation of related party transactions that require disclosure (e.g., by type of related party transaction). In these cases, the auditor would be required to test the compilation and disclosure of these transactions and the extent of the auditor's testing on the underlying transactions, consistent with the requirements of Auditing Standard No. 13, should be commensurate with the risks of material misstatement."

We suggest that language similar to that in Appendix 4 be added to paragraph 15 in order to clarify the requirements and allow appropriate auditor judgment in determining the testing approach for a "type" of related party transaction.

Office of the Secretary
 Public Company Accounting Oversight Board
 May 30, 2012
 Page 2

Paragraph 17 contains requirements to be applied to each previously undisclosed related party relationship or transaction, including the requirement to treat the related party transaction as a significant risk and performing the procedures required by paragraph 15. We believe there may be instances where previously undisclosed transactions may be determined to not represent a significant risk without the performance of all the procedures in paragraphs 17 and 15. For example, previously undisclosed transactions may occasionally be over looked by management due simply to their inconsequential nature. We believe paragraph 17 should be clarified to provide for auditor judgment in determining if the previously undisclosed relationship or transaction should be treated as a significant risk, and in determining the extent of procedures necessary to address the risk of material misstatement. We believe this would be consistent with the stated intent of the PCAOB's risk assessment standards.

Paragraph 20 requires the auditor to communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, and other significant matters arising from the audit regarding the company's relationships and transactions with related parties. Since some entities, such as small non-issuer brokers and dealers, do not have an audit committee, we suggest that the standard further clarify the expectations as to with whom the auditor should communicate. This could be accomplished by including a definition of the term "audit committee" consistent with that included in the PCAOB's *Proposed Auditing Standard Related to Communications with Audit Committees*.

Proposed Amendments to Auditing Standard No. 12, *Identifying and Assessing Risk of Material Misstatement*

Paragraph 10A in the Proposed Amendments requires the auditor to perform procedures to obtain an understanding of the financial relationships and transactions with executive officers, and the Proposed Amendments also include a definition of "executive officer." Additional discussion in Appendix 4, page A4-42 states that "the population for the proposed procedures required by paragraph 10A is the list of executive officers disclosed in the securities filing or the executive officers included on Schedule A of Form BD." We believe this Appendix 4 discussion is important since it is inherently a management responsibility to determine those employees empowered as executive officers, and the reporting of these officers in securities filings involves matters of legal interpretation. Accordingly, we suggest that language similar to that in Appendix 4, page A4-42 be incorporated into the final amendments to AS 12 to clarify that it is management's responsibility to designate the executive officers, and the auditor's responsibility under paragraph 10A relates to those officers so designated.

Paragraph 11 includes a requirement to obtain an understanding of compensation arrangements with senior management other than executive officers. While "executive officer" is defined in the Proposed Amendments, there is no definition of "senior management." We suggest that the final amendments be clarified by including a definition of "senior management" for purposes of applying the requirements of paragraph 11.

Crowe Horwath LLP supports the Board's efforts to improve its auditing standards and the reporting for investors. We hope that our comments and observations will assist the Board in its consideration of the matters in the Proposed Standard and Proposed Amendments.

Cordially,



Crowe Horwath LLP



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 1633 Broadway
 New York, New York 10019-6754
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May 31, 2012

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

Re: *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards*

PCAOB Rulemaking Docket Matter No. 038

Deloitte & Touche LLP (“D&T”) is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the “PCAOB” or the “Board”) on its *Proposed Auditing Standard – Related Parties (the “proposed standard”), Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards (the “proposed amendments”)*, PCAOB Release No. 2012-001; PCAOB Rulemaking Docket Matter No. 038 (February 28, 2012).

OVERALL COMMENTS

We support the Board’s efforts to strengthen audit quality by enhancing the auditing standards relating to the auditor’s consideration and evaluation of:

- A Company’s identification of, accounting for, and disclosure of its relationships and transactions with related parties,
- Significant unusual transactions, and
- The other matters addressed in the proposed amendments, including executive compensation.

In responding to the Board’s request for comments on the proposed standard and proposed amendments, we offer the following observations:

Clarity of Requirements and Implementation Guidance. In Appendix 4, the Board provides additional discussion and background information regarding certain of the proposed requirements in the proposed standard and proposed amendments, and discusses the basis for the proposals. In many cases, the discussion in Appendix 4 clarifies a requirement, makes its intended purpose more readily apparent or provides useful implementation guidance. We therefore recommend that the Board incorporate, wherever possible, the additional clarity and implementation guidance included in

Appendix 4 into the final standard and conforming amendments. Included below are some specific recommendations for including material from Appendix 4 into the final standard and conforming amendments. We also encourage the PCAOB to consider whether additional aspects of Appendix 4 should be similarly incorporated into the final standard.

RELATED PARTIES PROPOSED AUDITING STANDARD

1. **Clarity of Requirements and Linkage to Objective.** We agree with the premise that management is responsible for the identification of, accounting for, and disclosure of relationships between a company and its related parties with appropriate oversight by the company’s audit committee. We note that this premise underpins the introductory paragraph of the proposed standard as well as the objective of the auditor described in paragraph 2.

We are, however, concerned that the first sentence of paragraph 3, in requiring the auditor “to perform procedures to identify the company’s related parties” could infer that the auditor is primarily responsible for doing so, thereby holding the auditor to a higher level of responsibility than that described in the introductory paragraph and the overall objective paragraph. We propose that this sentence be modified to be more consistent with the introductory paragraph and the objective as follows:

“The auditor should perform procedures to **evaluate the company’s identification of its** ~~identify the company’s~~ related parties, obtain...”

2. **Performing Inquiries about Related Party Relationships and Transactions.** Paragraphs 6, 7 and 8 of the proposed standard address the auditor’s responsibilities for making inquiries of management, the audit committee, and others within the company, regarding related party relationships and transactions with related parties. The purpose of these inquiries is not clearly apparent from the language of the proposed standard. We observe that the guidance on pages A4-8 and A4-9 of Appendix A is however helpful in explaining their intended purpose. We also observe that some of the requirements do not appear to allow for the appropriate use of auditor judgment in determining the parties most likely to provide the best information, and the nature of the inquiries to be made of each party identified. We believe this will result in inquiries having to be made that would add effort and cost to the audit that might not have a commensurate benefit.

Accordingly, we have the following recommendations:

- a. Incorporate the guidance from A4-8 and A4-9 into the final standard to provide the appropriate context for the auditor’s inquiries.
- b. Include an appropriate qualifier in the first sentence of paragraph 7 (e.g., “as appropriate, and to the extent necessary”) to allow auditors to exercise appropriate professional judgment in making appropriate inquiries to address the risks in this area.

3. **Responding to Related Party Transactions Required to Be Disclosed or Deemed a Significant Risk.** We agree that when performing risk assessment procedures, including making the inquiries of management, the audit committee and any others within the company (in accordance with paragraphs 6-8 of the proposed standard), it is appropriate for risk

assessment procedures and inquiries to encompass all such parties and transactions. However, when the auditor is performing procedures to address risks of material misstatement related to identified related parties or related party transactions, we do not believe that it is necessary, in accordance with the Board’s risk assessment standards¹, to perform procedures on *each* and *every* individual related party transaction, especially transactions that are of a similar type and subject to the same or similar risks of material misstatement. We also note that there is useful implementation guidance in Appendix 4 about how to apply this requirement, and additionally about what kind of additional procedures the auditor might perform. We are concerned that if it remains in the Appendix only, the requirements within the proposed standard itself could be misinterpreted.

Accordingly, we have the following recommendations:

- a. Modify paragraphs 15.a, 15.b and 15.d to incorporate the guidance in Appendix 4 on page A4-19, which discusses how aggregation of similar transactions may be appropriate under the applicable financial reporting framework, thereby providing the auditor the ability to exercise judgment in planning and performing procedures to address “types” of related party transactions.
- b. Incorporate into the final standard the additional guidance in Appendix 4, at pages A4-20 and A4-21, which contains useful information about additional procedures that might be appropriate for the auditor to perform, depending on the nature of the transaction and the risks of material misstatement to the financial statements.

4. Addressing Undisclosed Related Parties and Related Party Transactions. We agree that the identification of previously undisclosed related parties and related party transactions may be indicative of increased risk, and potentially fraud risk, and therefore such identification frequently will warrant increased auditor focus. Paragraph 17 addresses the auditor’s responsibilities in this regard. We observe that, as drafted, paragraph 17 does not however provide the auditor with the ability to exercise judgment in determining whether previously undisclosed related parties and related party transactions are of such significance to warrant the performance of additional procedures, and, if so, which of the procedures enumerated in the bulleted list would be necessary and appropriate in the circumstances. Rather, as proposed, paragraph 17 would require the auditor to perform *all* such procedures in *all* cases, and *all* previously undisclosed related party relationships and transactions would be treated as significant risks (thereby requiring the performance of the additional procedures set forth in paragraph 15). To be consistent with the Board’s risk assessment standards that are premised upon audit responses being tailored to the significance of the risks of material misstatement that they are intended to address, we have the following recommendations:

- a. Revise the requirement in paragraph 17 to make it applicable to “significant” related party relationships or transactions that were not previously disclosed. The use of the term “significant” in this manner would enable the auditor to exercise appropriate judgment in deciding which of the previously undisclosed related party relationships or transactions pose risks of material misstatement to the financial statements, thereby warranting the performance

¹ PCAOB Auditing Standards 8–15.

of the procedures enumerated in the lettered points within paragraph 17.

- b. Amend paragraph 17e to require that the auditor *consider* whether a previously undisclosed related party relationship or transaction poses a significant risk of material misstatement, and, if so, perform the procedures in paragraph 15, i.e., instead of requiring such procedures in *all* cases.

5. Communicating With the Audit Committee. We support open dialogue between the auditor and the audit committee on matters that will better enable the audit committee to exercise their oversight role over a company’s financial reporting. We therefore support the requirements in the proposed standard addressing required auditor communications about related party relationships and transactions. In order to assist with the implementation of these required communications, we have the following observations and recommendations:

- a. As a practical matter, audit committees often find it challenging to have “full” attendance, especially at in-person meetings. Paragraph 20 requires that significant matters be communicated to the full audit committee prior to issuance of the auditor’s report. Some of these matters might be communicated orally as opposed to in writing (i.e., where it is easier to deliver communications to all members of the audit committee), and may also be communicated during in person meetings. We suggest the Board remove the word “full” in order to provide for the situation when a quorum of members is present at a meeting where matters are being discussed, but not necessarily the entire audit committee.
- b. When defining “audit committee” in the proposed standard, we recommend the Board align such definition with the Board’s Proposed Auditing Standard on Communications with Audit Committees to allow for alternative corporate governance structures, such as those in non-issuer brokers and dealers where there might not be a board or audit committee.

PROPOSED AMENDMENTS TO OTHER AUDITING STANDARDS

1. Auditing Significant Unusual Transactions. We agree that significant unusual transactions warrant increased auditor attention due to the possibility of misstatements, whether due to error or fraud. We observe that there is useful implementation guidance included in Appendix 4 about the additional procedures that might be appropriate, depending on the nature of the significant unusual transaction and the risks of material misstatement of the financial statements (page A4-37). Consistent with our comments above, we recommend that this guidance be incorporated into the final amendments to the PCAOB’s risk assessment standards.

2. Understanding Financial Relationships and Transactions with Executive Officers and Senior Management. We agree executive officers may be in a unique position to perpetrate fraud, and that the motivation to do so may be influenced, in part, by their financial relationships and transactions with the company. We are therefore supportive of the Board’s efforts to strengthen audit quality through enhancing the existing requirements relating to understanding financial relationships with senior management and the specific procedures set forth in paragraph 10A of the proposed amendments. We have the following observations and recommendations in this regard:

- Executive officers are defined in paragraph 3 of Appendix A of the proposed amendments; this definition makes reference to the applicable Securities and Exchange Commission Rules (“SEC Rules”) that address the identification of executive officers and contain the

requirements as to what information is required to be disclosed in the company's securities filings.

- Appendix 4 (pages A4-41 and A4-42) specifically notes that, “[t]he population for the proposed procedures required by paragraph 10A is the list of executive officers disclosed [by the company] in securities filings...” This additional discussion makes it clear that it is the company's responsibility to prepare the list of executive officers, and, therefore, that the auditor's responsibilities with respect to the procedures in paragraph 10A of the proposed amendments is limited to the persons included on such list. We therefore recommend that this additional clarification be included in the final amendments. It should be clear that the auditor does not have responsibility for auditing whether the list of executive officers provided by the company complies with the SEC Rules.

* * *

D&T appreciates the opportunity to provide our perspectives on these important topics. Our comments are intended to assist the PCAOB in analyzing the relevant issues and potential impacts. We encourage the PCAOB to engage in active and transparent dialogue with commenters as the proposed standard is evaluated and changes are considered. If you have any questions or would like to discuss these issues further, please contact William Platt at 203-761-3755 or Megan Zietsman at 203-761-3142.

Very truly yours,

Deloitte + Touche LLP

cc: James R. Doty, PCAOB Chairman
 Lewis H. Ferguson, PCAOB Member
 Jeanette M. Franzel, PCAOB Member
 Jay D. Hanson, PCAOB Member
 Steven B. Harris, PCAOB Member
 Martin F. Baumann, PCAOB Chief Auditor and Director of Professional Standards

Mary L. Schapiro, SEC Chairman
 Luis A. Aguilar, SEC Commissioner
 Daniel M. Gallagher, SEC Commissioner
 Troy A. Paredes, SEC Commissioner
 Elisse B. Walter, SEC Commissioner
 James L. Kroeker, SEC Chief Accountant
 Brian T. Croteau, SEC Deputy Chief Accountant



May 31, 2012

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

Re: PCAOB Rulemaking Docket No. 038

Eide Bailly LLP commends the Board's ongoing commitment to the improvement of audit quality and appreciates the opportunity to provide our comments on the PCAOB's proposed standard *Related Parties*, as well as proposed *Amendments to Certain PCAOB Standards Regarding Significant Unusual Transactions* and *Other Proposed Amendments to PCAOB Auditing Standards*. We support the Board's proposed auditing standard and related proposed amendments intended to strengthen the procedures performed by auditors to identify, assess and respond to the risks of material misstatement associated with an issuer's related party transactions and/or significant unusual transactions. We do, however, have the following comments regarding specific items in the proposed standards that we believe warrant further consideration.

Proposed Standard – *Related Parties*

Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties

Paragraph 3 of the proposed standard requires the auditor to perform procedures to identify the company's related parties. We believe that a more appropriate requirement is to have the auditor perform procedures to determine that management has appropriately identified the company's related parties, and that the auditor assesses the risk of the existence of unidentified related parties, and thus related party transactions that may result in a material misstatement of the financial statements and related disclosures.

We believe that the omission of clear linkage to the concept of auditor risk assessment in this requirement may result in an overly burdensome requirement for the auditor to identify, assess and perform audit procedures for all related party transactions, regardless of their materiality and/or risk of material misstatement.

Additionally, we believe that such a change will better align the requirements in paragraph 3 with those in paragraph 16 regarding relationships or transactions with related parties previously undisclosed to the auditor.

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Responding to the Risks of Material Misstatement

Paragraph 15 of the proposed standard establishes specific requirements for “*each* related party transaction, or type of related party transaction, that is either required to be disclosed or determined to be a significant risk”. We believe that this paragraph may be interpreted as a requirement that these procedures be applied to all disclosed related party transactions, regardless of the auditor’s assessment of risk. Accordingly, we recommend that the language in this paragraph be modified so that it is clear that auditor judgment, based upon the auditor’s risk assessment, will be applied in the determination of the nature and scope of procedures to be performed.

Communications with the Audit Committee

Paragraph 20(b) requires communication with the Audit Committee of “the identification of significant related party transactions (i) that have not been authorized or approved in accordance with the company’s established policies or procedures and (ii) for which exceptions to the company’s established policies or procedures were granted”. While we consider this to be an appropriate Audit Committee communication, we are concerned that this implies a level of formality with respect to the authorization or approval of such transactions that does not exist with many smaller issuers, and thus uncertainty for the auditors of those issuers as to their responsibility to assess the issuer’s policies and procedures and the level of communication required.

Also, we believe that all requirements with respect to communications with the Audit Committee should be included within one standard. Accordingly, we suggest that these requirements in paragraph 20 be placed within the Board’s proposed standard, *Communications with Audit Committees*, with cross-references between the two standards included as considered necessary and appropriate.

Proposed Amendments to Certain PCAOB Standards Regarding Significant Unusual Transactions

We do not believe that the standard is clear with respect to the definition of a “significant unusual transaction”. Appendix 4 of the Release indicates that the proposed amendments, specifically those to AU Section 316.66, would “describe significant unusual transactions as significant transactions outside the normal course of business for the company or that otherwise appear to be unusual to their timing, size, or nature.” However, we believe that the proposed amendment to AU Section 316.66 falls short of describing or defining the term as suggested in Appendix 4, and that a clear definition and/or description of this term will assist auditors in achieving the objectives the Board desires for these transactions.

Once again, we appreciate the opportunity to comment on the proposed standard and related amendments. We would be pleased to discuss our comments with the Board or its staff. Please direct any questions on our comments to Brian Bluhm, Director of Assurance Services, at 612.253.6590.

Sincerely,



Eide Bailly LLP

June 19, 2012

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

Re: PCAOB Rulemaking docket matter No.38: Proposed Auditing Standard Related to Related Parties; Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions; and Other Proposed Amendments to PCAOB Auditing Standards

Dear Board Members:

Eli Lilly and Company (“Lilly”) appreciates the opportunity to comment to the Public Company Accounting Oversight Board (“PCAOB”) on the PCAOB Release No. 2012-001, Proposed Auditing Standard Related to Related Parties; Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions; and Other Proposed Amendments to PCAOB Auditing Standards (the “Proposed Standard”). Lilly is a large, multinational pharmaceutical company, with presence in over 50 country jurisdictions, and creates and delivers innovative medicines that enable people to live longer, healthier, and more active lives.

Lilly supports the Proposed Standard’s objectives to strengthen existing audit procedures for identifying, assessing, and responding to the risks of material misstatement associated with a company’s related party transactions. We generally agree that the proposed amendments improve the audit requirements related party transactions. However, we are concerned regarding the extent of the auditor requirements related to executive compensation. The Proposed Standard requires the auditor to obtain an understanding of the company’s financial relationships and transactions with its executive officers. The Proposed Standard requires that the procedures should be designed to identify risks of material misstatement, and be sufficient to identify whether these financial relationships and transactions could create conditions (e.g. incentives and pressures) that result in risks of material misstatement, including fraud risks. These procedures include, but are not limited to, reading employment contracts, compensation contracts, proxy statements, other relevant company filings with the SEC or other regulatory agencies that relate to the company’s financial relationships with its executive officers and other employee agreements.

We agree with the PCAOB that it is important for the auditor to understand the company’s financial relationships with its executive officers and for the auditor to consider the risk to the audit. We also understand that there are incentives and pressures for executive officers to meet financial targets and that such incentives and pressures can result from executive compensation arrangements that are linked to company performance. However, we are concerned with the extent of the required audit procedures in the Proposed Standard and the potential unintended consequences of the auditors focus on executive compensation plans.

We believe that the proposed procedures are generally too broad and could potentially be interpreted by auditors that performance based compensation arrangements with executive officers will needed to be substantively audited which is a significantly different perspective than assessing an area for risk. The proposed procedures for a large multinational company would require a significant amount of time

and effort. We are concerned that requiring these procedures for all companies regardless of risk and professional judgment would not be cost beneficial for identifying areas of potential fraud or financial statement misstatement. While we agree that the executive compensation plans should be considered for risk, we believe the required procedures should be narrowed to require the auditors to review the proxy to understand the executive compensation plans and assess the risk to the audit. The auditors should first determine that a significant risk to the financial statement exists prior to performing extended substantive auditing procedures related to executive compensation arrangements.

In addition, we believe there may be unintended consequences by requiring too many audit procedures over executive compensation, such as the auditor's unintentionally influencing the design of the executive compensation structure. Companies may structure executive compensation arrangements to avoid potential issues related to auditor required procedures or to comply with auditor recommendations. The changes to executive compensation arrangements may not be in the best interest of the company from an overall perspective but may provide an appearance of lowering risk. We do not believe this is the role of the auditor as there are many others that have the responsibility to oversee executive compensation such as the board of directors, compensation committee, audit committee, etc.

Again, Lilly supports the PCAOB's efforts to improve the audit procedures related to related party transactions. However, we believe it is critical to focus the audit procedures on the areas of significant risk and are specifically concerned with the proposed expansion of required procedures related to executive compensation. We believe there are greater areas of exposure related to relationships with executive officers, such as supplier or customer relationships, that outweigh the risks of executive compensation. In addition, the auditors already have audit procedures regarding the risk of executive compensation and these additional procedures do not add a significant amount of additional benefit for the additional cost of performing them given that procedures are already being performed. We believe that the required procedures should be narrowed to focus the procedures to maximize the benefits from a risk perspective and limit the unintended consequences. In addition, the related party procedures should focus the requirements on the areas of greatest risk.

We appreciate the opportunity to express our views and concerns regarding the Proposed Standard. If you have any questions regarding our response, or would like to discuss our comments further, please call me at (317) 276-2024.

Sincerely,

ELI LILLY AND COMPANY

/s/Arnold C. Hanish

Arnold C. Hanish
Vice President, Finance and
Chief Accounting Officer



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31 May 2012

Ms. Phoebe W. Brown, Secretary
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

PCAOB Rulemaking Docket Matter No. 038 - 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 Ms. Brown:

Ernst & Young LLP (EY) is pleased to submit comments on the Public Company Accounting Oversight Board's (PCAOB or Board) proposed auditing standard - related parties, proposed amendments to certain PCAOB auditing standards regarding significant unusual transactions and other proposed amendments to PCAOB auditing standards (the Proposal). We support the Board's efforts to update its interim standards and believe that updating the requirements of AU Section 334, *Related Parties*, and adopting other proposed amendments have the potential to improve audit quality. However, we have some concerns with certain aspects of the Proposal that are addressed below.

Fraud risk and related party transactions

The Proposal could be read to create a presumption that all related party transactions are indicative of significant risks. This is in contrast to paragraph 2 of International Standard on Auditing No. 550 (ISA 550), which refers to transactions with related parties as transactions that *might* lead the auditor to identify a significant risk (or fraud risk) based on the transaction. ISA 550 also states that many related party transactions occur in the normal course of business and, in such circumstances, they may not carry a higher risk of material misstatement than similar transactions with unrelated parties. We do not believe that there should be a presumption that all related party transactions represent significant risks. To provide this helpful context, we recommend that the Board include a statement similar to paragraph 2 of ISA 550 as a note to paragraph 3 or 4 of the Proposal. We believe that this view is consistent with the intent of the Board's risk assessment standards.

In addition, we believe that the addition of footnote 4 to paragraph 3 of the Proposal creates an implication that all related party transactions represent transactions for which lesser amounts than the materiality level for the financial statements taken as a whole would influence the judgment of a reasonable investor. Depending on the facts and circumstances, this may be the case for certain related party transactions. However, we do not believe that it is the case for *all* related party transactions. Because Auditing Standard No. 11, *Consideration of materiality in planning and performing an audit* (AS11), applies to the audit as a whole, we believe that the footnote reference to AS 11 in paragraph 3 of the Proposal is unnecessary and could be misleading. We recommend that the

Board remove footnote 4.

Related party transactions previously undisclosed to the auditor

We recommend that the Board include appropriate thresholds for applying procedures to relationships or transactions with related parties previously undisclosed to the auditor. As the proposed standard is written, we believe that the procedures in paragraphs 16 and 17 of the Proposal would apply to *all* related party relationships or transactions previously undisclosed to the auditor. As discussed above, we do not believe that all related party transactions should be considered significant risks. We believe that auditors should be required to evaluate the risk of material misstatement related to any related parties or related party transactions previously undisclosed to the auditor. However, we believe the response described in paragraph 17 of the Proposal inappropriately establishes a presumption that such undisclosed related parties or related party transactions are significant risks. We further believe that the audit response to the identification of previously undisclosed related parties or related party transactions should be tailored to the auditor's evaluation of the facts and circumstances.

We recommend that the Board limit the procedures in paragraph 16 to previously undisclosed transactions with related parties that the auditor determines are or may be significant. We also recommend that the Board delete paragraph 17.e. and include it as a note to paragraph 17.d. (i.e., the auditor would be required to perform the procedures required by paragraph 15 only if the auditor determined that the undisclosed transactions represented a significant risk). This would be consistent with the requirements in paragraph 15 of the Proposal and the application of Accounting Standards Codification Section 850, *Related Party Disclosures* (ASC 850).

Interaction of certain requirements with the accounting framework

While we appreciate the Board's intent to strengthen its standards in the area of related party transactions, we believe that the substance-over-form issues discussed in Appendix 4 of the Proposal¹ are issues that have been addressed by the accounting standard setters. In fact, there are a number of transactions that are, under US GAAP, accounted for based on their legal form. ASC 850 provides requirements related to management's disclosure of transactions with related parties. It does not provide requirements related to recognition or measurement of transactions with related parties, and the accounting for related party transactions often does not differ from the accounting for transactions with third parties.

We urge the Board to work within the parameters established by accounting standard setters and to avoid any requirements that could alter the accounting for related party transactions, some of which are appropriately accounted for based on their legal form. We are concerned that some of the language in Appendix 4 could result in auditors being required to challenge the appropriateness of the accounting standards. While we have not commented on changes to Appendix 4 that we think would be appropriate, we believe the following two suggested changes may reduce the likelihood of any possible misconception about accounting requirements for related party transactions. We recommend

¹ See, for example, pages A4-6, A4-13 and A4-26 of the Proposal.

these changes because we believe that the Board's risk assessment standards² and Auditing Standard No. 5, *An Audit of Internal Control that is Integrated with an Audit of Financial Statements*, provide an appropriate framework to identify and assess risks of material misstatement for all significant accounts, and that it is not necessary to separately identify related party transactions for purposes of risk assessment.

1. We recommend the following revision to paragraph 5.c.:

~~Account for and~~ Disclose relationships and transactions with related parties in the financial statements.

2. We recommend the following revision to paragraph 12:

~~The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. This includes identifying and assessing the risks of material misstatement associated to with related party parties and relationships and transactions with related parties. disclosures.~~

Requirement to perform other procedures to meet the objective of the standard

The requirement in paragraph 15.d. of the Proposal is for the auditor to “perform other procedures as appropriate, depending on the nature of the related party transaction and the related risks of material misstatement, to meet the objective of the standard.” To our knowledge, this is the first time that such an open-ended requirement has been included in one of the Board's auditing standards, and we encourage the Board to be more specific about the procedures that would be required. We are concerned that without clarity, such a requirement will be very difficult to meet and could result in additional and potentially unnecessary work being undertaken to avoid risk of subsequent regulatory or legal challenges to the sufficiency of audit procedures. We believe that the Board should be explicit about what additional procedures would be required to meet the Proposal's objective. The Proposal's objective provides context for understanding the requirements in the standard. However, the way paragraph 15.d. is currently written does not provide the auditor with a clear understanding of what other procedures would need to be performed to meet the objectives of the Proposal.

Evaluating financial statement accounting and disclosure

We are concerned that the requirement in paragraph 18 of the Proposal could be misleading regarding the auditor's responsibility for evaluating the fair presentation of the financial statements. While the auditor may conclude that the financial statements are materially misstated based on a missing or incomplete related party disclosure, we believe that such an evaluation is complex and must be made based on individual facts and circumstances. We do not believe that auditors are responsible for evaluating the fair presentation of related party transactions in isolation. Rather, we believe that auditors are responsible for evaluating whether the financial statements are presented fairly in all

² See Auditing Standards Nos. 8-12.

material respects, in conformity with the financial reporting framework. The second sentence of paragraph 18 implies that the auditor's evaluation of the fair presentation of the financial statements occurs in a piecemeal fashion and that we evaluate individual disclosures in isolation, which is not the case.

We recommend the following revision to paragraph 18:

The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable ~~whether the financial statements are presented fairly, in all material respects, in conformity with the applicable~~ financial reporting framework, including the appropriate disclosure of related parties and related party transactions. This includes evaluating whether the financial statements contain the information regarding related party transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

Definition of "executive officer"

Proposed paragraph 10A to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (AS 12) (at A3-1), would require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers and to identify risks of material misstatements that relate to such relationships and transactions. The term "executive officer" would be defined in paragraph 3A to Appendix A of AS 12 using the Securities and Exchange Commission's (SEC) definition of executive officer. Further, Appendix 4 states that the population for which the proposed procedures would apply would be the list of executive officers disclosed in the company's filings with the SEC.

We are concerned that, over time, including the definition of executive officer in AS 12 will lead to an interpretation that auditors are responsible for auditing the completeness of the company's list of executive officers as determined in accordance with securities law. We believe this is a legal determination. We recommend that the Board amend the definition of executive officer to read, "The list of executive officers determined by the issuer or broker or dealer as included in their respective filings with the Securities and Exchange Commission."

Requirements related to the company's financial relationships and transactions with its executive officers

We recommend that the Board clarify its intent regarding the proposed requirements related to transactions with executive officers. We do not believe that the proposed procedures are intended to influence the design of executive compensation programs or to call into question the policies and procedures that companies have in place to direct executive compensation decision making. However, some have raised concerns that the Proposal would require the auditor to evaluate executive compensation arrangements, including whether the level of risk associated with the arrangements is appropriate. We understand that this is not the Board's intent and we do not read the Proposal in this manner, but we believe that it would be helpful for the Board to clarify its position in its adopting release.

Use of release text

We believe that it is important for the Board to provide insights into both its deliberations when drafting the standards and its rationale for creating the requirements in the standard in its proposing and adopting releases. The release text in Appendix 4 of the Proposal, in most cases, simply repeats the information provided in Appendices 1, 2 and 3 without further background, rationale or other explanation. Additional insight into the Board's considerations would help us provide meaningful comments to the Board and could help auditors execute audits in a manner consistent with the Board's expectations, thus supporting the performance of high quality audits.

To further enhance the usefulness of the Board's future standards, we also recommend that the Board consider including certain examples from the release text (Appendix 4) in the standards themselves. These examples would be helpful to auditors and we believe they would improve audit quality. Including these examples in the final audit standard would provide the auditor with ideas about how to apply the requirements without the need to find the original release text, which, in most cases, does not appear with the final standard on the Board's website. Some examples in Appendix 4 that we believe would be helpful to include in this Proposal are:

- ▶ Examples of matters regarding related parties that the engagement team might discuss
- ▶ Examples of when, in evaluating the management's and others' responses to inquiries, the auditor could take into account information obtained from different sources
- ▶ Examples of other procedures that might be appropriate for the auditor to perform, depending on the nature of the transaction and the risks of material misstatement to the financial statements

We do not believe that including examples in audit standards should necessitate those examples becoming performance requirements (i.e., "should" statements). Given the nature of the examples, they cannot capture all possible facts and circumstances. However, we believe they provide valuable context about considerations in the design and execution of specific audit procedures.

Gaining an understanding of "significant unusual transactions"

We would like to highlight an area of possible future misunderstanding in proposed paragraph 66A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Management does not have a term that is equivalent to "significant unusual transaction" in its literature (i.e., the applicable accounting framework, COSO or SEC management guidance). Transactions that are identified by the auditor as "significant unusual transactions" will likely be those transactions that management views as the result of its non-routine or estimation processes. Management's processes and related controls may not be different for "significant unusual transactions" than for other similar transactions. It may be helpful for the Board to clarify this point in a note to proposed paragraph 66A to limit any future misunderstandings between the auditor and management.

Additional comments

1. We recommend that the Board delete the phrase "(or the lack thereof)" from paragraphs 3,



6.d. and 15.a. of the Proposal. We understand the Board's intent in adding this concept to the performance requirements and agree that we should be aware of the possibility that transactions with related parties may not have a business purpose. However, we do not believe that the requirements as enumerated in the Proposal (i.e., inquiry and reading of documents to understand the business purpose of transactions) will provide the auditor with evidence about a lack of business purpose.

We acknowledge that similar language is included in paragraph 23 of ISA 550. However, ISA 550 includes the concept of a transaction lacking a business purpose in the context of the auditor's evaluation of significant related party transactions outside the normal course of business. We believe that the term is appropriate in this context and we would not object to the Board including a requirement for the auditor to evaluate, using information obtained through the performance of the auditor's procedures, the business purpose (or lack thereof) for identified significant related party transactions outside the normal course of business. We do not believe that the Proposal's inclusion of the phrase "(or lack thereof)" accomplishes the Board's intent.

2. We recommend that the Board not amend paragraph 6.l of AU Sec. 333, *Management Representations* (AU 333), because the proposed additional language would duplicate the language of proposed paragraph 11A to AU 333.
3. Page 30 of Appendix 4 of the Proposal mentions that a significant unusual transaction does not necessarily need to occur infrequently and that the transaction can occur quarterly or more frequently. We suggest that the Board provide examples of situations that would not occur infrequently and nonetheless be considered significant unusual transactions. This would help auditors apply the requirements of the standard as the Board intends.

* * * * *

We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

Ernst & Young LLP



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

15 May 2012

Ref.: AUD/PRJ/HBL/LAN/SHA

Dear Sir or Madam,

Re: FEE Comments on PCAOB Rulemaking Docket Matter No. 038 - Proposed Auditing Standard on Related Parties - Proposed Amendments to Certain PCAOB Auditing Standards regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards

FEE (the Federation of European Accountants) is pleased to provide you with its comments on the PCAOB Rulemaking Docket Matter No. 038 - Proposed Auditing Standard on Related Parties - Proposed Amendments to Certain PCAOB Auditing Standards regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards.

Our general comments on the issues raised in the PCAOB proposed standard that are relevant from a European or international perspective are set out in the appendix attached and can be summarised as follows:

1. In general, FEE believes that alignment in auditing standards worldwide, to the maximum degree possible, is beneficial for capital market participants with cross-border interests and global activities. The new proposed standard on related parties introduces a closer alignment with the equivalent ISA issued by the IAASB. However, differences remain as displayed in the comparative analysis. Given that related parties often have cross-border elements in large companies, FEE believes that differences in audit standards regarding the audit of related parties should be kept to a minimum with differences only arising from specific national requirements.
2. It would be appropriate to explicitly include fraud risk in the objective of an audit standard on related parties.
3. Throughout the standard, it should be highlighted that the responsibility to identify related parties is the one of the company in line with the objective of the standard, and not of the auditor.
4. A true two-way communication between the auditor and the audit committee regarding related parties should be further highlighted. This additional focus on two-way communication in a PCAOB audit standard would give due consideration to a global solution on the matter, in light of the current European debate on strengthening the role of audit committees and the communication between the auditor and the audit committee.



For further information on this FEE¹ letter, please contact Lotte Andersen at +32 2 285 40 80 or via email at lotte.andersen@fee.be from the FEE Secretariat.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Philip Johnson', followed by a long, horizontal, slightly wavy line extending to the right.

Philip Johnson
President

¹ FEE is the Fédération des Experts comptables Européens (Federation of European Accountants). It represents 45 professional institutes of accountants and auditors from 33 European countries, including all of the 27 European Union (EU) Member States. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 700.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent and sustainable European economy. FEE's objectives are:

- To promote and advance the interests of the European accountancy profession in the broadest sense recognising the public interest in the work of the profession;
- To work towards the enhancement, harmonisation and liberalisation of the practice and regulation of accountancy, statutory audit and financial reporting in Europe in both the public and private sector, taking account of developments at a worldwide level and, where necessary, promoting and defending specific European interests;
- To promote co-operation among the professional accountancy bodies in Europe in relation to issues of common interest in both the public and private sector;
- To identify developments that may have an impact on the practice of accountancy, statutory audit and financial reporting at an early stage, to advise Member Bodies of such developments and, in conjunction with Member Bodies, to seek to influence the outcome;
- To be the sole representative and consultative organisation of the European accountancy profession in relation to the EU institutions;
- To represent the European accountancy profession at the international level.

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Association Internationale reconnue par Arrêté Royal en date du 30 décembre 1986



Appendix: Responses to the specific questions

International alignment

International alignment of auditing standards enhances the quality of audits based on globally accepted auditing standards at national level, including the acceptance of audit reports beyond home jurisdictions. In addition, aligning requirements worldwide regarding communication with audit committees facilitates the participation of non-national members in audit committees which is a corporate governance consideration that multinational companies face.

The new proposed standard on related parties introduces a closer alignment with the equivalent ISA issued by the IAASB. In this context, FEE welcomes the comparison between the proposed standard and the ISAs included in Appendix 5. Currently, this appendix is mainly descriptive with references to the requirements in each set of standards. Although the comparison with equivalent ISAs is useful, it would be beneficial to users if the PCAOB provided detailed comments as to why the PCAOB believes that specific differences remain necessary. Given that related parties often have cross-border elements in large companies, FEE believes that differences in audit standards regarding the audit of related parties should be kept to a minimum with differences only arising from specific national requirements.

In future projects, increased transparency regarding the standard setting process would facilitate those commenting on the proposals performing an analysis of the proposals as well as the application of the PCAOB audit standards by auditors of multinational companies that normally operate in an ISA environment. This would altogether lead to higher quality standards. Such transparency could be achieved by providing markup texts of the proposals and through providing further arguments as to why the amendments proposed would lead to higher audit quality. In this context, it should be borne in mind that higher audit quality is only achieved through changing of behaviour by auditors, which is not necessarily achieved by setting standards, but through their application.

Appendix 4 is quite extensive and could benefit from having more concise conclusions that clearly set out the reasons for the decision to amend a specific provision. With these amendments to Appendix 4, FEE recommends that it is published as a “Basis for Conclusions”. Such Basis for Conclusions is found very useful in practice, as acknowledged by other standard setters, such as the IASB and the IAASB.

Framework neutral approach and need for definitions (paragraphs 1 and 18) – Questions 1 and 10

The proposed standard does not contain any specific definitions, but refers in footnote 1 of paragraph 1 to the relevant requirements of the US Securities and Exchange Commission (SEC) for the company under audit.

It would be clearer if this reference to SEC requirements in footnote 1 is replaced by a reference to “*Applicable financial reporting framework*” similar to the approach used in paragraph 18. Such a



reference highlights that financial statements audited in accordance with PCAOB audit standards can be prepared under other financial reporting frameworks besides US GAAP. Furthermore, this would be aligned with current practice, as the current PCAOB audit standard AU 334 *Related Parties*, refers to other frameworks, including IFRS, as referred to in footnote 3 of Appendix 4.

As financial statements in the US audited in accordance with PCAOB audit standards, at some point in the future, may be prepared in accordance with other financial reporting frameworks than US GAAP, FEE recommends that footnote 1 is transformed into an explicit definition of “Related parties”. This definition should preferably refer to “Applicable financial reporting framework” in addition to US GAAP. This would align footnote 1 with the proposed paragraph 18 and would facilitate the applicability of the standard². It would also entail that the audit standard on related parties is sustainable, given future changes in the applicable financial reporting framework.

Objective and fraud risk (paragraph 2) – Question 2

The objective of the proposed standard on related parties does not refer to fraud risk. Since fraud by related parties can be viewed as a major risk factor, FEE believes that it would be appropriate to explicitly include fraud risk in the objective of an audit standard on related parties.

Auditor responsibility for identification of related parties (paragraphs 3-5) – Question 3

According to paragraph 3, the auditor is required to “... *perform procedures to identify the company’s related parties ...*” (emphasis added). A similar approach appears in paragraph 4 and in paragraph 20 in relation to communication with the audit committee.

However, according to the objective of the standard (which is similar to the requirement regarding “... *obtaining an understanding of the internal control ...*” in paragraph 5), it is under the responsibility of the company to identify related parties. The task of the auditor is subsequently to assess whether the related parties have been appropriately identified by the company. This assigns the requirement for identification of related parties to the company and not to the auditor.

FEE finds that the requirement to identify related parties should be on the company in line with the objective in paragraph 2. Furthermore, the requirement should refer to the internal control systems of the company in relation to identification of related parties. The auditor is subsequently, as required by the last sentence of paragraph 3 required to assess the risk of material misstatement for non-identified related parties. Therefore, the first part of the first sentence in paragraph 3 with a corresponding amendment in paragraph 4 should appropriately read:

“The auditor should perform procedures to assess whether the company’s internal control systems have appropriately identified related parties, ...”

² Inspiration for such a definition can be found in the equivalent international standard, ISA 550 Related Parties, paragraph 10 (b).



Audit procedures and examples in Appendix A (paragraph 11) – Question 5

Paragraph 11 requires the auditor to “... *evaluate whether information that comes to the auditor’s attention during the audit indicates ...*”. Examples of such information are included in Appendix A with lists of sources of information in paragraphs A2 and A3.

Appendix A appears to be quite prescriptive. A more principles-based approach in line with the common risk-based audit involving professional judgement is preferable. FEE understands the requirement in paragraph 11 combined with the examples in Appendix A in the way that the auditor is to assess these sources of information if reviewed during an audit, but not if these documents are considered as not relevant to the audit in question. It may be beneficial to clarify that there is a threshold for what kind of information or transaction the auditor is expected to act upon in this way.

Intercompany account balances (paragraph 14)

Paragraph 14 refers to audit procedures regarding intercompany account balances, but does not specify which procedures.

FEE recommends that the paragraph explicitly states that the audit procedures performed should ensure that the intercompany account balances are appropriately reconciled by the company.

Financial capability of related parties (paragraph 15)

Paragraph 15 (c) requires the auditor to “...*evaluate the financial capability of the related parties with respect to significant uncollected balances, ...*”. An identical requirement has been proposed as an amendment to the audit standard on “Considerations of Fraud in Financial statements”.

It should be made clearer what threshold “significant” refers to, especially whether it is just in respect of material balances.

Procedures regarding undisclosed related parties (paragraphs 16-17) – Questions 11-12

The split between paragraphs 16 and 17 is not clear, as paragraph 17 contains the procedures mentioned in paragraph 16. The two paragraphs could therefore be merged. In addition, paragraph 17 (e) makes reference to the fact that all related parties that have been identified by the auditor and not by management should be treated as a significant risk. FEE believes that there should be some assessment of these related party transactions to ensure that they are not clearly immaterial and thus do not need to be assessed any further.



Communication with the audit committee (paragraph 20) – Question 15

The requirements regarding communication with the audit committee are in our view appropriate.

Communication with the audit committee is in paragraph 8 proposed to take place during the planning phase of the audit. However, given the current European debate on strengthening the role of audit committees and the communication between the auditor and the audit committee, which also is being debated by the PCAOB, FEE recommends that a true two-way communication between the auditor and the audit committee is further highlighted. This is also mentioned in our response to the active PCAOB project on Communications with Audit Committees.

Such additional highlighting could be done through the use of the terminology “ ... communicate with ...” instead of “... communicate to ...”, but also by adding a “Note” in paragraph 20 highlighting the need for two-way communication between the auditor and the audit committee regarding the issue of related parties.

Audit standard on related parties to change the audit report – Question 16

FEE believes that any requirements regarding the content of the audit report should be addressed in the standard on audit reports.

As mentioned in previous consultations, FEE supports the current PCAOB initiative to improve the communicative value of the audit report and believes that all aspects of the future content of the audit report should be addressed together in that project. It is essential, given the political focus that audit and audit reports attract at the moment, in particular in Europe, to achieve coherent and sustainable responses to the criticism expressed on the current structure and content of the audit report. Therefore, FEE does not find it appropriate to consider piecemeal amendments to the content of the audit report in separate active PCAOB projects, but would instead encourage the PCAOB to develop an overall strategy for its standard setting activities resulting in an appropriate split between the various projects.



May 17, 2012

VIA ELECTRONIC MAIL

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, NW
Washington, D.C. 20006

Re: PCAOB Rulemaking Docket Matter No. 038 (Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards)

Dear PCOAB:

I appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) proposed rules, **Docket Matter No. 038 (Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards)**. I am an experienced auditor of subsidiaries of public companies subject to PCAOB standards and rules and an auditor of referring broker dealers that are not public companies that will be subject to PCAOB standards and rules. I believe my experience as a broker dealer auditor, as well as my experience as a bank auditor, auditor of subsidiaries of public companies and committee member of our state society of CPA's Banking and Stock Brokerage Committees allow me to bring a useful perspective.

Please note that all comments are those of the undersigned, Howard Gluckman, C.P.A., and do not represent any opinion of my firm or any other individual members or employees or consultants of my firm, Metis Group Certified Public Accountants LLC.

I support the Board's efforts in proposing these rules and I find them generally well thought, well written and clear. I generally do not support additional clarifications, which could limit the professional judgment necessary to comply with the standards and unnecessarily increase the cost, especially to smaller reporting entities. Current auditing standards should suffice for any qualified auditor. Under current standards an auditor is required to and will investigate all significant related party transactions and discuss them with management and the audit committee, as deemed appropriate in the circumstances.

May 17, 2012

Public Company Accounting Oversight Board

Re: PCAOB Rulemaking Docket Matter No. 038

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I therefore find that some of the positions can only bring additional steps that will lead to additional auditor hours and costs when they would not add to the quality of the audit engagement or its conclusions or public safety in reporting.

I respectfully request the Board to consider the following suggestions before finalizing the rules.

1. The proposed standard requires the auditor to communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. An auditor currently reports to an audit committee his audit findings from the audit of the financial statements as a whole, any reportable conditions, and internal control reporting under SOX, if applicable. If the company has an adequate system of internal control, already being reported upon and audited in connection with SOX and/or the SEC, that system should and will cover related party transactions. If not, the auditor would currently be required to report to the audit committee such a deficiency, which by definition would be significant. If an auditor has any comments about how the company handles and reports on related party transactions, they appear to be covered by the current auditing standards and reporting requirements to audit committees.

This proposal seems to establish a new separate report of "the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationship and transactions with related parties." I would assume the auditor will have to set up a separate audit program, work papers, partner review, and second partner review for this new reporting requirement. Clearly there also will have to be a separate fee for this work.

The proposal does not appear to have any waiver for non-significant or immaterial items. A lot of companies, especially subsidiaries of a group, have related party transactions that are handled properly, and are reported satisfactorily whether the amounts are material or not. There may be no need to discuss such cases with an audit committee or prepare a special audit program/procedure and special report. This proposal seems to require a separate program and separate reporting to the audit committee in even such a case.

I believe the proposal should have a waiver for execution, preparation and issuance of this audit report to the audit committee and specific communication to the audit committee, when the related party transactions are either already well known and discussed, not unusual in their nature, or not material or significant. When there is no risk of misleading financial statements, why add new requirements which will waste valuable time and resources?

May 17, 2012

Public Company Accounting Oversight Board

Re: PCAOB Rulemaking Docket Matter No. 038

Page 3 of 3

2. The proposed standard would amend AU sec. 333.06 for audits and interim reviews to require that the auditor obtain written representations from management indicating that management has disclosed to the auditor the names of all of the company's related parties and all relationships and transactions with related parties. The proposed standard also would amend AU 333.06 to require the auditor to obtain a written representation from management that there are no side arrangements or other arrangement (either written or oral) undisclosed to the auditor. The current AU 333 already requires the auditor obtain written representation from management that related party transactions have been properly recorded and disclosed in the financial statements. The additional mention specifically of "the names of all of the company's related parties and all relationships and transactions with related parties" only seem to imply that this is more important than other significant parts of audit information the auditor must obtain from management. Obviously, the auditor cannot evaluate related party transactions without knowing who the related parties are, as well as the various possible relationships. This line of reasoning by the PCAOB can lead to a requirement that the management representation letter include statements that the auditor was supplied the names of all banks dealing with the company, the names of all lenders, the names of all significant customers, the names of all executives, etc. Because without the auditor having all that information accurately supplied by management too, the auditor cannot properly perform the audit, and there is a risk of material misstatement. Continue this line of reasoning and the management representation letter will become a book. It is already difficult for management to understand all the implications of the current management representation letter.

The proposal lacks a definition of what is meant by "side arrangements or other arrangement" for this specific representation from management to have sufficient usefulness. Again, if management cannot clearly understand what they are representing, what value is that? We will only end up with management testifying in some future court proceeding that they signed the management representation letter, but really no one knows what it all means.

I thank you again for the opportunity to offer my thoughts on the proposal. I would be happy to discuss any of these matters. You can reach me at 212-643-0099 extension 242 or by email at hgluckman@metisgrouppllc.com.

Respectfully submitted,

HGluckman

Howard Gluckman, C.P.A.



May 31, 2012

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Re: PCAOB Rulemaking Docket Matter No. 38, *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 Board Members and Staff:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards*. Due to the significance to investors of investee relationships and transactions with related parties and those with executive officers and the importance of appropriately considering significant unusual transactions, we support strengthening PCAOB standards related to these matters and respectfully submit our comments and recommendations on the Board's proposals.

Overall, we agree with the broad objective for the auditor to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements based on the applicable financial reporting framework (a framework neutral approach). We have some concerns, however, with the clarity of the supporting requirements to identify related parties, obtain an understanding of relationships and transactions with related parties, and respond to the risks of material misstatement as set forth in the proposed standard. These concerns are expressed below.

Identifying related parties and understanding relationships and transactions

The proposed standard, in paragraph 3, requires the auditor to "...perform procedures to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes (or the lack thereof) of the types of transactions involving related parties." Because management has the primary responsibility for the financial statements and identifying related party relationships and transactions, we do not fully agree with how this requirement is worded. We are primarily concerned with the statement "the auditor should perform procedures to identify the company's related parties." This statement not only infers that the

auditor has the same responsibility as management, but it also seems contradictory to the objective of the auditor in paragraph 2, which is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements by management. Accordingly, we suggest that the Board modify the requirement so that it properly focuses on the auditor's responsibility to "perform procedures to determine whether management has properly identified the company's related parties" (the completeness assertion).

We also believe that the procedures required by paragraphs 5 through 8 could be better linked to the more general, overarching requirement in paragraph 3 and the identification and assessment of risks in paragraph 12, meaning that the auditor performs the procedures in paragraphs 5 through 8 and any other risk assessment procedures considered appropriate. Ultimately, these procedures support the requirement in paragraph 12 to identify and assess the risks of material misstatement.

Responding to the risks of material misstatement

The proposed standard, in paragraphs 15 and 17, includes fairly prescriptive audit requirements for *each* related party transaction, or *type* of related party transaction, that is either required to be disclosed in the financial statements or determined to be a significant risk and for a previously undisclosed related party or relationship or transaction with a related party. Although we generally agree with the nature of those procedures, we believe that the proposal does not appropriately take into account the auditor's risk assessments for a particular related party or transaction, nor does it seem to allow for the use of professional judgment based on the nature of the related party relationship or transaction. For example, with respect to paragraph 15, we would expect the auditor to perform substantive procedures on material related party transactions or types of transactions; however, the types of procedures to be performed may vary based on the risk of material misstatement due to fraud or error, including consideration of whether the transaction is recurring, complex, or unusual. In this regard, to focus the auditor's attention on areas that pose greater risk of material misstatement, we believe that the Board should consider revising the proposed requirements to differentiate the auditor's responsibilities for related party transactions that are deemed to be significant risks from those that are material but otherwise do not pose such risks. This would allow the auditor's procedures to be commensurate with the identified risks.

Likewise, we are concerned with certain requirements in paragraph 17, which requires the auditor to perform specific procedures if the auditor identifies previously undisclosed related party relationships or transactions. Particularly, paragraph 17e assumes that all previously undisclosed related party transactions are significant risks, requiring the auditor to perform all of the procedures required by paragraph 15 without consideration of the auditor's reassessment of the risk of material misstatement required by paragraph 17g. Accordingly, we request the Board to incorporate paragraph 17e within paragraph 17g, thereby requiring the auditor to determine whether the previously undisclosed related party transaction represents a significant risk for which the procedures in paragraph 15 would then apply. We also suggest that the Board combine the requirements in paragraphs 17b and 17f as well as the requirements in paragraphs

17d and 17g. Combining paragraphs 17b and 17f would provide a better link between understanding why the relationship or transaction was previously undisclosed and the related implications on the auditor's assessment of internal control over financial reporting. Similarly, combining paragraphs 17d and 17g would more clearly indicate that the auditor's reassessment of the risk of material misstatement would need to take into account the need to perform procedures to identify other potential undisclosed relationships.

Understanding relationships and transactions with executive officers

The proposed amendments require auditors to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The purpose of such procedures is to identify conditions that could result in risks of material misstatement, including fraud risks and undisclosed related party relationships and transactions. We support these proposed amendments and have provided specific comments for the Board's consideration below. Nevertheless, we believe that there is a misperception by some that the procedures are intended to influence executive compensation programs, and therefore, we strongly encourage the Board to address this misunderstanding through discussion in the final release or in other communications.

Additional discussion and guidance

Appendix 4 – Additional Discussion of the Proposed Standard and Proposed Amendments and Questions for Public Comment (Appendix 4) provides a detailed discussion of the proposed standard and proposed amendments and includes some additional requirements and additional guidance in the form of suggested procedures. We believe that the discussion assists auditors in understanding the intent of the proposed requirements and that it will be essential to carry forward key matters to the final release. In particular, the additional discussion in Appendix 4 emphasizes the risk of fraud and fair presentation, which are not as prominently discussed in the proposed standard. Appendix 4 also provides several examples of additional procedures that the auditor may perform in certain circumstances. We are very concerned that the Board's construct in setting its standards by excluding essential guidance from those standards hinders an auditor's ability to comply. We encourage the Board to consider this matter in finalizing its proposal and in the development of its codification of the entire body of standards and guidance.

Other comments

The following offers more specific comments related to the proposed standard and the proposed amendments for the Board's consideration.

Paragraph	Comment
Appendix 1 – Proposed Standard, <i>Related Parties</i>	
7	We agree that the auditor should inquire of others within the company regarding relationships and transactions with related parties. We also believe that paragraph 7 appropriately acknowledges that the extent of those inquiries may vary. However, the first sentence in this paragraph requires the auditor to inquire of others regarding the matters in paragraph 6. This can be misconstrued to mean that all inquiries in paragraph 6 are required, but the auditor determines the extent of those inquiries. We believe that all of the inquiries may not apply to all of the individuals listed in paragraph 7.

Paragraph	Comment
8	To corroborate management's responses to the auditor's inquiries in paragraph 6, we propose expanding the inquiries of the audit committee to include the audit committee's understanding of the business reasons or business purposes of significant related party transactions.
11	We understand the purpose of this requirement and agree that the auditor should apply professional scepticism and be aware of information coming to the auditor's attention that contradicts other evidence obtained, including related parties previously undisclosed to the auditor. We question, however, the grammatical accuracy and clarity of the requirement. Information may come to the auditor's attention that requires further evaluation by the auditor. The requirement, however, indicates that the auditor evaluates <i>whether</i> information that comes to the auditor's attention indicates that previously undisclosed matters might exist. This essentially infers a separate evaluation of all information obtained by the auditor. Accordingly, we question the appropriate use of the phrase "evaluate whether" and, in consideration of the requirement in paragraph 16, propose an alternative requirement for the auditor to "remain alert" for information or other conditions that indicate related parties or relationships and transactions with related parties previously undisclosed to the auditor might exist. This would be consistent with the discussion in Appendix 4.
14	Although we recognize that the requirement to perform procedures on intercompany account balances as of concurrent dates is based on an existing requirement, we believe that additional context is necessary to more fully describe the auditor's responsibilities. We believe that the procedures performed by the auditor would depend on the type of account balance, its materiality and whether it is eliminated in consolidation, the requirements of the applicable financial reporting framework, and the risk of material misstatement. We also believe that, when fiscal years differ, testing could be performed at a concurrent interim date; the requirement, as proposed, may be read to infer that testing is required as of period end. Further, it would be helpful to recognize the coordination of activities with other auditors involved in the audit.
19	We believe that the requirement to express a qualified or adverse opinion presumes that the statement by management regarding arm's length transactions is material to the financial statements. The Board may consider clarifying this requirement to include the assessment of materiality to the overall financial statements. In addition, it may also be helpful to indicate the reason why the lack of evidence could result in an adverse opinion, rather than a disclaimer of opinion; that is, generally accepted accounting principles in the United States of America and International Financial Reporting Standards as issued by the International Accounting Standards Board require management to substantiate arm's length representations, resulting in a departure from generally accepted accounting principles. Other foreign accounting frameworks, however, may not be as explicit.
20	This paragraph addresses the auditor's responsibility to communicate certain matters regarding the auditor's evaluation of relationships and transactions with related parties to the audit committee. Although we understand that the primary communication in the first sentence of paragraph 20 is aligned with the scope of the proposed standard in paragraph 1, it is unclear what the Board expects the auditor to communicate beyond the significant matters that are specifically identified. Accordingly, in lieu of the two separate requirements related to these audit committee communications, we suggest that the Board retain the requirement in the second sentence of paragraph 20, while eliminating the first sentence and replacing it with a separate item (e) such as follows "Other significant matters, if any, related to the auditor's evaluation of the company's identification of, accounting for, and disclosures of its relationships and transactions with related parties."
Appendix A	Appendix 4 indicates that an auditor would not be required to review each source of information referenced in Appendix A, but may be required to perform auditing procedures with respect to certain of those sources. We suggest that the Board include this discussion within Appendix A.

Paragraph	Comment
Appendix 2 – Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions	
AU sec. 316 66A(c)	Paragraph 66A requires auditors to design and perform procedures to obtain an understanding of the business purpose (or lack thereof) of each significant unusual transaction. Specifically, paragraph 66A(c) requires an evaluation of the financial capability of the other parties with respect to significant uncollected balances, guarantees, and other obligations, if any. We agree that this is an important auditor consideration, and we also agree with the examples of information that were provided that might be relevant to the auditor's evaluation. We are concerned, however, with situations that may arise in which information related to an unrelated third party is not available for the auditor to make such an evaluation. It would be helpful for the Board to acknowledge such circumstances and the related auditor response. We have the same observation with respect to the requirement in paragraph 15c of the proposed standard.
AU sec. 316 67	Paragraph 67 includes a list of matters that the auditor should evaluate when making an evaluation as to whether the business purpose (or lack thereof) indicates that a significant unusual transaction may have been entered into to engage in fraudulent financial reporting. For the most part, we agree with the matters listed. However, we request the Board to consider whether certain matters should be included within paragraph 66A, which requires the auditor to understand the business purpose (or lack thereof). For instance, to obtain an understanding of the business purpose (or lack thereof) of each significant unusual transaction, we would expect auditors to understand the form and complexity of the transaction, the related and unrelated parties involved and their financial capability, and the economic or commercial substance of the transaction. Such understanding would then influence the auditor's evaluation related to fraud risk, in addition to certain of the other matters listed in paragraph 67
Appendix 3 – Other Proposed Amendments to PCAOB Auditing Standards	
AS 12 11, A3A	It may be possible that executive officers, as defined, and senior management may be the same individuals for certain entities, particularly for non-issuer brokers and dealers. Thus, we believe that it would be helpful to recognize this point within the final standard. Similarly, we note that PCAOB standards are also applied to other types of non-issuer entities, such as those that are subsidiaries of issuers. The definition of executive officer, however, does not seem to fully contemplate the application of PCAOB standards to these non-issuer entities. We believe that understanding compensation arrangements with senior management may be sufficient when performing separate audits of such non-issuer entities.
AU sec. 315 09	We request the Board to reconsider the form of inquiry of the predecessor auditor regarding the company's relationships and transactions with related parties and significant unusual transactions. Because relationships and transactions with related parties and significant unusual transactions should be appropriately reflected and disclosed within the financial statements and because the inquiries in paragraph 09 primarily pertain to the auditor's acceptance of the audit engagement, we believe that any required inquiry of the predecessor auditor could be focused on the predecessor auditor's views related to the risk of fraud related to these matters. The specific inquiries proposed by the Board, however, would be more appropriate during the review of the predecessor's audit documentation.
AU sec. 333 06	We suggest that the Board consider combining the management representations concerning related parties and related party transactions; in particular, those related to arm's-length transactions (subparagraph I and paragraph 11A). We believe that this will help streamline and clarify the auditor's responsibilities.
AU sec. 9543 05	Paragraph 05 is being amended to require the other (component) auditor to inquire of the principal (group) auditor as to matters significant to the audit. First, we believe that the Board should clarify the requirement to indicate that the matters significant to the auditor are those transactions, adjustments, or other matters that have come to the group auditor's attention that may require adjustment to or disclosure in the financial statements of the component. Second, we note that paragraphs 06 and 07 are not being amended; these paragraphs still infer that the inquiry is based on the component auditor's judgment.

Paragraph	Comment
AU sec. 722 24	The amendment to subparagraph g indirectly infers that the auditor should be obtaining the names of all related parties and all relationships and transactions with related parties on a quarterly basis, while there is no equivalent required inquiry of management to do so. Although we recognize that this may be appropriate in an initial review of interim financial information, it may be best to amend paragraph 18(c) to require inquiries of management regarding changes in related parties or significant new related party transactions. The representation itself can then be focused on management's disclosure of such changes to the auditor.

We would be pleased to discuss our letter with you. If you have any questions, please contact Karin A. French, National Managing Partner of Professional Standards, at (312) 602-9160.

Sincerely,





May 15, 2012

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

Dear Board Members:

The Audit and Assurance Services Committee of the Illinois CPA Society (“Committee”) is pleased to comment on the Proposed Auditing Standard, *Related Parties, Proposed Amendment to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (Docket Matter No. 38). The organization and operating procedures of the Committee are reflected in the attached Appendix A to this letter. These comments and recommendations represent the position of the Illinois CPA Society rather than any members of the Committee or of the organizations with which such members are associated.

The Committee reviewed and considered the questions contained in Appendix 4 – Additional Discussion Page A4-21. With the exception of the additional comment below, the Committee believes that the objective of the proposed standard is appropriate and does not have comments with respect to the questions raised.

In addition, the Committee respectfully submits the following additional comment related to the proposed standard:

1. Paragraph .04 of AU Section 334 – *Related Parties* states, “An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered.”

This sentence was excluded from the PCAOB Proposed Standard – *Related Parties*. The Committee is concerned that without this sentence, the proposed standard creates an unrealistic and unacceptable expectation that the auditor is responsible to identify any and all related parties and related party transactions, whether or not the relationship or transaction is material and whether or not the relationship or transaction is fraudulently concealed. This implication is inconsistent with the auditors’ responsibility to design audit procedures in a manner that will identify risks of *material* misstatements. In particular, due to the nature of related parties and related party transactions, the auditor cannot be held responsible for discovering *all* such parties and transactions.

The Committee believes that the PCAOB should consider including the sentence quoted above in the proposed standard.

The Illinois CPA Society appreciates the opportunity to express its opinion on this matter. We would be pleased to discuss our comments in greater detail if requested.

Sincerely,

James J. Gerace, CPA
Chair, Audit and Assurance Services Committee

Elizabeth J. Sloan, CPA
Vice Chair, Audit and Assurance Services Committee



ILLINOIS CPA SOCIETY

APPENDIX A

AUDIT AND ASSURANCE SERVICES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2012 – 2013

The Audit and Assurance Services Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members. The Committee seeks representation from members within industry, education and public practice. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of audit and attestation standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of audit and attestation standards. The Subcommittee develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

Public Accounting Firms:**National:**

Katarina Babic, CPA	McGladrey & Pullen LLP
Robert D. Fulton, CPA	Baker Tilly Virchow Krause, LLP
James J. Gerace, CPA	BDO USA, LLP
Bradley E. Gnade, CPA	McGladrey & Pullen LLP
Howard L. Gold, CPA	CliftonLarsonAllen LLP
Jeremy L. Hadley, CPA	Pricewaterhouse Coopers
Jon R. Hoffmeister, CPA	CliftonLarsonAllen LLP
James R. Javorcic, CPA	Mayer Hoffman McCann P.C.
Michael J. Pierce, CPA	McGladrey & Pullen LLP
Elizabeth J. Sloan, CPA	Grant Thornton LLP
Kevin V. Wydra, CPA	Crowe Horwath LLP

Regional

Jennifer E. Deloy, CPA	Frost, Rittenberg & Rothblatt, P.C.
Sharon J. Gregor, CPA	Selden Fox, Ltd.
Timothy M. Hughes, CPA	Wolf & Company LLP
Andrea L. Krueger, CPA	Corbett, Duncan & Hubly, P.C.
Matthew G. Mitzen, CPA	Blackman Kallick LLP
Stephen R. Panfil, CPA	Bansley & Kiener LLP

Local:

Scott P. Bailey, CPA	Bronner Group LLC
Loren B. Kramer, CPA	Kramer Consulting Services, Inc.
Carmen F. Mugnolo, CPA	Philip + Rae Associates, CPA's
Geoff P. Newman, CPA	Weiss & Company LLP
Steven C. Roiland, CPA	Kessler Orlean Silver & Co., P.C.,
Jodi Seelye, CPA	Jodi Seelye, CPA
Richard D. Spiegel, CPA	Steinberg Advisors, Ltd.
Timothy S. Watson, CPA	Benford Brown & Associates, LLC

Industry:

Todd W. Bailey, CPA	kCura Corporation
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Educators:

David H. Sinason, CPA	Northern Illinois University
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Staff Representative:

Ryan S. Murnick, CPA	Illinois CPA Society
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Mr. Martin F. Baumann
 Associate Chief Auditor
 Public Company Accounting Oversight Board
 c/o Office of the Secretary
 1666 K Street, N.W.
 Washington, D.C. 20006-2803
 USA

By E-mail: comments@pcaob.org

May 15, 2012

541

Dear Mr. Baumann,

**Re.: PCAOB Rulemaking Docket Matter No. 038: PCAOB Release No. 2012- 001, February 28, 2012
 Proposed Auditing Standard – Related Parties
 Proposed Amendments to Certain PCAOB Auditing Standards
 Regarding Significant Unusual Transactions
 And Other Proposed Amendments to PCAOB Auditing Standards**

The IDW would like to thank you for the opportunity to comment on the PCAOB's Proposed Auditing Standard – Related Parties and Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions And Other Proposed Amendments to PCAOB Auditing Standards (hereinafter collectively referred to as the "proposed standard") released February 28, 2012.

Since the PCAOB's interim standard dealing with related parties dates from 1983, we certainly support the PCAOB dealing with related parties on the one hand and significant unusual transactions on the other, as these important areas have often been a common feature in recent fraud cases. Consequently, we also support the idea that specific other PCAOB auditing standards be amended at this stage, where appropriate. We recognize that the revisions mean that the PCAOB's standards will be brought further in line with the IAASB's fraud and related party standards, which were revised during its recent clarity project. Nevertheless, we continue to have concerns as to the differences between the two sets of standards.

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GESCHÄFTSFÜHRENDER VORSTAND:
 Prof. Dr. Klaus-Peter Naumann,
 WP StB, Sprecher des Vorstands;
 Dr. Klaus-Peter Feld, WP StB CPA;
 Manfred Hamann, RA



Page 2 of 6 to the comment letter dated May 15, 2012, to the PCAOB

In this letter we have not responded to individual questions raised, but comment instead on those areas with which we have concerns. We submit our comments as follows:

Alignment with Auditing Standards Promulgated by the IAASB

As we had previously commented in a number of letters to the PCAOB, we welcome the updating of the PCAOB's interim standards, and particularly welcome the efforts made to align the proposed standard with the relevant ISAs as a measure towards the international convergence of auditing standards needed for international capital markets. In this context, we would like to refer to our previous letters in which we addressed this issue more fully, as we have chosen not to repeat our comments. We nevertheless confirm our previously stated views.

Indeed, our main areas of concern in respect of this proposed standard revolve around the issue of compatibility with the respective IAASB standards dealing with related parties, which we discuss in more detail below.

Potential Drawbacks of the PCAOB Approach

In comparing the proposed standard with the IAASB's corresponding standards we note a number of instances where the relevant ISAs require the auditor to perform procedures directed toward a certain aim, but provide flexibility by guiding the auditor with application material suggesting possible ways in which it might be appropriate for the auditor to tackle this, rather than prescribing a list of procedures to be performed. In contrast, the proposed standard often specifies outright certain, or all, of these possibilities as required procedures.

We would like to point out one example in which we suggest this approach may result in over-prescription:

According to the discussion in Appendix 4, the PCAOB is proposing the auditor identify any incentives and pressures management might face that could lead management to manipulate financial reporting, by requiring, in a new paragraph (paragraph 10A of AS-12), that the auditor always perform specific work – including reading employment and compensation contracts – in regard to compensation arrangements with all executive officers. We note that the PCAOB is proposing to retain the extant flexible approach of paragraph 11 of AS-12 only in regard to compensation arrangements in respect of those members of senior management other than the executive officers.



Page 3 of 6 to the comment letter dated May 15, 2012, to the PCAOB

It is not clear to us why the PCAOB is proposing to add this particular stringent requirement as a further procedure designed to identify risks of material misstatement, when the PCAOB has already specified that management override is a significant risk¹.

In our opinion, adding this “additional” risk recognition procedure as a requirement in all audits will not lead to an increase in audit quality, since the auditor is already required to treat management override as a significant risk. There may, however, be circumstances in which the auditor considers the procedures necessary in deepening his or her understanding of the particular company’s circumstances, and as such we believe the current more flexible approach of extant paragraph 11 remains appropriate.

In our view there are further potential drawbacks to taking such a rules-based approach in the area of related parties, including the effect thereof on the expectations gap between what the public expects of an auditor and what an auditor has the power to achieve in practice. The rules based approach adopted by the PCAOB may leave the impression to the public that auditors are in a position to obtain virtually absolute assurance in relation to related parties. This applies in particular in regard to the identification of related parties, as we discuss below. In our opinion, the PCAOB standard should be quite clear in acknowledging the fact that management and not the auditor is responsible for the identification of related parties, and that while the auditor can perform procedures to seek to recognize fraud risk factors that may be associated with related parties, an audit cannot involve extensive or unlimited “fishing expeditions” to identify all related parties. An audit is an assertion-based engagement rather than a direct engagement and the auditor is therefore responsible for obtaining audit evidence as to whether the assertions made by management in respect to its financial statements are appropriate or not.

We note that the IAASB has included information in paragraphs A16 and A18 of ISA 550 on this aspect by clearly stating in the last sentences of A18 that in the absence of effective controls over related parties, an auditor may even be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions, which would require the auditor considering implications for the auditor’s report. In the absence of such information in the proposed standard, we believe there is a danger that public expectations may remain un-

¹ In line with ISA 240.31, paragraph 69 of AS-12 states: “The auditor’s identification of fraud risks should include the risk of management override of controls.” and the note in paragraph 71b of AS-12 states “A fraud risk is a significant risk.”



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realistic. In our opinion, the inclusion of a note similar to that included under paragraph 19 of the proposed standard regarding arms length transactions would be appropriate.

Purpose and Scope of the Objective

We agree with the statement on page A4-4: “Providing an overarching concept as an audit objective for the auditor to take into account while performing the procedures required by the proposed standard can assist the auditor in performing those procedures, including developing other procedures as required, and evaluating the results of those procedures. An overarching concept can be especially helpful when judgment is required, for example, when designing additional procedures not specifically required by the proposed standard. Given the increased risk of material misstatement associated with transactions with related parties, avoiding a mechanical approach could improve audit quality and potentially address concerns regarding the auditor’s consideration of related party transactions.”

However, in order to achieve this “benefit” in terms of the auditor’s use of professional judgement, as well as reinforce the references within the standard to fraud, we would like to suggest that the objective also make reference to fraud risk factors, since this is a significant aspect in the auditor’s considerations on related parties. Indeed, while we accept that changes are being proposed to the PCAOB’s fraud standards too, the fact that only two references to fraud are made in the proposed standard may detract from this aspect. This could lead to public perceptions that related party relationships and transactions form a relatively straightforward aspect of an audit.

Responsibility for the Identification of Related Parties

There is a mismatch within the text of the proposed standard in regard to what the auditor is required to do in the context of related party identification.

The introduction of the proposed standard in paragraph 1 states that the standard establishes requirements regarding the auditor’s evaluation of a company’s identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. Paragraph 11 of the proposed standard requires that the auditor should evaluate whether information that comes to the auditor’s attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.



Page 5 of 6 to the comment letter dated May 15, 2012, to the PCAOB

In contrast, paragraph 3 of the proposed standard requires, among other things, the auditor to “perform procedures to identify the company’s related parties, ...”. Paragraph 4 starts by saying “In identifying related parties and obtaining and understanding of....., the auditor should.....”.

We suggest the Board amend the wording of these requirements as well as the subheading preceding paragraph 3, to recognize that the management of a company is the party that is responsible for the identification of related parties, not the auditor. In contrast, the auditor is responsible for identifying risks of material misstatement, including any risks of material misstatement associated with related party relationships and transactions. We suggest the wording in paragraph 3 be revised to read “As part of the auditor’s risk assessment procedures required by AS-12 (specific mention of related parties could then be included in paragraph 5 of AS-12), the auditor should perform procedures to evaluate management’s identification of the company’s related parties, ...” Paragraph 12 could then be deleted. We further suggest that all other references to the auditor’s identification be likewise amended to reflect the nature of the auditors’ responsibilities in this area.

Definitions

We appreciate the fact that the PCAOB has chosen not to define the term related party within the proposed standard, but instead to require the auditor to look at the SEC requirements applicable to the company subject to audit. This approach allows sufficient flexibility for any future developments in financial reporting applicable to issuers.

Text amending paragraph 66 of AU Sec 316 includes a definition of the term significant unusual transactions: “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”)...”. We suggest this definition be more prominent by clearly identifying it as a definition.

We note that this term is used elsewhere in this as well as in other standards, where it is either not explained or explained in an inconsistent way. For example the text of the Note under paragraph 13 of the proposed standard Related Parties states: “...for related party transactions that are also significant unusual transactions (e.g., significant related party transactions outside the normal course of business)”. It is thus unclear whether the PCAOB intends there to be a difference here or not, i.e., whether it intends to specifically exclude related party transactions that, although within the normal course of business, otherwise



Page 6 of 6 to the comment letter dated May 15, 2012, to the PCAOB

appear to be unusual due to their timing, size, or nature. Although we do not believe any such differentiation is intended, the inclusion of a definition of the term would be helpful.

Areas that Would Benefit From Guidance

In specific areas, we see a need for the PCAOB to provide additional guidance. For example, paragraph 14 of the proposed standard requires the auditor perform procedures on intercompany balances. Matters such as the expected extent of such procedures, how they might vary according to the auditor's assessment of risk of material misstatement are not addressed. We suggest the PCAOB provide guidance in this area. The requirement of paragraph 15d. of the proposed standard for the auditor to perform other procedures as appropriate would similarly benefit from additional guidance in the final standard (currently this issue is discussed giving examples in the additional discussion in Appendix 4).

If you have any further questions about our comments, we would be pleased to discuss our comments with you.

Yours very truly,

Klaus-Peter Feld
Executive Director

Gillian Waldbauer
Technical Manager



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

Katharine E Bagshaw FCA
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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

Contents	Paragraph
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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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May 30, 2012

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

PCAOB Rulemaking Docket Matter No. 038

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 Ms. Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2012-001, "*Proposed Auditing Standard - Related Parties; Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions; and Other Proposed Amendments to PCAOB Auditing Standards*" (the Release).

Overview

We support the Board's initiative to improve the independent auditor's evaluation of a company's identification of, accounting for, and disclosure of its relationships and transactions with related parties by proposing a new auditing standard that would replace the Board's interim auditing standard, AU sec. 334, *Related Parties*. We also support the Board's initiative to improve audit quality through its proposed amendments intended to enhance the auditor's identification and evaluation of a company's significant unusual transactions and to improve the auditor's understanding of a company's financial relationships and transactions with its executive officers. We agree that these areas can pose significant risks of material misstatement of the financial statements and deserve the Board's attention at this time.

We have summarized in the remainder of this letter our observations and recommendations for the Board's consideration to enhance and clarify the auditor's responsibilities in the development of a final standard and amendments to PCAOB Auditing Standards.



Office of the Secretary
Public Company Accounting Oversight Board
May 30, 2012
Page 2

We look forward to continuing to work with the Board and other stakeholders on finding ways to strengthen audit quality and improve the conduct of audits in areas of increased risk.

Proposed Standard, *Related Parties*

Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties

Paragraph 3 of the proposed standard states that, “The auditor should perform procedures to identify the company’s related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes (or the lack thereof) of the types of transactions involving related parties.” This wording suggests that the auditor has a primary responsibility to identify a company’s related parties and related party transactions. To be consistent with paragraph 1 of the proposed standard, the nature of the auditing procedures included in the proposed standard, and the fact that management has the primary responsibility to identify, account for and disclose a company’s related parties and related party transactions, we recommend that the Board modify paragraph 3 of the proposed standard to state, “The auditor should perform procedures to determine whether the company has properly identified its related parties, ...”.

Appendix 4, Section I.C of the Release, states that, “The requirements in paragraph 3 of the proposed standard apply to related party transactions, whether they are required to be disclosed or not in the financial statements, such as intercompany transactions.” We believe that whether a transaction eliminates in consolidation should be a factor to consider in determining the nature, timing, and extent of both risk assessment and response procedures and recommend that the Board include this consideration in the final standard.

Identifying and Assessing Risks of Material Misstatement

Appendix 4, Section I.D of the Release, indicates that under existing requirements of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, that “the auditor should determine whether any of the identified and assessed risks of material misstatement are fraud risks or other significant risks.” The Board requested comment on whether there are particular related party transactions that should be deemed a fraud risk or other significant risk (question 8 in Appendix 4, Section D of the Release). We recommend that particular related



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party transactions not automatically be deemed a fraud risk or other significant risk. Rather, this assessment should be based upon facts and circumstances.

Responding to the Risks of Material Misstatement

Transactions with Related Parties Required to be Disclosed in the Financial Statements or That are a Significant Risk. Paragraph 15 of the proposed standard requires the auditor to perform procedures for *each* related party transaction, or *type* of related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk. The guidance is not clear as to how the auditor would satisfy this requirement, as the use of the phrase “the transaction” in paragraphs 15a, 15b and 15d could be interpreted to mean that the auditor would be required to perform the procedures outlined in paragraph 15 of the proposed standard for all transactions comprising a *type*, as opposed to allowing the auditor to exercise professional judgment in determining the extent to which underlying transactions should be tested. Appendix 4, Section I.E of the Release, provides additional discussion regarding the requirements in paragraph 15, stating that, “Accounting principles applicable to the company may allow the aggregation of related party transactions that require disclosure (e.g., by type of related party transaction). In these cases, the auditor would be required to test the compilation and disclosure of these transactions and the extent of the auditor's testing on the underlying transactions, consistent with the requirements of Auditing Standard No. 13, should be commensurate with the risks of material misstatement.” We recommend that the Board incorporate this discussion within a final standard to acknowledge that the auditor should exercise professional judgment in determining the testing approach for related party transactions comprising a *type*.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or That are a Significant Risk. Appendix 4, Section I.E of the Release, provides an example in which the auditor should “examine the underlying documents supporting the transfer of title and ownership to obtain audit evidence that supports management's assertion regarding its rights and obligations,” as well as “obtain audit evidence that supports management's assertion regarding the existence of the asset (e.g., inspection of the asset)” if a company makes a material purchase of property, plant and equipment from an unconsolidated related party. We recommend that the Board provide additional clarification in a final standard as we believe the inspection of an asset would be necessary only in unusual circumstances when the auditor has already examined documentation supporting the transfer of title and ownership.



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Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor. We appreciate the Board's focus on outlining procedures at paragraph 17 of the proposed standard that it believes the auditor should perform when a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. We believe, however, that the requirements limit the auditor's ability to exercise professional judgment in designing audit procedures responsive to assessed risks. We recommend that the Board modify the requirement to allow the auditor to exercise professional judgment in determining whether a related party or relationship or transaction with a related party previously undisclosed to the auditor rises to a level of significance that would warrant performance of procedures c, d and e at paragraph 17 of the proposed standard.

Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor. Paragraph 17e of the proposed standard states that the auditor should treat previously undisclosed related party transactions as a significant risk, and requires the auditor to perform the procedures required by paragraph 15 of the proposed standard. We recommend that the Board modify the requirement in paragraph 17e of the proposed standard to allow the auditor to exercise professional judgment in determining whether, based on the facts and circumstances, a previously undisclosed related party transaction should be treated as a significant risk, and whether the auditor should perform the procedures required by paragraph 15 of the proposed standard.

Evaluating Financial Statement Accounting and Disclosures

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions. Paragraph 19 of the proposed standard states that, "If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion." This statement does not seem to permit the auditor to exercise judgment relative to the significance of management's refusal to modify the disclosure, especially when considered relative to the Board's interim auditing standard, AU sec. 334, *Related Parties*, which states that, "the auditor should express a qualified or adverse opinion, depending on materiality." We believe it is appropriate for the auditor to be able to exercise judgment in this case and recommend that the Board modify paragraph 19 of a final standard consistent with the Board's interim auditing standard to include the reference to materiality.



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Communications with the Audit Committee

We agree that it is essential for the auditor to communicate with the audit committee on a timely basis and appreciate the Board's acknowledgement of instances where it is most efficient to communicate through the audit committee chair. We also support the requirement for the auditor to communicate to the audit committee those matters initially communicated to the audit committee chair. As suggested in our comment letter to the Board on the audit committee communications proposal,¹ in order to recognize that not all members of the audit committee must be present in order to achieve a quorum, we recommend that the word "full" be removed from the note to paragraph 20 of the proposed standard.

Paragraph 20 of the proposed standard states that, "The auditor should communicate to the audit committee, in a timely manner, and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties" and "other significant matters arising from the audit regarding the company's relationships and transactions with related parties." We recommend that the Board consider defining the term *audit committee*² in the proposed standard using the same definition as used in Appendix A of the audit committee communications proposal.³ We believe defining the term *audit committee* in the proposed standard will clarify the Board's expectation as to whom the auditor is responsible for communicating to in circumstances in which a company does not have a governance structure that includes a board of directors or audit committee (or equivalent body).

¹ See KPMG LLP's comment letter on the Board's Rulemaking Docket Matter No. 030, *Proposed Auditing Standard Related to Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU sec. 380*, dated February 29, 2012.

² Appendix A of the proposed auditing standard related to *Communications with Audit Committees* currently defines the audit committee as: "A committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, the entire board of directors of the company. For audits of non-issuers, if no such committee or board of directors (or equivalent body) exists with respect to the company, those persons designated to oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company."

³ See *Proposed Auditing Standard Related to Communications with Audit Committees*, PCAOB Release No. 2011-008.



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Appendix A - Examples of Information and Sources of Information That Could Indicate That Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor Might Exist.

Paragraph A3 included in Appendix A of the proposed standard contains examples of sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Appendix 4, Section I.C, of the Release states that, “The proposed standard would not require an auditor to review each source of information referenced in Appendix A.” We recommend that the Board incorporate this discussion within a final standard to acknowledge that the auditor should exercise professional judgment in determining the sources of information to review to assist in the identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Other Proposed Amendments to PCAOB Auditing Standards

Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement

Paragraph 10A in the proposed amendment to Auditing Standard No. 12 sets forth specific procedures for the auditor to perform “to obtain an understanding of the company’s financial relationships and transactions with its executive officers.” Paragraph A3A in the proposed amendment to Auditing Standard No. 12 defines an executive officer as, “The president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company.” Appendix 4, Section III.A of the Release, states that the proposed definition for *executive officer* is “based on the SEC definition of an executive officer in Rule 3b-7 under the Exchange Act and a list in Schedule A of Form BD.” The Appendix also provides additional discussion regarding the requirements in paragraph 10A, stating that, “The population for the proposed procedures required by paragraph 10A is the list of executive officers disclosed [by the company] in the securities filing or the executive officers included on Schedule A of Form BD” and additionally references to Item 401(b) of Regulation S-K. We recommend that the Board incorporate this discussion within the final amendments to Auditing Standard No. 12, so that it remains clear in such final amendments that the auditor’s responsibility is limited to executive officers disclosed by the company included in these filings.



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Paragraph 11 in the proposed amendment to Auditing Standard No. 12 states that the auditor should “obtain an understanding of compensation arrangements with senior management other than executive officers referred to in paragraph 10A.” Given that the auditor is required to perform procedures with respect to executive officers, as defined, it is unclear why the auditor would be required to obtain an understanding of compensation arrangements for additional members of management (senior management). We recommend that the Board reconsider the need for the requirement at paragraph 11 of the proposed amendment to obtain an understanding of compensation arrangements for senior management other than executive officers. Should the Board decide to retain the proposed requirement in the final amendment, it would be helpful to understand the reasons why the additional requirement is considered necessary.

Additionally, should the Board retain the proposed requirement in the final amendment, we believe that the proposed amendment does not clearly define the individuals that would comprise senior management beyond the definition of executive officers included at paragraph A3A in the proposed amendment to Auditing Standard No. 12. Because the Board has defined executive officers in the proposed amendment, we recommend that the Board also include a definition of senior management in the final amendment to Auditing Standard No. 12.

Finally, we believe that the proposed amendment is not clear as to the procedures the auditor should perform to obtain an understanding of the compensation arrangements with senior management other than executive officers and how the auditor’s performance obligations differ from that with respect to executive officers. We recommend that the Board provide guidance in the final amendment as to the procedures the auditor should perform with respect to senior management other than executive officers, similar to how paragraph 10A of the proposed amendment provides procedures the auditor is required to perform to obtain an understanding of the company’s financial relationships and transactions with its executive officers.

Public misinterpretation of the intent of the proposed requirements related to compensation arrangements. Based on a review of articles published by others in the financial press, there appears to be public misinterpretation regarding the proposed amendments to Auditing Standard No. 12 relating to compensation arrangements. There is some concern that auditors could exert inappropriate influence on executive compensation decisions.



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- One commentator has written that the proposed amendments, “in some cases, may enhance auditors’ influence on executive pay decision-making.”⁴
- Another commentator has suggested that “CFOs should be on the lookout for an entirely new and potentially more invasive accounting-related influence on executive compensation.”⁵ This commentator further notes that “the proposed amendments could spur corporate auditors to force changes to executive-compensation programs due to unacceptable risks of material misstatement, an increased risk of fraud, or both.”⁶
- Another commentator has written that, “If this proposal becomes a reality then it might be possible that an auditor could tell a company that its compensation programs are “too risky” and that they cannot sign off on the financials, placing outside auditors in the role of pre-approving executive compensation programs.”⁷
- Another commentator has stated that the proposed amendments “have excited concern that they will lead to auditors having greater involvement in, and, perhaps, influence over, executive compensation decisions.”⁸ This commentator goes on to state that “it is legitimate to question whether these proposed amendments would cause auditors to interfere with, to attempt to influence or to second guess executive compensation decisions.”⁹

The proposed amendments may create certain expectations that are not intended by the PCAOB, including the expectation that the auditor’s work will mitigate the risk that compensation arrangements will lead to excessive risk-taking. We believe it is important that the Board clarify the auditor’s responsibility and address the auditor’s expectation gap with regard to executive compensation arrangements in the final amendments. We believe that the

⁴ Steve Seelig, March 1, 2012, *PCAOB Proposal Could Bring Added Auditor Involvement in Executive Compensation Decisions*, Retrieved from <http://www.towerswatson.com/blog/executive-pay-matters/6523>

⁵ Andrew Liazos, March 12, 2012, *Will Auditors Influence How Executives Are Paid?*, Retrieved from http://www3.cfo.com/article/2012/3/compensation_liazos-executive-compensation-audit-pcaob-fas123r

⁶ *Id.*

⁷ Michael S. Melbinger, March 7, 2012, *PCAOB Butts in on Executive Compensation?*, Retrieved from <http://www.winston.com/index.cfm?contentID=19&itemID=159&itemType=25&postid=837>

⁸ Dudley W. Murrey, Quentin Faust, and Andrews Kurth LLP, April 5, 2012, *PCAOB Proposes New Audit Standard for Related Party Transactions and Excites Concern About Auditor Involvement in Executive Compensation Decisions*, Retrieved from <http://www.natlawreview.com/article/pcaob-proposes-new-audit-standard-related-party-transactions-and-excites-concern-abo>

⁹ *Id.*



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May 30, 2012
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Board should highlight that the proposed amendments with regard to an auditor's performance obligation relative to executive officer compensation arrangements are intended solely to assess and respond to risks of material misstatement, and not to place the auditor in a position to influence or approve compensation policies and practices. Accordingly, we also recommend that the Board include the second full paragraph at Page A4-44 in the final amendments (which importantly emphasizes that the proposed audit procedures are intended to assist the auditor in identifying and assessing risks associated with a company's financial relationships and transactions with its executive officers). We also recommend that the second line of this paragraph refer to "compensation" policies and procedures.

* * * * *

We appreciate the Board's careful consideration of our comments, and support the Board's efforts. We would be pleased to answer any questions regarding this comment letter.

Very truly yours,

KPMG LLP

Cc:

PCAOB

James R. Doty, Chairman
Lewis H. Ferguson, Member
Jeanette M. Franzel, Member
Jay D. Hanson, Member
Steven B. Harris, Member
Martin F. Baumann, Chief Auditor and
Director of Professional Standards

SEC

Mary L. Schapiro, Chairman
Luis A. Aguilar, Commissioner
Daniel M. Gallagher, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner
James L. Kroeker, Chief Accountant
Brian Croteau, Deputy Chief Accountant

RE: Docket 038

The purpose of audits is to provide investors accurate information about companies they are interested in so they may make rational judgments. The Proposed Auditing Standard on Related Parties and Proposed Amendments on Significant Unusual Transactions are a step in the right direction to make sure that auditing procedures provide accurate information but do not go far enough.

Significant Unusual Transactions:

JP Morgan Chase's admission that it may have lost more than \$2 billion on credit default swaps is the most recent example of unusual transactions that should have been reported. According to news accounts these losses occurred because at least part of the bank was betting on the direction its whole portfolio of investments were likely to take. Whether this would have been a technical violation of the Volcker Rule, as Senator Levin has said, or not, as the bank claims, is not as important as the recognition that the bank was putting material sums of money at risk by engaging in naked gambling.

Theoretically the price of bonds reflects the risk of default. Credit default swaps are supposed to be insurance against price movements, but are really naked bets that, but for the exemption in the Gramm-Bliley Act, could be prosecuted as illegal gambling or, at the very least, as buying insurance from an unregistered insurance company. There might be some justification for insuring against a price change in one investment by buying a specific credit default swap, but the only justification for buying credit default swaps for a portfolio is greed. Such an investment may lead to large fees but multiplies the risk.

Have we forgotten how the financial system froze because there were so many credit default swaps that no one knew were good or bad? In fact the problem is still a very real risk to our financial system. According to various analyses there are about \$300 trillion of credit default swaps floating around the financial system and no one knows what their net amount is or what our exposure would be if there were another recession in Europe. Although apparently 95% of these credit default swaps are held by our largest six banks, significant losses in any one of them would have an adverse impact on our economy. At the very least, these six banks should be subject to auditing procedures that insure that the amount and kind of credit default risks they have on their books will be reported so investors can more accurately evaluate them.

Related Parties:

Investors need to make sure the directors of corporations represent the interests of shareholders and not of management who nominated them in the first place. The growth in management income has been phenomenal and cannot be justified by any rational economic theory. Since the 1970s, median pay for executives at the nation's largest companies has more than quadrupled, even after adjusting for inflation, whereas pay for a typical non-supervisory worker over the same period has dropped more than 10 percent, according to the Bureau of Labor Statistics. Are American CEOs really worth more than 10 times what British CEOs are paid, as measured by the median income of their employees? A study done by Harvard law professor Lucian Bebchuk *et al.* showed that "the top executive teams of Bear Stearns and Lehman Brothers derived cash flows of about \$1.4 billion and \$1 billion respectively from cash

bonuses and equity sales during 2000-2008." They also found that 10 percent of the profits of the largest 1,000 corporations in the United States went to those companies' top five officers in 2005, but that the CEO's pay correlates negatively with the profitability and market valuation relative to book value. In short, the firms with high CEO pay are not the best performers. What percentage it is now, particularly on Wall Street, is probably beyond mere mortals' comprehension.

Wall Street, or the financial sector, is in a class by itself. From 1960 to 1984 Wall Street's share of U.S. corporate profits averaged 17 percent, but from 1985 to 2008 its share rose to an average of 30 percent. This huge bundle of money attracts some of the best minds in America to Wall Street, where they spend their time designing financial instruments that add little or nothing to economic growth, according to Volcker, but generate huge fees that Wall Street is fighting to protect. This helps explain why in 2010 the share of pretax income going to the wealthiest 0.01 percent reached its highest levels since the IRS began recording incomes in 1913. Of course, some of the CEOs, like Steve Jobs, deserved substantial salaries because of what they have accomplished, but why did the average executive's pay at the nation's largest companies grow from 42 times the average worker's income in 1990 to 325 times it in 2010? And, what is the justification for the enormous sums given to seemingly failed CEOs like Hewlett-Packard's Carly Fiorina?

Auditors should have procedures in place so they can report in detail how the top executives' pay is determined and that it seems reasonable in light of the corporation's performance.

Respectfully submitted,

Martin Lobel
Lobel, Novins & Lamont, LLP
888 17th St. NW #810
Washington, D.C. 20006
Lobel@LNLLaw.com

(By way of full disclosure, I am also Chairman of the Board of Tax Analysts, www.tax.org, but the views expressed are my own.)

May 4, 2012

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

Re: PCAOB Rulemaking Docket Matter No. 038

McGladrey LLP appreciates the opportunity to offer our comments 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*. McGladrey LLP is a registered public accounting firm serving middle-market issuers, brokers, and dealers. We support the PCAOB's proposed auditing standard and related proposed amendments to other auditing standards intended to strengthen existing audit procedures for identifying, assessing, and responding to the risks of material misstatement associated with a company's related party transactions. However, we have the following comments related to specific paragraphs of the proposal that we believe should be clarified or modified.

Proposed Standard, *Related Parties*

Objective

We believe the objective in paragraph 2 of the proposed standard should be clarified to read as follows (additions are in bold and deletions have been stricken through):

The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties **have been identified** and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties

Paragraph 3 of the proposed standard requires the auditor to perform procedures to identify the company's related parties. We believe the first clause in the first sentence of paragraph 3 should be revised to require the auditor to perform procedures to determine that management has identified the company's related parties. Our recommendation for the modification is as follows:

The auditor should perform procedures to ~~identify~~ **determine whether** the company's **has properly identified its** related parties . . .

Responding to the Risks of Material Misstatement

Paragraph 15 of the proposed standard requires the auditor to perform certain procedures for each related party transaction, or type of related party transaction, that is either required to be disclosed in the financial statements or determined to be a significant risk. However the required procedures in paragraphs 15.a., b. and d. refer to "the transaction," which could be interpreted to suggest that all

PCAOB Rulemaking Docket Matter No. 038
May 4, 2012
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transactions comprising a “type” must be subjected to the required procedures. We believe these paragraphs should be clarified to indicate that testing transactions from each “type” of related party transaction is sufficient.

If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, paragraph 17.e. requires the auditor to perform the procedures required by paragraph 15 of the standard, treating the related party transaction as a significant risk. We believe paragraph 17.e. should be revised to allow for the auditor to evaluate the reason for and the significance of the nondisclosure and exercise professional judgment in determining an appropriate audit response.

We are unclear as to the meaning of paragraph 17.g., which seems to imply that the auditor’s assessment of inherent and control risk should be reconsidered. We believe the risk of the possible existence of other transactions with the related party previously undisclosed to the auditor is addressed in paragraphs 17. a. – d., and the risk of failing to properly account for and disclose such transactions is addressed in paragraph 17.e. We believe paragraph 17.g. should be deleted and the first sentence of paragraph 17.h. should be revised to read as follows:

Evaluate the implications for the audit ~~if of~~ management’s nondisclosure to the auditor of a related party or relationship or transaction with a related party ~~indicates that fraud or an illegal act may have occurred.~~

Communications with the Audit Committee

We believe all required auditor communications with the audit committee should be codified in one standard. Therefore, we suggest the requirements in paragraph 20 of the proposed standard be moved to the Board’s *Proposed Auditing Standard on Communications with Audit Committees*. The proposed standard on related parties could then include a cross-reference to the requirements in the Board’s *Proposed Auditing Standard on Communications with Audit Committees*.

We believe the “and” between the (i) and the (ii) in paragraphs 6.f., 7 and 20.b. of the proposed standard should be changed to “or”.

We would be pleased to respond to any questions the Board or its staff may have about these comments. Please direct any questions to John Keyser, National Director of Assurance Services, at 702-759-4046.

Sincerely,



McGladrey LLP



1095 Avenue of the Americas
New York, NY 10036

Peter M. Carlson
Executive Vice President and
Chief Accounting Officer
pcarlson@metlife.com

May 31, 2012

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

Re: Request for Public Comment: *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* [PCAOB Rulemaking Docket No. 38]

Dear Office of Secretary:

MetLife, Inc. (MetLife) appreciates the opportunity to provide comments to the Public Company Accounting Oversight Board's (PCAOB) Request for Public Comment: ***Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards*** (the Proposed Standard).

MetLife is a leading global provider of insurance, annuities and employee benefit programs, serving 90 million customers in over 50 countries. Through its subsidiaries and affiliates, MetLife holds leading market positions in the United States, Japan, Latin America, Asia Pacific, Europe and the Middle East.

MetLife supports the objective of the Proposed Standard to improve the auditor's evaluation of, identification of, accounting for, and disclosure about related parties and significant unusual transactions. We generally agree with the Board that improvements in this area are important to the protection of the interests of investors and to the preparation of informative, accurate, and independent audit reports. However, we are concerned about certain aspects of the Proposed Standard, specifically (i) the potential limitations on auditor judgment and use of materiality in deciding on the extent of procedures regarding related party and significant unusual transactions and (ii) the extent of involvement of auditors in reviewing and/or questioning executive compensation contracts.

Additionally, a number of the proposed procedures are currently fulfilled through normal and customary oversight by the board of directors and/or audit committee. We believe that the auditor's involvement in these circumstances could be inappropriate and also would not be cost beneficial in identifying the areas of potential fraud or financial statement misstatement.

The Appendix presents our more specific comments on certain issues raised in the Proposed Standard.

We once again thank you for the opportunity to respond to your proposal and your consideration of our observations and comments. If you have any questions regarding the contents of this letter, please do not hesitate to contact me.

Sincerely,

A handwritten signature in blue ink, appearing to read "Peter M. Carlson". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Peter M. Carlson
Executive Vice President and
Chief Accounting Officer

cc: Eric Steigerwalt
Executive Vice President and
Interim Chief Financial Officer

Karl Erhardt
Senior Vice President and
General Auditor

Appendix:**Proposed Auditing Standard, Related Parties and Proposed Amendments Regarding Significant Unusual Transactions**

We acknowledge the efforts of the Board to improve auditing standards with respect to related party and significant unusual transactions. However, we believe the Proposed Standard may be too prescriptive, as it does not appear the proposed guidance encourages the application of auditors' judgment (the cornerstone of the audit profession) based on their assessment of risk and the level of assurance needed to render their audit opinion. The Proposed Standard seems to create the presumption that related party and significant unusual transactions are, by default, significant audit risks requiring auditors to perform substantive testing. We believe the auditor should be able to apply judgment based on risk, materiality, evaluation and related testing of controls and then determine how much substantive testing is necessary to achieve the needed level of assurance that the financial statements are free of material misstatement.

We encourage the Board to consider making the final guidance less prescriptive and, instead, provide clearer guidance to auditors on the determination and documentation of risks and their mitigating controls, materiality decisions, and how this should be taken into consideration while determining the appropriate level of control testing and substantive procedures.

Consideration of the Company's Financial Relationships and Transactions with Executive Officers

We agree that the financial relationship of a company with its executive officers and directors can present certain unique risks. However, we also believe that the current auditing literature appropriately conveys the procedures to be performed by auditors relating to these particular risks. Existing laws and regulations, especially those relating to SEC-reporting entities, impose significant obligations to disclose executive compensation arrangements. In our opinion, the extensive disclosure obligations and certain shareholder approval requirements applicable to executive compensation provide ample information to investors and other users of financial statements to allow them to judge risks related to such arrangements. We are further concerned that the proposed amendments could potentially transform the traditional auditor's role from providing assurance on the reliability of financial statements to evaluating appropriateness of the executive compensation and its business purpose and impact. The involvement of auditors in executive compensation discussions could conflict with the responsibility of a board of directors to determine the appropriate levels of compensation to attract the best talent to fulfill the business strategy of the company.

As a final point, the proposed amendments could result in inefficient use of a company's resources. Board of directors and possibly senior management could spend a significant amount of time on providing, explaining, and possibly defending business decisions associated with the level of executive compensation, which may not otherwise be identified as a significant financial statement risk. We suggest that the proposed amendments should require that auditors first ascertain that a significant financial statement risk exists prior to performing extended substantive auditing procedures on compensation arrangements.



MID-SIZE BANK COALITION OF AMERICA

ASSOCIATED BANK

May 11, 2012

BANK OF HAWAII

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

BOK FINANCIAL

CITY NATIONAL BANK

COMMERCE BANCSHARES, INC.

EAST WEST BANK

Re: PCAOB Rulemaking Docket Matter No. 038

FIRSTBANK HOLDING COMPANY

Ladies and Gentlemen:

FIRST HAWAIIAN BANK

FIRST HORIZON NATIONAL CORPORATION

On behalf of the Midsize Bank Coalition of America (“MBCA”), we are commenting on the Board’s proposed changes to Auditing Standard No. 12 dated February 28, 2012 pertaining to executive compensation.¹

FIRSTMERIT CORPORATION

FROST NATIONAL BANK

Background on MBCA

FULTON FINANCIAL CORPORATION

HANCOCK BANK

By way of background, the MBCA is a non-partisan financial and economic policy organization comprising the CEOs of mid-size banks doing business in the United States. Founded in 2010, the MBCA, with now 29 members, was formed for the purpose of providing the perspectives of mid-size banks on financial regulatory reform to regulators and legislators. As a group, the MBCA banks do business through more than 3,800 branches in 41 states, Washington D.C. and three U.S. territories. The MBCA’s members’ combined assets exceed \$450 billion (ranging in size from \$7 to \$30 billion) and, together, its members employ approximately 77,000 people. Member institutions hold nearly \$336 billion in deposits and total loans of more than \$260 billion.

IBERIA BANK

MB FINANCIAL

OLD NATIONAL

ONE WEST BANK

PEOPLE’S UNITED BANK

RAYMOND JAMES BANK

SILICON VALLEY BANK

SUSQUEHANNA BANK

TCF FINANCIAL CORPORATION

THE PRIVATE BANK

TRUSTMARK CORPORATION

UMB FINANCIAL CORPORATION

UMPQUA BANK

VALLEY NATIONAL BANK

¹ PCAOB Release No. 2012-001 (February 28, 2012).

WEBSTER BANK

Overview of Comments

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

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.

² 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 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.³ 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.⁴ “Qualified performance-based compensation” is compensation paid solely on account of the attainment of one or more pre-established, objective performance goals.”⁵

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.⁶ However, a possible

³ 26 U.S.C. 162(m).

⁴ 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.

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

⁶ See Audit Standard 12, paragraph 11, and AU Sec. 316.85. For example, A U 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 (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.

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.⁷ 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 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."⁸

Another PCAOB board member cited the "possibilities and perils of period-end window-dressing and other kinds of form-over-substance maneuvers intended to

⁷ 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.

⁸ 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.

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."⁹

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

Yours Truly,



Russell Goldsmith
Chairman, Midsize Bank Coalition of America
Chairman and CEO, City National Bank

cc: Mr. Jack Barnes, People's United Bank
Mr. Greg Becker, Silicon Valley Bank
Mr. Daryl Byrd, IBERIABANK
Mr. Carl Chaney, Hancock Bank
Mr. William Cooper, TCF Financial Corp.
Mr. Raymond Davis, Umpqua Bank

⁹ 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.

Mr. Dick Evans, Frost National Bank
Mr. Mitch Feiger, MB Financial, Inc.
Mr. Philip Flynn, Associated Bank
Mr. Paul Greig, FirstMerit Corp.
Mr. John Hairston, Hancock Bank
Mr. Robert Harrison, First Hawaiian Bank
Mr. Peter Ho, Bank of Hawaii
Mr. John Hope, Whitney Holding Corp.
Mr. Gerard Host, Trustmark Corp.
Mr. John Ikard, FirstBank Holding Company
Mr. Bob Jones, Old National
Mr. Bryan Jordan, First Horizon National Corp.
Mr. David Kemper, Commerce Bancshares, Inc.
Mr. Mariner Kemper, UMB Financial Corp.
Mr. Gerald Lipkin, Valley National Bank
Mr. Stanley Lybarger, BOK Financial
Mr. Dominic Ng, East West Bank
Mr. Joseph Otting, One West Bank
Mr. Steven Raney, Raymond James Bank
Mr. William Reuter, Susquehanna Bank
Mr. Larry Richman, The PrivateBank
Mr. James Smith, Webster Bank
Mr. Scott Smith, Fulton Financial Corp.
Mr. Michael Cahill, Esq., City National Bank
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May 17, 2012

Office of the Secretary
Public Company Accounting Oversight Board
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Washington, D.C. 20006-2803

Submitted via email to: comments@pcaobus.org

**Re: PCAOB Release No. 2012-001 Proposed Auditing Standard—Related Parties;
Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant
Unusual Transactions; and Other Proposed Amendments to PCAOB Auditing Standards**

PCAOB Rulemaking Docket Matter No. 38

The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 28,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above captioned release.

The NYSSCPA's Auditing Standards, International Accounting and Auditing, and SEC Practice Committees deliberated the release and prepared the attached comments. If you would like additional discussion with us, please contact Jan C. Herringer, Chair of the Auditing Standards Committee at (212) 885-8133, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,



Richard E. Piluso
President

Attachment



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**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

COMMENTS ON

**PCAOB RELEASE NO. 2012-001
PROPOSED AUDITING STANDARD—RELATED PARTIES;
PROPOSED AMENDMENTS TO CERTAIN PCAOB AUDITING STANDARDS
REGARDING SIGNIFICANT UNUSUAL TRANSACTIONS;
AND OTHER PROPOSED AMENDMENTS TO PCAOB AUDITING STANDARDS**

PCAOB RULEMAKING DOCKET MATTER NO. 38

MAY 17, 2012

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**New York State Society of Certified Public Accountants Comments on
PCAOB Release No. 2012-001 Proposed Auditing Standard—*Related Parties; Proposed
Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual
Transactions; and Other Proposed Amendments to PCAOB Auditing Standards***

PCAOB Rulemaking Docket Matter No. 38

Overall Comments

We welcome the Public Company Accounting Oversight Board's (Board's) efforts to improve Auditing Standards applicable to related party relationships and transactions and significant unusual transactions. Overall, we agree with the above referenced Release ("the proposal").

In particular, we agree with the Board's decision to adopt a "framework neutral" approach and to allow the relevant financial reporting framework to provide the definition of a related party. We believe that the Board's consideration of both related party transactions and significant unusual transactions in tandem (creating a linkage between these two audit areas) is an intelligent way of addressing this limitation.

Related party transactions cannot be presumed to represent "arms-length" transactions. Therefore, the Accounting Standards bodies have emphasized the need for disclosure of such transactions so that the user of a company's financial statements is aware that the economic implications of such transactions may not represent otherwise expected economic results.

Similarly, certain other relationships, other than related party, may result in transactions that are not carried out at "arms-length" terms, for example, where the benefits to one or both parties to a transaction are unusual due to their timing, size or nature. Such unusual transactions do not meet the accounting framework definition of a related party. However, the recognition in the Release that the financial statements are impacted by such transactions that may be carried out at "non-arms-length" terms has significant implications on the utility of those financial statements and the financial picture that they portray. Therefore, we recognize the importance of emphasizing in Auditing Standards the identification of significant unusual transactions. Only then can the auditor identify and assess the risks with which a material misstatement and the appropriate accounting recognition and disclosure issues can be dealt. We believe that this is the fundamental objective and purpose for identifying both related party transactions and significant unusual transactions.

One overriding concern, however, is that no Auditing Standard will insure that all related parties will be identified. While an auditor can and should be vigilant in attempting to identify related parties, addressing the completeness assertion is normally difficult because it involves searching for the unknown. This inherent limitation on the ability of an auditor to detect material misstatements, particularly as it relates to related parties, is due in part to the greater opportunity for collusion, concealment or manipulation by management, resulting in an unavoidable risk that not all related parties will be identified. Similarly, some transactions may not appear to be unusual because oral commitments or side agreements may not be made known to the auditor and the existence of such may be extremely difficult to detect. We agree that a well-designed and executed audit (using the guidance set forth in the proposal) should identify many related party

and significant, unusual transactions. However, we are concerned that the standard implies that the auditor will always be able to identify all such transactions.

Additional Comments

We have certain comments which we hope will be useful to the Board as it deliberates this issue. Where applicable, the comments are referenced to the specific paragraph of the proposal.

Examples of Transactions

While the definition of a related party is contained in Generally Accepted Accounting Principles (GAAP) literature, it may be useful to auditors for the Board's Auditing Standards to contain illustrative examples of the types of transactions which may either be related party transactions or unusual transactions. Obviously, it would be impossible to provide a comprehensive list of such transactions.

Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties

Identification—Paragraph 3 of Appendix 1, Proposed Standard, *Related Parties*, indicates that “[T]he procedures performed should be designed to identify...transactions with related parties... previously undisclosed to the auditor.” We agree that such a statement is appropriate as an objective of the standard, but may be problematic as a requirement because the ability to assess the unknown, regardless of the care in planning and designing procedures and the diligence in executing those procedures, may not in all cases identify related parties that management has not disclosed to the auditor. For this reason, we suggest revising this paragraph accordingly. See our comments under “Overall Comments.”

Internal Control—We agree with the requirement of paragraph 5, *Obtaining an Understanding of Internal Control over Financial Reporting*, paragraph 5 of Appendix 1, Proposed Standard, *Related Parties* that requires the auditor to obtain an understanding of the controls management has established. However, we believe that the proposed standard would be strengthened by including additional guidance that explains that in certain situations controls over related party relationships and transactions may be deficient, may more readily be overridden by senior management or may not exist. In these situations, the auditor may not be able to rely, in any way, on the control structure in designing audit procedures to obtain adequate audit evidence.

Inquiries—The principal way in which related parties will be identified remains inquiries. The proposal should make clear that the provisions of *Performing Inquiries*, paragraphs 6 to 8 of Appendix 1, Proposed Standard, *Related Parties*, are merely illustrative of the procedures to be employed, and that inquiries should be made of any individuals from whom relevant information may be obtained. Management officials could include, for example, the CEO, the CFO, general counsel, senior marketing and sales personnel and senior operating officials.

Previously Undisclosed Relationships—*Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor*, Paragraphs 16 and 17 of Appendix 1, Proposed Standard, *Related Parties*, discusses what an auditor should do if the auditor becomes aware of additional potential related parties. As part of the assessment, the auditor should carefully consider whether the failure to disclose this information originally provides evidence that the veracity of management can no longer be trusted. In many cases inquiries will be the only way to identify related parties. When the responses prove to be incomplete, or worse, misleading, the auditor should assess the impact of this on the auditor's ability to form an overall opinion on the financial statements. This potential should be emphasized in the proposal and reporting guidance provided for such circumstances. It should be noted in the Standard that even though the SEC may not accept such a report modification, the auditor's obligation is, nevertheless, to issue only the type of report that is warranted by the circumstances.

Evaluating Financial Capability

We recognize the current guidance in paragraph 10c of AU Section 334, *Related Parties Disclosure*, indicates that evaluating the financial capabilities of the related parties with respect to significant uncollected balances, *etc.* should be considered. However, we are concerned that an absolute requirement as stated in *Responding to the Risks of Material Misstatement*, paragraph 15c of Appendix 1, Proposed Standard, *Related Parties*, of the proposal may be difficult to perform when the related party is privately held and not controlled by the audit client.

Further, the assessment that the audit client has the ability to exercise significant influence over the related party (or *vice versa*) may have been made, but that does not necessarily equate to management of the audit client having sufficient influence over the related party to demand the receipt of non-public information (*e.g.*, the related party's income tax return). When management does not have sufficient information to make an appropriate assessment of collectability, management must assess whether it has met the requirement for revenue recognition under GAAP.

The auditing procedures set forth in *Responding to the Risks of Material Misstatement*, paragraph 15d. are very broad. It appears to be an indication that, absent the procedures designed to identify related party transactions specified in *Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties*, paragraphs 3 to 8 of Appendix 1, Proposed Standard, *Related Parties*, of the proposal, the Board believes that all related party transactions should be identified. See our previous comments under "Overall Comments" and "Identifying Related Parties."

Please consider the impact of these comments on Appendix 2, *Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions*, pages A2-6 to 8.

Audit Committee Communication

We agree with the requirement of *Communications with the Audit Committee*, paragraph 20. We believe, however, that the cohesiveness of the proposal could be improved by adding communication with the audit committee to the objective of the proposal. Also, we suggest

adding the following to the end of paragraph 6 of Appendix 1, Proposed Standard, *Related Parties*:

See the requirements of *Communications with the Audit Committee*, paragraph 20d where management is unable to convince the auditor of the validity of the business reasons for the transactions.

Comment on Appendix A to Appendix 1, Proposed Standard, *Related Parties*:

Are the sources of information set forth in paragraph A3, Page A1-11, contingent on the indications that related party transactions may exist? If not, is the auditor expected to plan the audit to search for all sources of information set forth in paragraph A3, Page A1-11? This could result in a significant expansion of the audit.

Comment on Appendix 2 Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

We recommend inserting the term “significant” before the word “infrequent” on page A2-5 under “AU sec. 722, *Interim Financial Information*.” The bullet point, as revised, would state:

The occurrence of significant infrequent or significant unusual transactions.

Comments on Appendix 3—Other Proposed Amendments

On page A3-3, we recommend changing “understanding of” to “knowledge about.”

On page A3-3, we note that the additional audit work paper sections that the Board is suggesting the predecessor auditor “should ordinarily permit” the successor auditor to review are sections that could involve significant matters of auditor judgment. Because the decision to provide the successor access to work papers is a matter of the predecessor auditor’s judgment, the successor may find it difficult to obtain access to such work paper sections.

On page A3-4, the Board has proposed an amendment to AU sec. 330, *The Confirmation Process*, to replace the footnote to paragraph 27. In addition to this amendment, we believe guidance should be provided that explains that, with respect to confirmation requests of related parties, the auditor should consider the reliability of the response to a confirmation request and that the auditor should obtain further audit evidence to resolve any doubts, if any exist, about the reliability of such a response.

On page A4-5, in the second to last paragraph, does the Board expect the procedures applicable to inter-company transactions be applied to those which are eliminated in consolidation? If so, this should be explained more fully in the proposed standard.

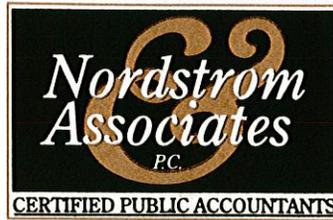
On page A4-36, the ability to evaluate the financial capabilities of an unrelated other party to a transaction may be difficult, if not impossible to do. See our comments under “Evaluating Financial Capability.”

Comments on Appendix 5

We appreciate the PCAOB's efforts to review the differences and similarities regarding this proposed standard and amendments with the existing analogous standards of the International Auditing and Assurance Standards Boards (IAASB) and Auditing Standards Board (ASB). Audits involving international entities have an inherent risk in this area due to the variances in practice methodology and evolving standards, and private companies do not have the same reporting obligations as public companies. Outlining the variance in these standards can be very helpful to auditors seeking to develop audit processes when dealing with international subsidiaries or understanding the requirements of a foreign parent or a private entity and we encourage continuing this practice.

In particular, as noted by the PCAOB, various proposed standards and amendments do not have the equivalent or similar standards internationally: page A5-16, (Section A of Appendix 2) *Significant Unusual Transactions, Identifying Significant Unusual Transactions*; page A5-19, (Appendix 3) Auditing Standards No. 12, *Identifying and Assessing Risks of Material Misstatement* and AU sec 315, *Communications Between Predecessor and Successor Auditors*; page A5-20, AU sec. 333, *Managements Representations*; page A5-22, AU sec. 722, *Interim Financial Information* or obligations under either international standards or for private companies; and, page A5-20 AU sec 316, *Consideration of Fraud in a Financial Statement Audit*. These differences will require the auditors to assess the different level of audit work performed at the various local levels in order to determine overall adequacy of the procedures performed relating to related parties and significant unusual transactions.

Bruce J. Nordstrom, CPA
Godfrey C. Loper, Jr., CPA
Marjorie T. McClanahan, CPA
Timothy D. Hansen, CPA



MEMBER
American Institute of
Certified Public Accountants
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May 21, 2012

Public Company Accounting Oversight Board
Office of the Secretary
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Washington, D.C. 20006-2803

Submitted by e-mail: comments@pcaobus.org

Re: Rulemaking Docket Matter No. 38

I am Bruce J. Nordstrom, President and Certified Public Accountant with Nordstrom & Associates, P.C. and Chairman of the Audit Committee for Pinnacle West Capital Corporation ("Pinnacle West"). Pinnacle West is the NYSE-listed parent company of Arizona Public Service Company, the largest electric utility company in the state of Arizona, serving more than a million customers. It is in my capacity as Audit Committee Chair for Pinnacle West that I respectfully submit comments on the Public Company Accounting Oversight Board's ("PCAOB") *Proposed Auditing Standards on Related Parties and Related Amendments to PCAOB Audit Standards* (the "Release"), in particular the proposed procedures related to company transactions with executive officers.

I have been asked by the Audit Committee to bring to your attention concerns with respect to the portion of the Release that deals with the auditors' reviews of transactions with executive officers. The Release includes proposed procedures that I believe are significantly in excess of what is needed to accomplish its objectives with respect to transactions with executive officers. Rather than approaching concerns with a straightforward, cost- and time-effective solution, the Release casts a wide net that places unnecessary requirements on auditors and unnecessary costs and burdens on issuers, management and even members of the boards of directors of public companies.

Required Reading of Proxy Statement

The current auditing standards do not require a company's independent auditors to read the company's proxy statement. (See Paragraph 11 of Auditing Standard No. 12, which only requires an auditor to consider reading public information regarding the company.) This is the only proposed change to Auditing Standard No. 12 that appears reasonable. The SEC rules governing the required content of proxy statements has been much

expanded in recent years (most recently in the Dodd-Frank Act). Public company boards and their committees now spend considerable time and effort in reviewing the proxy statement for completeness and accuracy. The proxy statement contains the very information that should be the focus of inquiry under the Release, and provides auditors with a thorough understanding of the company's executive compensation structure, arrangements with certain key officers and the extent to which the compensation structure may incentivize risk-taking. (See Items 402(s) and 407(h) of SEC Regulation S-K.) A required review by the auditors of the proxy statement, coupled with discussions with management to address questions or to attain a better understanding of underlying compensation structures, would be a more reasonable and measured solution to the concerns cited throughout the Release.

The proposed definition of "Executive Officers"

The proposed amendments require the auditor to read employment and compensation contracts for each "executive officer," which is an expanded scope of officers subject to any such review and scrutiny. The SEC's focus is on obtaining detailed compensation related information for named executive officers ("NEOs"). The Release's expansion of this concept to require auditors to delve into the compensation for a broader group of officers is unfounded based on research cited by the PCAOB in the Release. The Release references a study that examined SEC accounting and auditing enforcement releases from 1997 to 2008. The study found that either the chief executive officer or chief financial officer was named in 89 percent of the enforcement actions involving fraudulent financial reporting. (See footnote 15 of the Release). Given these statistics, the PCAOB's broadening of the scope beyond NEOs and requiring auditors to perform analyses of each of the broadly defined "executive officers" is unnecessary. In the case of Pinnacle West and based on its interpretation of the Release, this expansion nearly triples the number of executives subject to this higher level of required scrutiny by its independent auditors.

The additional time an auditor might need to perform this review could be significant due to the unique circumstances and nature of employment and compensation related agreements. As the Release recognizes, auditors may not be suited to understand and evaluate these arrangements, and may need to hire outside experts themselves in order to perform the level of risk assessment required in connection with their audit. Both of these factors unnecessarily increase the cost burden on companies compared to the likely benefit to the investing public of the additional procedures.

Inquiry of Compensation Committee Chairperson and Compensation Consultants

Any required inquiry by the auditors of the compensation committee chairperson would be unnecessarily intrusive and burdensome on the chairperson's time, particularly in light of the proposed expanded definition of executive officer discussed above. Use of board members for purposes of providing audit support should be done on a selective basis, and the proposed amendment to require this as part of the auditing standard goes beyond what should be required. Again, a requirement for an auditor to read the proxy statement and make inquiries of management would be consistent with addressing the concerns

described in the Release. Access to the compensation committee chair could be afforded on a case-by-case basis if the auditor's review prompts specific concerns, for example with the CEO's or CFO's compensation arrangements.

Second, any discussion with the compensation committee's independent compensation consultant seems on its face to be a duplication of efforts. The very reason a committee hires an outside compensation consultant is to gain the perspective of an outside expert to assess the company's compensation structure. Compensation consultants have the required level of expertise to assess the appropriateness of a company's compensation structure. For the Release to require the auditor to make another level of inquiries of these consultants is unsettling. The release does not provide any justification for making these advisors subject to questioning by auditors. It could affect the consultant's objectivity and independence from influence if it is asked to, in effect, justify compensation decisions of the company that the consultant has reviewed. As you know, the SEC has promulgated regulations under the Dodd-Frank Act specifically directed towards ensuring independence of consultants to the compensation committee. (See SEC Release Nos. 33-9199 and 34-64149.)

In summary, I feel that the costs and burdens of the proposed amendments to Auditing Standard No. 12 are disproportionate to the stated rationale for the Release. Page A4-42 of the Release includes the following statement: "Understanding how a company has structured its compensation for executive officers can assist the auditor in understanding whether such compensation arrangements affect the assessment of the risks of material misstatement." While our committee does not disagree with this statement, we believe the Release's approach is overly broad and intrusive in light of the reasonable alternatives described above.

Sincerely,



Bruce J. Nordstrom



May 9, 2012

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

Transmitted by e-mail to: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 038

We are pleased to respond in this letter to the Board's proposed standard (PS) entitled *Related Parties* that is included as Appendix 1 to its Release No. 2012-001 (the Release) of February 28, 2012. Our comments also relate in certain respects to other portions of the Release including Appendix 2, entitled "Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions."

We are pleased that the Board has decided to address these important areas of modern financial auditing and provide better guidance to auditors with respect to these sensitive risks. We are confident that the final standard will improve audit quality and, thus, be a valuable addition to our professional literature.

Our specific responses to the 25 questions posed by the Board in Appendix 4 to the Release are presented in the attachment to this letter. Our most significant concerns, however, are set forth in detail in the following paragraphs numbered 1-7, below (1-3 of which are overarching). The numbers are provided to facilitate back-referencing, wherever applicable, from our responses in the attachment.

1. The second foregoing paragraph notwithstanding, we believe that the overall tone of PS is too prescriptive because of numerous and excessive use throughout both the PS and the accompanying explanatory material contained in the Release of directives and other references that use terms that are designated in the Board's Rule 3101 as describing "unconditional" or "presumptively mandatory" responsibilities of auditors. As a result, in our opinion, the PS does not sufficiently encourage or even allow for the application of auditor judgment consistent with the risk assessment standards, and does not provide adequate guidance to auditors as to the application of such judgment in relation to scope determination in this area. This is particularly troublesome at this time when the dominant trend in standard-setting generally should be towards principles-based, and away from rules-based, standards.
2. In our opinion, the overly prescriptive, one-size-fits-all nature of the PS and the accompanying material in the Release is wholly inconsistent with the assertion that appears on p. A4-4 of Appendix A, section B, that the broad objective of the PS may effectively eliminate a mechanical approach, stated as follows:

“A broadly stated objective to guide the auditor's actions also may eliminate a mechanical approach for examining relationships and transactions with related parties, which could result in the auditor not appropriately considering all the facts and circumstances in determining and performing audit procedures. Given the increased risk of material misstatement associated with transactions with related parties, avoiding a mechanical approach could improve audit quality and potentially address concerns regarding the auditor's consideration of related party transactions.”

In this regard, as set forth in Appendix 5 of the Release (p. A5-2), we take note that the analogous standards of both the ASB (clarity project) and IAASB both contain application guidance and explanatory material that does not impose requirements, *per se*, but “is relevant to the proper application of the requirements.” We ask the Board to consider adopting a similar approach for many of the proposed so-called “requirements” now presented in the PS, itself. However, although it is apparent, nevertheless, that the IAASB standards do contain many unconditional and presumptively mandatory requirements that (in many cases, inappropriately, in our opinion) limit opportunities for auditor judgments regarding audit scope, we do not believe the conclusions of other standard-setting bodies should be allowed to control those of the PCAOB.

3. As noted in paragraph 1, above, the overall prescriptive tone of the PS and accompanying material is the direct result of the fact that the Release is replete throughout with (a) what appears to us to be extreme (and perhaps unintended) overuse of the term “requirement” (or alternatively, “require” or “must”) all denoting unconditional responsibility, and (b) with similar overuse of the presumptively mandatory term “should.” Although the tone is pervasively evident throughout Release, we are concerned primarily with the prescriptive language used in ¶s 6-8, 11, 15 and 17 of the PS. Despite a few somewhat vague references to risk considerations as triggering such responsibilities, we believe the unnecessary and excessive use of such terms will generate a perceived but unwarranted burden on auditors (1) to perform the procedures set forth in the PS or alternatives judgmentally deemed “sufficient to achieve the objectives of the standard,” and (2) in the latter instance, to document judgments justifying the use of such alternatives, even when the risk of material misstatement is not deemed significant enough to warrant the procedures. We believe a one-size-fits-all approach will add unnecessary costs to many audits.
4. In addition, there are several references in the Release to so-called “requirements” of other standards, particularly in Appendix 4, Part C, *e.g.* AU sections 334.05 and .09, paragraphs 5 through 11 of PCAOB Auditing Standard (AS) No. 11, and paragraph 7 of AS No. 12, all of which exclusively use only the presumptively mandatory expressions, “should” and “should consider” and do not contain any unconditional responsibilities as are associated with the term “requirement” under Rule 3101. We believe use of the term “requirement” in this loose fashion in the Release is confusing and that it should be used more precisely in the final version of the release only when it is consistent with Rule 3101.
5. Accordingly, before issuing a final standard, we believe the Board and its staff should do the following two things.
 - First, carefully reconsider the use of the terms defined in Rule 3101, including in references to other standards, and judiciously step them down wherever warranted by the circumstances at least one notch to allow more auditor judgment, bearing in mind that even the term “should consider” may likely add a documentation burden to many audits that is unwarranted by the circumstances and, therefore, add unnecessary costs that do not contribute to audit quality. Alternatively, wherever appropriate, we believe the final standard should provide audit guidance using only expressions in reference to procedures like “may wish to,” “might consider” or “that might be appropriate” (the latter being used in Appendix 4, on p. A4-37, none of which would present the costly Rule 3101 burden of creating self-serving, defensive documentation when otherwise unwarranted.
 - Second, add specific guidance to the final standard that is not present in the PS and that would assist auditors in identifying low inherent risk circumstances that could clearly be viewed as warranting neither performing nor considering procedures described in the final standard (or suitable alternatives).

6. We observe that AU sections 316.66-.67, in both their current and proposed amended versions (Appendix 2 to the Release) discuss the auditor's obligation to evaluate and understand the rationale for "significant unusual transactions" that could be indicative of fraud. Older versions of the auditing standards suggested that if unable to understand the business purpose of such transactions, the auditor may not be able to express an unqualified opinion. This suggestion seems to have devolved from the current and proposed versions of AU section 316. We believe it should be restored along with reporting guidance that would include examples at both the opinion qualification and disclaimer levels, depending on the significance of the matter.¹ We also believe the final standard should not focus with regard to significant unusual transactions solely on fraud risk (in the context of AU section 316) but rather also on the adequacy of disclosure in general with respect to transparency and the perceived needs of users.
7. Lastly, we note that in Appendix 3 to the Release (pp. A3-2 and A3-3), the Board proposes an amendment to AU section 315 that would state that a predecessor auditor "should ordinarily" permit a successor to review portions of audit documentation that likely involve significant matters of auditor judgment, including "those related to relationships and transactions with related parties, and "those related to significant unusual transactions." Professional standards in the U.S. have never laid any responsibilities in the lap of predecessors with regard to communications with successors, only *vice versa*. The use of the term "should" in the proposed amendment (to AU section 315) might suggest a presumptively mandatory responsibility under Rule 3101 but when coupled with the word "ordinarily" becomes muddy and confusing.² We believe it is time to address clearly such a responsibility on the part of predecessors, perhaps not only in an auditing standard but in an ethics standard as well. Similarly, although unrelated to the current proposal, we believe such obligations for unfiltered communications should be extended in AU section 543 to apply to those with principal auditors, particularly for auditors of equity method investees who are not subject to control by the reporting investor entity. We recommend the use of the presumptively mandatory expression "should" in such instances without qualification except to state that the only permitted exceptions would be unpaid fees or pending or threatened litigation against the predecessor or investee auditor with respect to the subject audit work.

Thank you for this opportunity to comment on this proposal. Once again, we hope the Board finds our comments useful in its deliberations on this important matter. Please contact the undersigned at hlevy@pbtk.com or 702/384-1120 if there are any questions about these comments.

Very truly yours,
Piercy Bowler Taylor & Kern, Certified Public Accountants



Howard B. Levy, Principal and
Director of Technical Services

Attachment

¹ Auditors should be reminded in the final standard that even though the SEC may not accept such a report modification, the auditor's obligation is, nevertheless, to issue only the type of report that is warranted by the circumstances.

² Another example of the use of a directive noted in the Release that is confusing (*vis a vis* Rule 3101) and that we believe should be avoided is the inherently contradictory term "may be required," which appears in Appendix 4 on p. A4-12.

- Q1.** *Is the framework neutral approach described in the introduction of the proposed standard appropriate? If not, why not?*
- A1.** Yes. However, although we are aware of related party disclosure requirements under Rule 4-08(k) of Regulation S-X, we are unaware of any operative definition of “related parties” dictated by the SEC or its staff for financial reporting purposes (as footnote 1 to the PS appears to imply) other than the definitions contained in U.S. GAAP (FASB’s *Accounting Standards Codification*, Master Glossary) or other accounting framework in use. We believe footnote 1, as it now appears in the PS, should be clarified to remove the confusing implication of an SEC definition.
- Q2.** *Is the objective of the proposed standard appropriate? If not, why not?*
- A2.** Although we concur with the basic substance of the objective set forth in ¶2 of the PS, we firmly believe that the term “determine whether” that is used in that paragraph is too absolute and should be replaced with “afford reasonable assurance that” since the term “reasonable assurance” is consistent with the most fundamental and deeply ingrained concept in our auditing standards.
- Q3.** *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?*
- A3.** Subject to **A2**, above, yes.
- Q4.** *Are the procedures for identifying related parties and obtaining an understanding of relationships and transactions with related parties appropriate?*
- A4.** Subject to our overriding concerns as set forth in paragraphs 1-3 and paragraph 5 of the main body of this letter, we believe the procedures for identifying related parties and obtaining an understanding of relationships and transactions with related parties that are set forth in ¶s 6-8 and 11 of the PS (and supplemented in Appendix A to the PS) appear appropriate but only when warranted by risk and materiality and other circumstantial considerations (see **A6**, below).
- Q5.** *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?*
- A5.** See **A4**, above. Of course additional examples could be presented in Appendix A, but since the lists would nevertheless still need to be characterized in ¶A1 of Appendix A, as not all-inclusive, we believe listing more examples would be unnecessary.
- Q6.** *Is paragraph 12 of the proposed standard appropriately aligned with the existing requirements regarding the identification and assessment of risks of material misstatement?*
- A6.** As we have suggested in paragraphs 1, 3 and paragraph 5 of the main body of this letter, we believe ¶s12-13 of the PS give only what might be characterized as limited and ineffective “lip service” to the applicability of risk and other judgmental factors with respect to scope determination in this area. Consequently, we believe the PS should be strengthened by providing more specific guidance as to how to relate risk, materiality and other circumstantial considerations to the selection of appropriate procedures to be employed relative to related party balances and transactions and significant and unusual transactions rather than the one-size-fits-all approach inherent in the PS.

- Q7.** *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?*
- A7.** We believe that dominant influence is, in substance, not a single fraud risk factor but rather a convenient term that is useful for grouping several fraud risk factors together such as those identified as “factors that may signal dominant influence.” in Appendix 4 of the Release (on pp. A4-14 and A4-15). We believe each of such factors should be identified in the body of the final standard as fraud risk factors, *per se*, in their own right.
- Q8.** *Are there particular related party transactions that should be deemed a fraud risk or other significant risk?*
- A8.** Semantically, we do not believe a transaction, itself, should be designated a fraud risk but rather that fraud risk is presented by and derived from certain perceived characteristics associated with some transactions. That said, we believe that coupled with AU section 316, the PS adequately describes the particular characteristics of certain related party transactions that, when observed, most commonly present heightened levels of fraud risk. We believe that the final standard should point out that (1) despite the fact that smaller, more closely-held issuers commonly engage in more frequent and significant related party transactions that are often less subject to controls executed by personnel who are not parties to these transactions, because of their significance, are ordinarily easier to detect by auditors with fewer procedures than would be “required” by the one-size-fits-all PS, and (2) that such transactions may, in fact, be legitimate and may not present fraud risks.
- Q9.** *Is paragraph 13 of the proposed standard appropriately aligned with the existing requirements regarding responding to the risks of material misstatement?*
- A9.** See **A6**, above.
- Q10.** *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?*
- A10.** Subject to our overriding concerns as set forth in paragraphs 1-3 and paragraph 5 of the main body of this letter, we believe the procedures that are set forth in ¶15 of the PS (and supplemented in Appendix A to the PS) appear appropriate but only when warranted by risk and materiality and other circumstantial considerations (see **A6**, above). However, if the Board discerns any specific circumstances where the objective of the PS (or any other auditing standard) is served by ¶14 of the PS, it certainly is not clear and should be articulated in the final standard.
- Q11.** *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?*
- A11.** Yes, subject to risk and materiality and other circumstantial considerations (see **A6**, above) and our other comments set forth in paragraphs 1-3 and paragraph 5 of the main body of this letter.
- Q12.** *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?*

- A12.** Subject to our overriding concerns as set forth in paragraphs 1-3 and paragraph 5 of the main body of this letter, we believe the procedures that are set forth in ¶17 of the PS (and supplemented in Appendix A to the PS) appear appropriate but only when warranted by risk and materiality and other circumstantial considerations (see **A6**, above).
- Q13.** *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?*
- A13.** Yes, with respect to ¶18 of the PS. (See **A14**, below, with respect to ¶19.)
- Q14.** *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?*
- A14.** Yes, except that we believe the first sentence in ¶19 of the PS should be extended by adding “in all material respects” at the end. In addition, we believe auditors should be reminded in the final standard that even though the SEC may not accept a report modification such as suggested by ¶19, the auditor’s obligation is, nevertheless, to issue only the type of report that is warranted by the circumstances.
- Q15.** *Are the requirements in the proposed standard for the auditor to communicate to the audit committee regarding relationships and transactions with related parties appropriate?*
- A15.** We believe the requirements of the PS relative to audit committee communications are substantially appropriate. However, we also believe that part c of ¶20 of the PS should be removed from the final standard and be left as only a matter for responding to questions if asked of the auditor by the audit committee. In addition, we believe that part d should be expanded to include (with appropriate cross-references to the proposed amendments to AU section 316 and/or AS No. 12) significant unusual transactions that were not identified as involving related parties.
- Q16.** *Should the proposed standard change the auditor's responsibilities for the auditor's report regarding related party transactions? If so, how?*
- A16.** We do not support any changes in auditor's responsibilities for the auditor's report except to provide guidance for reporting auditor reservations about the business purpose of significant related party or unusual transactions, as discussed in paragraph 6 of the main body of this letter, and to suggest possible consideration (*i.e.*, not mandatory consideration) of an optional emphasis paragraph when related party matters are particularly significant.
- Q17.** *Are the proposed amendments regarding the auditor's identification of significant unusual transactions appropriate? If not, why not?*
- A17.** We believe the proposed amendments regarding the auditor's identification of significant unusual transactions appear appropriate.
- Q18.** *Are the proposed amendments regarding the auditor's evaluation of significant unusual transactions appropriate? If not, why not?*
- A18.** Subject to our comments in paragraphs 6 of the main body of this letter regarding expanding the focus beyond fraud risk to matters of general adequacy of disclosure, we believe the proposed amendments regarding the auditor's evaluation of significant unusual transactions appear appropriate.

- Q19.** *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?*
- A19.** We believe the procedures in the proposed amendments to AS No. 12 that are set forth in ¶10A of Appendix 3 to the Release appear appropriate and properly characterized as presumptively mandatory; however, we would add reading of the minutes of the governing board and its compensation committee, if any.
- Q20.** *Are the other proposed amendments to PCAOB auditing standards appropriate? If not, why not?*
- A20.** We have no issues with the amendments proposed to other PCAOB standards other than as stated elsewhere herein but have not undertaken to review all extant PCAOB auditing standards for purposes of identifying other amendments we might believe are advisable.
- Q21.** *Are the proposed standard and proposed amendments appropriate for audits of brokers and dealers? If not, why not?*
- A21.** Except as set forth below in **A23**, and subject to all of the foregoing comments, we believe there are no reasons to believe the PS and proposed amendments when finalized will not be appropriate for audits of brokers and dealers in securities.
- Q22.** *Are there additional procedures specific to audits of brokers and dealers that should be included in the proposed standard and proposed amendments?*
- A22.** No. See **A21**, above.
- Q23.** *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.*
- A23.** We believe the final standard should expressly recognize that many nonissuer securities broker-dealers, many of which do not maintain custody of customer securities nor do they clear customer transactions, are so closely-held as to have no financial oversight or functional governance bodies other than the owner-managers, nor do they have any outside users of their financial statements other than regulators, thus making unconditional or presumptively mandatory audit committee communication of no practical benefit to anyone. Therefore, we believe exceptions to these communication responsibilities should be provided in the final standard for such circumstances.
- Q24.** *Is the Board's anticipated effective date appropriate?*
- A24.** Unless the Board significantly reduces the number of procedures the performance or documented considerations of which would be unconditionally or presumptively mandatory, and depending upon the length of time to be incurred before a final standard is ultimately issued, we believe the proposed effective date would likely be too soon to enable the preparation of adequate practice aids and presentation of staff training or to acclimate clients to the additional costs to be associated with the requirements of the new standard.
- Q25.** *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?*
- A25.** See **A24**, above.



May 30, 2012

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

Re: Request for Public Comment: *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards, PCAOB Rulemaking Docket Matter No. 038*

Dear Office of the Secretary:

Plante & Moran PLLC is a registered public accounting firm serving smaller and middle-market issuers, brokers, and dealers. We appreciate the opportunity to respond and provide our views to the Public Company Accounting Oversight Board (PCAOB or the Board) on its *Proposed Auditing Standard – Related Parties* (Proposed Standard), *Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (Proposed Amendments).

We support the PCAOB's proposed auditing standard and related proposed amendments to other auditing standards intended to strengthen existing audit procedures for identifying, assessing, and responding to the risks of material misstatement associated with a company's related party transactions. However, we have the following comments related to specific paragraphs of the proposal that we believe should be clarified or modified.

Proposed Standard – *Related Parties*

Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties

Paragraph 3 of the proposed standard requires the auditor to perform procedures to identify the company's related parties. This is somewhat inconsistent with both the Introduction and Objective of the proposed standard, which state the auditor's responsibility is to obtain appropriate audit evidence to determine if management has properly identified related parties. The second sentence of paragraph 3 requires the auditor to identify the likely sources of material misstatements in the financial statements that may arise from the company's relationships and transactions with related parties. We believe the second sentence of the paragraph should be moved to the first sentence to stress the importance that the auditor should consider the likely sources and risks of material misstatements to the financial statements prior to performing procedures related to testing of the identification of related parties. Our recommendation for the modification is as follows:

Office of the Secretary
Public Company Accounting Oversight Board

May 30, 2012

The auditor should identify the likely sources of potential material misstatement in the financial statements that may arise from the company's relationships and transactions with related parties or relationships or transactions with related parties previously undisclosed to the auditor. To address the identified risks, the auditor should perform procedures to determine whether the company has properly identified its related parties, and gained an understanding of the terms and business purposes (or the lack thereof) of the types of transactions involving related parties.

Paragraph 6 of the proposed standard requires the auditor to make certain inquiries of management regarding related parties. The proposed standard requires the auditor to make the same inquiries regardless of the nature of the transaction. We believe paragraph 6 should be revised to allow for the use of auditor judgment to determine which inquiries should be made based on the nature of the transactions and the associated risk of material misstatement to the financial statements.

Responding to the Risks of Material Misstatement

Paragraph 15 of the proposed standard requires the auditor to perform certain procedures for each related party transaction, or type of related party transaction, that is required to be disclosed in the financial statements or determined to be a significant risk. In certain situations the potential related party transactions or types of transactions that may occur may not be considered a significant risk of material misstatement to the financial statements. We believe paragraph 15 should be revised to allow for the use of auditor judgment to determine the extent of procedures required in order to address the risk of material misstatement to the financial statements associated with related party transactions, or types of transactions, which are required to be disclosed in the financial statements.

Paragraph 17 of the proposed standard requires the auditor to perform certain procedures in situations in which the auditor discovers the existence of a previously undisclosed related party. The proposed standard appears to require the auditor to perform all of the listed procedures in all situations in which the auditor discovers the existence of a previously undisclosed related party. The proposed standard does not allow for different procedures to be performed based on the nature of the previously undisclosed related party and the associated risk of material misstatement. We believe paragraph 17 of the proposed standard should be clarified to allow for the use of auditor judgment to determine the extent of procedures that are required to be performed to address the risk of material misstatement in situations in which the auditor determines the existence of a previously undisclosed related party.

Thank you again for the opportunity to comment on this proposal. We would be pleased to respond to any questions the Board or its staff may have about these comments. Please direct any questions to Gregory Coursen, Director of Professional Standards, at 248-223-3360.

Plante & Moran, PLLC



Office of the Secretary
 Public Company Accounting Oversight Board
 1666 K Street, NW
 Washington, DC 20006-2803

May 31, 2012

RE: PCAOB Rulemaking Docket Matter No. 038, *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 Madam Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") *Proposed Auditing Standard — Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (the "proposed standard," "proposed amendments," or "proposals"). Overall, we support the Board's proposals and believe they will heighten the auditor's focus on the potential for material misstatement, particularly material misstatement due to fraud, arising from relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers. We believe our suggestions below will further improve the proposals and we encourage the Board to consider them in finalizing the proposals for issuance.

In the remainder of our letter, we have organized our suggestions about the proposals into the following topical areas:

- Proposed amendments to Auditing Standard No. 12
- Evaluating whether significant unusual transactions are indicative of fraud
- Use of the release text to interpret requirements
- Proposed effective date

Proposed amendments to Auditing Standard No. 12 (Question 19 in the release text)

Definition of senior management

The proposed amendments to PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (AS 12) would, among other matters, enhance an existing requirement in paragraph 11 to consider obtaining an understanding of compensation arrangements with senior management. Specifically, under the proposed amendments the auditor would be required to perform certain procedures to obtain an understanding of the company's financial relationships and transactions with its *executive officers*, a subset of senior management that is defined in Appendix A, for purposes of identifying and assessing risks of material misstatement. Page A4-42 of the release states that the proposed amendments would not change the existing requirement in paragraph 11 which applies to senior management, a larger population than executive officers. Defining executive officers as a subset of senior



management raises questions about who comprises the remaining population of senior management. We believe that, having defined "executive officers," the Board should also define the term "senior management" to enable consistency in executing the requirement to obtain an understanding of compensation arrangements, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses with respect to the population of senior management other than executive officers.

Clarifying the intent of the proposed amendments

The proposed amendments to AS 12 would require the auditor to make inquiries of the chair of the compensation committee, or its equivalent, and compensation consultants engaged by either the compensation committee or the company regarding the structure of the company's compensation for executive officers as part of the auditor's requirement to understand the company's financial relationships with its executive officers to identify the risks of material misstatement. Some compensation consultants are concerned that this might result in a company's compensation decisions being second guessed by the auditor, or that the auditor could consider certain compensation plan designs to be inappropriate. We believe that when the Board adopts a final standard, the Board should address this misunderstanding and clarify in the release text that the intent of the requirement is to focus auditors on identifying and assessing the risk of material financial statement misstatement due to financial arrangements with executive officers, not on forming a view of the appropriateness of the compensation programs.

Evaluating whether significant unusual transactions are indicative of fraud (Question 18 in the release text)

A proposed amendment to paragraph 67 of the Board's interim standard AU 316, *Consideration of Fraud in a Financial Statement Audit* (AU 316), would identify factors that the auditor should evaluate with respect to whether the business purpose (or the lack thereof) indicates that a significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. We believe that the factor "the company's accounting for the transaction enables the company to achieve certain financial targets" should be deleted because it suggests that management's consideration of financial targets is, by itself, an indicator of fraud that the auditor should evaluate, even if the accounting is appropriate. We believe this could lead to unnecessarily evaluating transactions for fraud that clearly have not been entered into to engage in fraudulent financial reporting or misappropriation of assets. Furthermore, this factor is unnecessarily redundant because other factors in the proposed amendments address questionable accounting practices that we believe are the appropriate situations for the auditor to evaluate with respect to whether the company has engaged in fraudulent financial reporting or misappropriation of assets, including, for example, the factor that "management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transactions (e.g., accounting-motivated structured transaction)."

Use of the release text to interpret requirements

Consistent with our comments on various other PCAOB proposed standards, we believe that some of the guidance and examples that have been provided in the release text would drive more consistent execution if instead contained in the standard itself. Examples of requirements that we believe would be enhanced by moving guidance and examples from the release text into the standard are identified below.



Procedures to perform with respect to related party transactions and significant unusual transactions

Paragraph 15 of the proposed standard would require the auditor to perform certain procedures with respect to each related party transaction, or type of related party transaction, that is either required to be disclosed or determined to be a significant risk, including in subparagraph (d) to "perform other procedures as appropriate, depending on the nature of the related party transaction and the related risks of material misstatement, to meet the objective of this standard." Page A4-20-21 of the release text identifies the following examples of procedures that might be appropriate for the auditor to perform with respect to fulfilling the requirement of paragraph 15(d):

- Inquiring directly of the related party regarding the business purpose of the transaction;
- Inspecting information in the possession of the related party or other parties to the transaction, if available;
- Reading public information regarding the related party and the transaction, if any;
- Reading the financial statements or other relevant financial information obtained from the related party, if available, to understand how the related party accounted for the transaction;
- Confirming the terms of the transaction with other parties with knowledge of the transaction (e.g., banks, guarantors, agents, or attorneys), if any;
- Confirming whether there are any side agreements or other arrangements (either written or oral) with the related party;
- Evaluating the transferability and value of collateral provided by the related party, if any; and
- Performing procedures at the related party, if possible.

We believe the example procedures identified above are helpful to auditors and should be incorporated into the proposed standard as examples to supplement the requirement in paragraph 15(d).

Similarly, proposed new paragraph .66A to AU 316, *Consideration of Fraud in a Financial Statement Audit*, would require the auditor to perform certain procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction. Such procedures are nearly identical to those discussed above in relation to paragraph 15 of the proposed standard, including in subparagraph .66A(d) a requirement for "performing other procedures, as appropriate, depending on the nature of the transaction and the risks of material misstatement, to obtain an understanding of the business purpose (or the lack thereof) of the significant unusual transaction." Page A4-37 of the release text identifies examples of procedures similar to those shown above that might be appropriate for the auditor to perform depending on the nature of the significant unusual transaction and the risks of material misstatement of the financial statements. We also believe these example procedures should be incorporated into the proposed amendments to AU 316 to supplement the requirement in paragraph .66A(d).

Assertions that transactions with related parties were conducted on terms equivalent to those prevailing in arm's-length transactions

Paragraph 19 of the proposed standard would require the auditor to determine whether the evidence obtained supports or contradicts management's assertion in the financial statements that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's length transaction. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's



assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.

Footnote 35 on page A4-27 of the release text states that "a decision by management to remove, at the auditor's request, such an assertion from the financial statements due to management's inability to provide the auditor with sufficient appropriate audit evidence might impact the auditor's assessment of internal control over financial reporting." We believe this is important guidance that should be included as an additional Note in paragraph 19 of the proposed standard.

Inquiries of the human resource director

Paragraph 7 of the proposed standard requires the auditor to inquire of others within the company about the matters identified in paragraph 6 concerning related parties and relationships and transactions with related parties. Examples of others to whom inquiries might be directed include, in paragraph 7(e), the human resource director or person in equivalent position.

Page A4-43 of the release text states that this inquiry of the human resource director "also could provide an opportunity to the auditor to obtain an understanding of the company's financial relationship and transactions with its executive officers and how that relationship could create conditions that could result in risks of material misstatement, including fraud risks." We believe that inquiries of the human resource director or equivalent should be included among the Board's other proposed amendments to AS 12 that require the auditor to obtain an understanding of the company's financial relationships and transactions with its executive officers.

Proposed effective date (Questions 24 and 25 in the release text)

The Board anticipates that the proposed standard and proposed amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2012. We believe this anticipated effective date is reasonable if the SEC approves the Board's final standard no later than December 31, 2012 which should allow sufficient time for firms to implement required training in early 2013.

* * * * *

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Michael J. Gallagher (646-471-6331), Brian R. Richson (973-236-5615) or Thomas Gaidimas (973-236-5036) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP



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 asymmetric

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,

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

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,

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/IPMC_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.

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.



via e-mail to: comments@pcaobus.org

May 14, 2012

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Concept Release (No. 2012-001) on Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards (PCAOB Rulemaking Docket Matter No. 038)

Ladies and Gentlemen:

The Society of Corporate Secretaries and Governance Professionals (the “Society”) appreciates the opportunity to provide comments on the Concept Release on Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards, PCAOB Release No. 2012-001, issued on February 28, 2012 (the “Concept Release”) by the Public Company Accounting Oversight Board (the “PCAOB”).

Founded in 1946, the Society is a professional membership association of more than 3,000 corporate secretaries, in-house counsel and other governance professionals who serve approximately 2,000 companies of almost every size and industry. Society members are responsible for supporting the work of corporate boards of directors and their committees and the executive managements of their companies regarding corporate governance and disclosure. Our members generally are responsible for their companies’ compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements.

The Society appreciates the PCAOB’s efforts to improve the relevance and quality of public company audit reports to investors. However, we have several concerns with the proposed amendments. We have limited our comments to the amendments that cause us the most concern, namely the proposed amendments to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (the “Proposed Amendments”) relating to executive compensation.¹

¹ APPENDIX 3 –Other Proposed Amendments to PCAOB Auditing Standards Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (Section III.A. of Appendix 4) Auditing

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We believe that the Proposed Amendments are unnecessary, would improperly involve the auditors in corporate governance matters and would create impediments in the relationship between a company's Board of Directors and its auditors. Current auditing standards, particularly AU Section 316, *Consideration of Fraud in a Financial Statement Audit* ("AU Section 316"), when combined with an adequate level of professional skepticism, provide sufficient guidance to auditors. Requiring auditors to become involved in executive compensation decisions that are appropriately reserved to the Board of Directors – and, in particular to its Compensation Committee – would upset well established concepts of corporate governance. It also would move the auditor away from its primary role of expressing an opinion on whether the financial statements fairly present the financial position of the company and whether its internal controls are adequate. Our detailed comments follow.

The Proposed Amendments Would Improperly Expand the Role of Auditors in the Executive Compensation Decision-Making Process

Corporate law in each state reserves decision-making authority, including over executive compensation matters, to the Board of Directors.² As part of this authority, the Board is responsible for overseeing the recruitment, retention, and compensation of the executive officers of the company. Typically, senior management determines, with Board oversight, the strategic direction of a company, and the Board (or, more likely, an independent Compensation Committee) approves company and individual performance targets for which to be compensated. In recent years, shareholders have demanded that the compensation packages directly link pay to

Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows: a. Paragraph 10A is added after paragraph 10:

10A. The auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements). The procedures should be designed to identify risks of material misstatement and should include, but are not limited to (1) reading employment and compensation contracts and (2) reading proxy statements and other relevant company filings with the Securities and Exchange Commission and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers. Concept Release p. A3-1.

² See, e.g., DEL CODE ANN. Tit 8 § 141(a) (2012) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."); MODEL BUS. CORP. ACT § 8.02(b) (2002) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.").

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performance. Thus, the Board and/or the Compensation Committee are charged with approving the best way to align executive performance with the company's objectives.

Existing laws and regulations impose significant obligations to disclose executive compensation arrangements between a company and its executives. For example, Item 402 of Securities and Exchange Commission Regulation S-K requires discussion and analysis of "compensation awarded to, earned by, or paid to the named executive officers." Item 402 further requires a summary compensation table disclosing the detail of all elements of compensation. Item 601(a)(10) of Regulation S-K requires the public filing of contracts with directors and officers, including "any management contract or any compensatory plan, contract or arrangement." Other rules mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") governing compensation committee independence, pay ratios, and compensation clawbacks, are forthcoming. In addition to the comprehensive disclosure regimen, laws and regulations effectively mandate that executive compensation plans be approved by a shareholder vote³, and further that shareholders have an advisory vote on pay at most publicly held companies. Besides these extensive disclosure obligations and shareholder approval requirements applicable to executive compensation, certain industries have extensive regulation over executive compensation matters. For example, financial services companies must comply with guidance issued by the federal banking agencies regarding incentive compensation arrangements and Section 956 of the Dodd-Frank Act. With this level of disclosure, regulation, and the shareholders' frequent opportunity to voice their concerns, investors and other users of financial statements are well equipped to judge the risks that executive compensation may pose for them.

Groups such as Institutional Shareholder Services and activist shareholders have also played a role in shaping executive compensation by raising concerns when they believe executive compensation is unreasonable or provides inappropriate incentives. While there may be occasions where inappropriate incentives lead to fraud such as improper revenue recognition, the larger and more important concern relates to the impact of properly authorized and recorded transactions that may reward short-term profits, but impede longer term strategic and other goals. We also note that these groups acknowledge that compensation decisions are legitimately made by the Board or its compensation committee and that they find the existing disclosure sufficient for their analytical purposes.

While the intended effect of proposed Paragraph 10A to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, may not be to fundamentally impact the traditional role of the Board with respect to executive compensation, we are concerned that the unintended consequence of the amendment will be to have precisely that impact. By specifically requiring auditors to assess the risk caused by executive compensation, the role of the auditor would be transformed from providing assurance as to the reliability and accuracy of financial

³ See 26 U.S.C. § 162(m) (2012) (Internal Revenue Code).

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statements to that of a judge of the appropriateness and business impact of the compensation system. We believe that this changed role is inappropriate.

Risk-taking is a corner stone of capitalism. Some decisions turn out better than others.⁴ But at the end of the day, directors, who are elected by shareholders and charged with understanding the risks of the business, are in the best position to make executive compensation decisions. Warren Buffett has observed that the most important question to ask assessing a business' ability to succeed is whether the business model will work. This and most other business risks by their very nature are not susceptible to audit review. It is not coincidental that discussion and analysis of business risks, including executive compensation, are not addressed in financial statements themselves, but rather in other mandatory disclosures under Regulation S-K such as risk factors, executive compensation and management discussion and analysis.

We also believe the Proposed Amendments would create the following new problems:

- Requiring the auditor to substantively judge executive compensation would fundamentally change the relationship between the Board and the auditor. Section 301(2) of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") made clear that the audit committee is directly responsible for the appointment, compensation, and oversight of the work of the auditor. Under the Proposed Amendments, the auditor would be required in effect to express an opinion on the Board's business judgment, making the auditor both an overseer and servant of the board. The Proposed Amendments also seem to suggest that the auditor has an independent duty to the compensation committee. In fact, we would expect auditors to become obligated to attend compensation committee meetings. This needlessly complicates the auditor-company relationship. Moreover, the Proposed Amendments would complicate – and likely minimize or eliminate – the valuable role performed by independent compensation consultants to boards of directors and compensation committees.
- Auditor comments and/or advice regarding executive compensation would generate documentation and other records that could complicate any litigation or claims relating to the matters in question. Further, the records arising from auditor comments or advice would not be subject to attorney-client privilege or similar protections and could result in increased liability on the part of companies and their shareholders.
- The Proposed Amendments would appear to place the auditor in the role of advising the Board on substantive business decisions. This role seems inconsistent with the non-audit service prohibitions in Section 201 of the Sarbanes-Oxley Act and, in fact, not suited to the auditor's areas of expertise. Rather, this expanded role would entail analyzing executive compensation risk without the need to connect the risk with the rewards. Consequently, the auditor's advice may be skewed in favor of limiting compensation in a

⁴ See e.g., *In re the Walt Disney Company Derivative Litigation* 907 A.2d 693 (Del. Ch. 2005).

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manner that may not be in the best interest of the shareholders. In fact, depending on the auditor, the risk assessment process could result in certain companies having uncompetitive compensation arrangements, and thereby, putting those companies at risk of losing talented executives.

We strongly believe that all decision-making risks associated with executive compensation should remain where they currently reside, at the Board or the Compensation Committee.

The Proposed Amendments Would Result in Inefficient Use of Company Resources

The Society strongly supports the PCAOB's mission to "further the public interest in the preparation of informative, accurate, and independent audit reports." However, the role of the auditor is not to be a guarantor of the reliability and accuracy of financial statements, but rather as the audit report states, "to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."⁵ We believe that as additional tasks and responsibilities are assigned to the auditor, regardless of whether a specific task or responsibility is necessary for a particular audit, the auditor increasingly becomes enmeshed in the minutiae of a company's daily transactions rather than remaining focused on the larger, macro-view of the company's financial statements.

As each task is piled on, costs increase while, we fear, the results diminish. If an auditor merely read a company's executive compensation disclosures as part of its audit procedures because it had specifically identified a heightened risk in its audit planning process, then the cost to the specific company would likely be low. More importantly, the cost would not be borne by companies whose auditors have not identified significant audit risk associated with the executive compensation arrangements. Unfortunately, as we have seen in each case when auditors are required to perform specific procedures, the procedures will take on a life of their own. We would expect auditors to seek to demonstrate to the PCAOB (and potential plaintiffs) that they have met their obligations under Auditing Standard No. 12, to determine that a formal risk assessment of executive compensation arrangements would be necessary. Whether this risk assessment would be performed by a company's auditor (in spite of the prohibitions under Section 201 of the Sarbanes-Oxley Act) or if the auditor would require a third party to perform this risk assessment is unclear. But what is clear is that management and the Board would need to spend additional time and resources supporting and defending a company's executive compensation decisions to its auditors. We believe that management and the Board should focus their resources on the business and business risk, while auditors should continue to assess risks to the integrity of the financial statements.

⁵ AU Section 110, *Responsibilities and Functions of the Independent Auditor*, paragraph .02 (emphasis added).

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Existing Auditing Standards Are Sufficient

Detecting fraud through the auditor's proper level of professional skepticism has long been a principle guiding financial statement audits. Since 1998, when the AICPA adopted Statement on Accounting Standards No. 82, *Consideration of Fraud in a Financial Statement Audit* ("SAS No. 82"), the detection of fraud has been an increasing focus of auditors. Since then, SAS No. 82 has been superseded by a more comprehensive framework to detect fraud with AICPA Statement on Accounting Standards No. 99, *Fraud Detection in a GAAS Audit* ("SAS No. 99"), which has been adopted by the PCAOB pursuant to Rule 3200T as AU Section 316. Certain concepts of SAS No. 99, such as the requirement for audit teams to have "brainstorming sessions" on the potential for material misstatement due to fraud have also been incorporated into PCAOB Auditing Standard No. 12.

Fraud, by its very nature, is difficult to detect. Typically, the most significant fraud involves senior level management actively concealing or misleading the auditors. Fraud is also difficult to detect because the circumstances of fraud, including the position of the perpetrator, the accounts affected, and the concealment method, are case-specific. That said, the current auditing literature provides practical guidance to auditors to detect fraud. For example, Paragraph .07 of AU Section 316 alerts auditors to three conditions that usually exist when fraud occurs (incentive, circumstances, and rationalization). The guidance also provides examples of audit procedures rather than specific one-size-fits-all requirements. Ultimately, however, regardless of whether specific audit procedures are mandated or whether merely suggested, completing audit procedures will be a fruitless effort unless the auditor exercises professional skepticism.

The Society believes the PCAOB should not mandate specific audit procedures, but be more principles-based in order to improve fraud detection. A "questioning mind and a critical assessment of audit evidence"⁶ will uncover more cases of fraud than requiring auditors to comply with the Proposed Amendments. While preventing fraudulent financial statements is in the best interests of all public companies, we strongly disagree that additional auditing procedures, applied broadly to all companies, is a cost-effective solution.

For all of these reasons, the Society does not support the proposed amendments set forth in the Concept Release.

⁶ AU Section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraph 13.

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We thank the PCAOB for its efforts to improve the effectiveness of audits in detecting fraud, and we would be happy to provide you with further information to the extent you would find it useful.

Respectfully submitted,

The Society of Corporate Secretaries and Governance Professionals

A handwritten signature in black ink, appearing to be 'R. Lamm', with a large loop at the start and a horizontal line extending to the right.

Robert B. Lamm,
Chair, Securities Law Committee

cc: James R. Doty
Lewis H. Ferguson
Daniel L. Goelzer
Jay D. Hanson
Steven B. Harris

TCF FINANCIAL CORPORATION

BRIAN J. HURD
EXECUTIVE VICE PRESIDENT
TCF NATIONAL BANK

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

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.¹

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.²

¹ PCAOB Release No. 2012-001 (February 28, 2012).

² 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

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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.

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.

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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.³ 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.⁴ "Qualified performance-based compensation" is compensation paid solely on account of the attainment of one or more pre-established, objective performance goals."⁵

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.⁶ However, a possible

³ 26 U.S.C. 162(m).

⁴ 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.

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

⁶ 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

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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.⁷ 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

(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.

⁷ 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.

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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."⁸

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."⁹

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.

⁸ 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.

⁹ 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.

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Very truly yours,

A handwritten signature in black ink, consisting of a large, stylized 'R' followed by a '10' and a horizontal line extending to the right.



May 15, 2012

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

RE: Proposed Auditing Standard – *Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards*

To Whom It May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of Certified Public Accountants in Texas, as well as the public interest. The TSCPA has established a Professional Standards Committee (PSC) to represent those interests on accounting and auditing matters. The views expressed herein are written on behalf of the PSC. The PSC has been authorized by the TSCPA Board of Directors to submit comments on matters of interest to the committee membership. The views expressed in this letter have not been approved by the TSCPA Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policy of the Texas Society of CPAs.

Our discussion of the above referenced exposure draft (ED) resulted in the following answers to the questions posed by the Board.

Question 1: Is the framework neutral approach described in the introduction of the proposed framework appropriate? If not, why not?

We agree with the framework neutral approach.

Question 2: Is the objective of the proposed standard appropriate? If not, why not?

We believe the objective of the proposed standard is appropriate.

Question 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?

In our opinion, the proposed standard clearly articulates the auditor's responsibility for identifying related parties and obtaining an understanding of the company's relationships and transactions with related parties.

Question 4: Are the procedures for identifying related parties and obtaining an understanding of relationships with related parties appropriate?

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The identification procedures and the procedures for obtaining an understanding of relationships with related parties appear to be appropriate.

Question 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?

We found this question to be somewhat difficult to understand. We believe a more appropriate question is whether the proposed standard is clear regarding the auditor's responsibility when information comes to his or her attention that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Paragraph 11, as well as Appendix 2 and Appendix 3 provide procedures and transaction types that provide potential indicators of previous undisclosed transactions with related parties. However, none of the aforementioned paragraphs are clear as to what the auditor's responsibility is for the information that comes to the auditor's attention that indicate that previous undisclosed transactions might exist. Paragraph 16 mentions that procedures should extend beyond inquiry of management. However, examples of such procedures are not provided in the proposed standard. If the Board has specific requirements in mind regarding procedures beyond the inquiry of management, then examples of such procedures should be included in Appendix A.

Question 6: Is paragraph 12 of the proposed standard appropriately aligned with the existing requirements regarding the identification and assessment of risks of material misstatement?

Paragraph 12 of the proposed standard appears to be aligned with the existing requirements regarding the identification and assessment of risks of material misstatements.

Question 7: Are there other examples of fraud risk 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?

We believe there are numerous examples of related party transactions that imply a fraud risk or other significant risk. The following examples represent the kind of related party transactions that may well be an indication of fraud risk or other significant risk. We feel that numerous examples such as these exist in this area.

- Related party sourced sales and revenue.
- Related party purchases of materials or services.
- Issuance of stock to related parties, especially in situations where the stock is paid for services provided by the related party.
- Debt conversions by third parties to related parties.
- Review of shareholder lists or non-objecting beneficial owners lists for potential undisclosed related parties.

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- Transactions through an attorney or corporate counsel concealing related parties.
- Review beneficial owner disclosures in 10Ks or S-1s for possible related parties.

Question 8: Are there particular related party transactions that should be deemed a fraud risk or other significant risk?

See our response to Question 7 above.

Question 9: Is paragraph 13 of the proposed standard appropriately aligned with existing requirements regarding responding to the risks of material misstatement?

We believe paragraph 13 of the proposed standard is appropriately aligned with the existing requirements regarding responding to the risks of material misstatement.

Question 10: Are the procedures regarding related party transactions required to be disclosed in financial statements, or that are a significant risk appropriate? Are there other specific procedures that should be required?

We feel the procedures are appropriate. Paragraph 15d seems to indicate that the auditor should do what is necessary to become satisfied that their procedures are sufficient to satisfy any concerns surrounding related party transactions.

Question 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?

We believe the requirements in paragraph 16 are appropriate.

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

We believe the requirements in paragraph 17 are appropriate, even when the relationship or transaction with related parties was previously undisclosed.

Question 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?

We are basically in agreement with the goals of the proposed standard. However, we find it difficult to conclude that a related party transaction is one that is performed on equivalent terms with an arms-length transaction. We believe this is true based on the nature of a related party transaction and the association of the parties involved. Thus, when we analyze the paragraph on page A4-27 that begins "A note to paragraph 19 . . ." we conclude that this proposed standard will cause a significant number of

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qualified audit reports to be issued due to the fact that quality independent substantiating evidence that must be mandatorily acquired will not be available or even exist.

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

As indicated in our answer to Question 13, we believe the auditor will have difficulty in obtaining corroborating evidence as to the arms-length equivalence of related party transactions. While the proposed standard appears appropriate, we question its practicality as it usurps management's responsibility for financial disclosure and accounting responsibility, and places the burden squarely on the auditor as a surety to the users of the financial statements. According to the Securities Acts of 1933 and 1934, this responsibility rests with entity management, not the auditor.

Question 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?

We believe these requirements are consistent with existing rules and are appropriate.

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

We believe the auditor should be encouraged to exercise his or her professional judgment in dealing with related party transaction issues and their impact on the auditor's report. Related party transactions pose a unique issue that does not lend itself to narrow reporting guidelines.

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

We believe the proposed amendments are appropriate.

Question 18: Are the proposed amendments regarding the auditor's evaluation of significant unusual transactions appropriate?

We believe the proposed amendments in this area are appropriate.

Question 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?

We believe the proposed amendments to Auditing Standard No. 12 are appropriate.

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

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The proposed amendments to PCAOB auditing standards appear to be appropriate.

Question 21: Are the proposed standard and proposed amendments appropriate for audits of brokers and dealers?

As long as the proposed standard and proposed amendments in this area are consistent with existing literature in this area, we believe they are appropriate.

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

We are not aware of any additional procedures in this area that should be included in the proposed standard and proposed amendments.

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

We believe the auditor's communication to audit committees included in the proposed standard is applicable to audits of brokers and dealers.

Question 24: Is the Board's anticipated effective date appropriate?

Question 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?

We do not believe the Board's anticipated effective date is appropriate as we believe it does not allow sufficient time for firms to incorporate the new requirements into the methodologies, guidance and audit programs, and staff training. We encourage the Board to reconsider its proposed effective date.

We appreciate the opportunity to provide input into the standards-setting process.

Sincerely,



Kathryn W. Kapka, CPA, CIA, CGAP
Chair, Professional Standards Committee
Texas Society of Certified Public Accountants



CENTER FOR CAPITAL MARKETS
 COMPETITIVENESS

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May 30, 2012

Ms. Phoebe W. Brown
 Secretary
 Public Company Accounting Oversight Board
 1666 K Street, N.W.
 Washington, DC 20006-2803

Re: PCAOB *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (PCAOB Release No. 2012-001, February 28, 2012 and PCAOB Rulemaking Docket Matter No. 038)

Dear Ms. Brown:

The U.S. Chamber of Commerce (the “Chamber”) is the world’s largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information. The Chamber created the Center for Capital Markets Competitiveness (“CCMC”) to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.

The CCMC believes that businesses must have a strong system of internal controls and recognizes the vital role external audits play in capital formation. The CCMC supports efforts to improve audit effectiveness and appreciates the opportunity to comment on the Public Company Accounting Oversight Board (“PCAOB”) *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (“the Proposal”).

The CCMC has some concerns about various aspects of the proposal, particularly the possibility of creating an expectation gap, possible overreach into corporate governance, use of release text and a failure to provide a cost benefit

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analysis. The CCMC believes that some minor additions could resolve the potential expectation gap and believes that the PCAOB should discuss the proposal with the various regulators that are considering or will soon propose executive compensation related regulations.

The CCMC concerns are discussed in more detail below.

I. Executive Compensation

The CCMC has long advocated that the PCAOB review existing auditing standards and make revisions to them if needed. So at the outset we are pleased that the PCAOB has undertaken the opportunity to review the existing standards and release the Proposal.

The Proposal includes proposed amendments to existing PCAOB auditing standards that would add requirements for auditors to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers, including executive compensation. While the Proposal states that the intent of this added requirement is to assist the auditor in identifying and assessing risks of material misstatement, media coverage of both the PCAOB's open meeting on February 28, 2012 and the Proposal itself reveals that this intent is not well understood. Indeed, the Proposal appears to be creating an expectation gap in regards to the auditor's role and responsibilities related to executive compensation.

Such an expectation gap can sow confusion amongst auditors, investors and businesses and frustrate the intent of the PCAOB in issuing the proposal. To help mitigate this gap, it might be useful to include the following statement from release text in the rule itself (perhaps as a footnote):

These proposed audit 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 associated with a company's financial relationships and transactions with its executive officers,

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*including unrecognized compensation, illegal acts, or other matters (e.g., self-dealing or conflicts of interest).*¹

The Proposal also states that the procedures the auditor should apply with respect to executive compensation include reading proxy statements and other relevant company filings with the Securities and Exchange Commission (“SEC”). However, the proxy statement would likely be drafted and certainly would be filed subsequent to the completion of the audit. And, the executive compensation sections of the annual proxy statement largely contain historical information—that is compensation information related to the most recent period for financial statements included in Form 10-K filed with the SEC. It would seem that executive compensation information contemporaneous with the period under audit would be most useful for informing the auditor’s identification and assessment of risk of material misstatement. Thus, while there may be other reasons for the auditor to read the proxy statement, it is not clear how doing so would accomplish the stated purpose with respect to executive compensation.

While we acknowledge that the Proposal is based upon and revising existing audit standards, the CCMC has expressed concerns regarding the possible encroachment of the PCAOB into areas of corporate governance that is within the purview of state corporate law, or under federal legislation, such as the Sarbanes-Oxley Act (“SOX”) within the jurisdiction of the SEC. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) the SEC is involved in or expected to propose a series of regulations on executive compensation including incentive based compensation in the financial services industry, pay for performance disclosures, pay ratio disclosures and independent compensation committees. The proposed incentive based compensation regulation is a joint rulemaking of several financial regulators.

The CCMC of course believes that the PCAOB should act within the bounds of its jurisdiction. However, we believe that the PCAOB should also coordinate with these regulators to understand how the proposals interacts with expected regulatory changes and if any changes to the proposal should be made as a result.

¹ See *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards (“Release”)* Page A4 44.

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Finally in regards to executive compensation, the Proposal maintains the PCAOB's existing audit requirements regarding the auditor obtaining an understanding of compensation arrangements with senior management other than executive officers. However, in doing so, the PCAOB needs to provide clarity on what is meant by senior management. While the Proposal includes a definition of executive officers, it does not define senior management or indicate how senior management would differ from executive officers (and existing auditing standards do not either).

II. Use of Release Text

The CCMC is concerned, as we have written before,² about the use of release text to modify a standard and provide guidance and interpretations not found in the standard itself. One very important example of this in the Proposal involves the objective of the proposed related party standard.³

Certainly an objective can guide the PCAOB in developing and drafting a proposed standard and, as such, would also guide the auditor in complying with a promulgated standard. However, instead of articulating that complying with the requirements of the proposed standard would meet the objective of the standard, the release text of the Proposal suggests that the auditor must somehow exercise judgment to meet the objective of the standard over and above complying with the requirements of the standard itself.

Essentially the release text articulates a policy statement with regards to an objective, which is not only new but inconsistent with previous statements by the PCAOB. Such a statement is misplaced in the release text of an exposure draft. Moreover, it would require open, thorough, and transparent due process before being articulated as a policy. The notions articulated in the release text appear to open the

² For example, see the March 2, 2010 letter from the United States Chamber of Commerce Center for Capital Markets Competitiveness to the PCAOB on the *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (PCAOB Rulemaking Docket Matter No. 026) and the February 29, 2012 letter from the United States Chamber of Commerce Center for Capital Markets Competitiveness to the PCAOB on the *Proposed Auditing Standard Related to Communications with Audit Committees* (PCAOB Rulemaking Docket Matter No. 030).

³ See release Page A4-4.

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door to enabling PCAOB inspections to generate deficiencies and to otherwise extend auditor liability. The CCMC cannot support such notions.

As we have previously stated, the CCMC recognizes that the release text has merit, particularly in exposure drafts of proposed standards, as it can facilitate better public input. Nonetheless, since release text in any final standard will be referenced by plaintiff attorneys, PCAOB inspectors, and other regulators as a touchstone for the PCAOB's intent, we encourage the PCAOB to be very cautious and transparent in crafting release text for adopting standards.

Finally, there are examples provided in release text of the Proposal that should be included in the standard itself. To illustrate, the release text includes examples of other procedures performed during an audit that may help with the identification of significant unusual transactions.⁴ These examples should be included in the amendments proposed to AU sec. 316 *Consideration of Fraud in a Financial Statement Audit* (pp. A2-6 and 7).

III. Significant Unusual Transactions

Proposed amendments to existing auditing standards in the Proposal would change the definition of significant unusual transactions. For example, currently AU sec. 316.66 states:

Evaluating the business rationale for significant unusual transactions.
During the course of the audit, the auditor may become aware of significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment. The auditor should gain an understanding of the business rationale for such transactions and whether that rationale (or lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

On the other hand, the Proposal would replace the existing paragraph with the following:

⁴ Ibid, Page A4-33

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Evaluating whether the business purpose for significant unusual transactions indicates that the transactions may have been entered into to engage in fraud. 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 misappropriation of assets.⁵

Not only does the Proposal eliminate the touchstone for “unusual” based on the entity and its environment, but release text goes on to explain that significant unusual transactions need not be infrequent, rather a significant unusual transaction could occur quarterly or more frequently.⁶ On the face of it, this appears counter-intuitive and will likely contribute to ambiguity down the road about what constitutes a significant unusual transaction.

An additional problematic aspect of the proposed amendments related to significant unusual transactions includes the expanded list of factors (from AU sec. 316.67) that the auditor should evaluate as to the business purpose of significant unusual transactions (pp. A2.7 and 8). For example, the factor *an accounting for a transaction that enables the company to achieve certain financial targets* is a broad catch-all that could sweep-in a variety of unintended transactions.

IV. Other Matters

The Proposal states the Board anticipates that the proposed standard and proposed amendments would be effective for audits of financial statements for fiscal years beginning on or after December 15, 2012. This proposed effective date is not unreasonable as long as the PCAOB adopts and the SEC approves a final standard before the end of 2012.

V. Cost Benefit Analysis

The Proposal does not contain a cost-benefit analysis and commenters are therefore unable to ascertain what the estimated costs are and the burdens that will be

⁵ Ibid, Page A2-6

⁶ Ibid Page A4-30. An additional subtlety here is that the Proposal appears to turn significant unusual transactions from an indicator of a fraud risk (see AU sec. 316.85) to a fraud risk per se.

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placed upon businesses and auditors as a result of the proposal. This inhibits the ability of commenters to provide the PCAOB with a fully informed analysis that could lead to beneficial changes in the Proposal.

Concluding Remarks

Once again, the CCMC appreciates the opportunity to comment on the Proposal. We believe that the proposal is an important step in reviewing existing standards and revising them if needed.

While the CCMC has concerns regarding the Proposal, we believe that improvements can be made to reduce the expectation gap and provide clarity for all stakeholders involved in financial reporting and that comments to the Proposal would be more informed with a public cost-benefit analysis. Also, the CCMC believes that the PCAOB should have discussions with regulators concerning executive compensation regulations currently under consideration and that the PCAOB should avoid any potential over-reach into executive compensation and corporate governance regulation.

Thank you for your consideration and the CCMC stands ready to assist in these efforts.

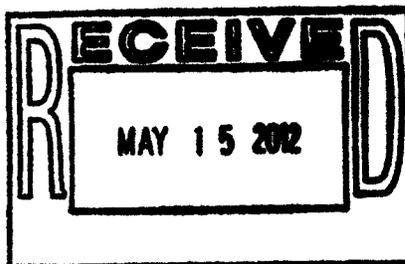
Sincerely,

A handwritten signature in black ink, appearing to read 'TK' with a long, sweeping horizontal stroke extending to the right.

Tom Quadman

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May 14, 2012

Office of the Secretary
PCAOB
1666 K Street, NW
Washington DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 038

Ladies and Gentlemen:

Thank you for the opportunity to provide comments on the Board's proposed Auditing Standard on *Related Parties*.

We recognize the Board's concern regarding related parties and audits of related party relationships and transactions. The Board could not have been clearer in its emphasis, as noted on page 9 of the Release:

Relationships and transactions with related parties have been a contributing factor in prominent corporate scandals, as discussed in the SEC study of five years of enforcement actions and in major enforcement cases, such as Enron Corporation, Tyco International, Ltd., and Refco, Inc. [Footnotes omitted.]

Although we share your concerns, UHY LLP cannot support the proposed Auditing Standard as written.

Background

When FASB Statement No. 57, *Related Party Disclosures*, was issued in March 1982, the Statement, like all other FASB Statements, included a "materiality box" after its effective date stating, "The provisions of this Statement need not be applied to immaterial items." In addition, paragraph 2, went even further than most standards, noting that "financial statements shall include disclosures of material related party transactions" [our emphasis]. Today, FASB ASC 105-10-5 paragraph 6 states, "the provisions of the Codification need not be applied to immaterial items."

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Undisclosed Relationships or Transactions

We discuss the notion of materiality because of the Board's proposed requirement in paragraph 17e of the standard on related parties. This paragraph proposes to treat any related party relationships or transactions previously undisclosed by management as a significant risk and subject to the requirements of paragraph 15. We believe that requiring undisclosed matters to *automatically* be treated as a *significant risk* is inappropriate because it precludes the auditor's use of professional judgment. While we understand the reason for heightened rigor in this situation, we note that in *all* other instances:

The auditor should use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of the inquiries about risks of material misstatement. [AS 12, *Identifying and Assessing Risk of Material Misstatement*, paragraph 55]

We believe that the auditor—as a professional—should always be provided the opportunity to assess the nature and materiality of related party relationships/transactions, to consider the reason for management's failure to disclose them, to consider the environment in which the relationships/transactions take place, and to assess the resulting risk of material misstatement. If the PCAOB wishes, given its concerns cited earlier, to establish a *higher standard* for undisclosed related party relationships/transactions, we suggest that the Board consider shifting the emphasis to the documentation required when an auditor encounters this situation. For example, it could require that undisclosed related party relationships/transactions be included in the auditors' communications with the issuer's audit committee without regard to materiality or other considerations. And, it could suggest—as discussed in footnote 4—that materiality assessments for related party relationships/transactions must be based on qualitative factors, not on quantitative factors.

Certainly, if an auditor using his or her professional judgment has a sense that the failure to disclose was willful or has some suspicious quality, it is appropriate for the failure to be treated as a significant audit risk. But, we believe that decision should be made by the auditor who has spent a significant amount of time assessing the issuer's operating environment and control structure, who has—as a professional—considered management's integrity and has established his or her audit plan accordingly. While we are not fond of using clichés to express our views, we can imagine no other change in professional auditing standards that would create a more “slippery slope.” Once the PCAOB begins to mandate the audit procedures required to be applied to specific relationships/transactions it will only be a matter of time until auditors will be found mechanically completing checklists and putting aside their professional judgment. We doubt this was the Board's intended outcome. While we agree that undisclosed related parties/relationships/transactions deserve special scrutiny, auditors should not be prohibited from using their professional judgment to determine which of these undisclosed matters constitutes a significant audit risk.

May 14, 2012
Office of the Secretary
Page 3

Completeness

We support the Board's proposal to modify AU sec. 333 to require management to make more complete representations about related parties. At the same time, we note that *current* AU sec. 334, paragraph .04 states, in part:

An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered. Nevertheless, during the course of his audit, the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and of common ownership or management control relationships for which FASB Statement No. 57 [AC section R36] requires disclosure even though there are no transactions. [Our emphasis added.]

Given the current proposal's *omission* of any concept similar to the first sentence above, does the PCAOB reasonably expect that the audit procedures it proposes will result in *all* related party transactions being discovered? AS No. 15, *Audit Evidence*, establishes the financial statement assertion of completeness. But, it is *management's* implicit or explicit assertion that all transactions and accounts that should be presented in the financial statements are so included, not the auditor's. While we recognize that it is not the norm for auditing standards to include such a statement, we believe the PCAOB should—at a minimum—clarify its expectations in this regard somewhere within the final standard.

Should you have any questions, please feel free to contact me at (203) 401-2101.

Very truly yours,



Paul Rohan, CPA
Partner
Director of Financial Reporting &
Quality Control



G A O

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

May 31, 2012

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Subject: PCAOB Rulemaking Docket Matter No. 038: PCAOB Release No. 2012-001: *Proposed Auditing Standard Related to Related Parties; Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions; and Other Proposed Amendments to PCAOB Auditing Standards*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) proposed auditing standard, *Related Parties*, amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other amendments to PCAOB auditing standards.

We appreciate the PCAOB's efforts to strengthen the existing audit requirements for identifying, assessing, and responding to the risks of material misstatements that may be associated with a company's related party and significant unusual transactions. However, we do have concerns that the proposed standard does not provide adequate guidance concerning the nature and extent of the auditor's actions and procedures that are specifically related to the risk of material misstatements associated with an entity's related party or significant unusual transactions. Although we do not advocate a prescriptive approach, adequate guidance is important to effectively provide the terms and boundaries that define the auditor's responsibility and the procedures necessary to identify, assess, and respond to the risks of material misstatements that may be associated with a company's related party transactions. In addition, we believe that the auditor's procedures should be more generally focused on determining whether management has properly identified and reported related party transactions, including consideration of management's process and controls concerning the identification and reporting of related party transactions.

The proposed requirements are designed to focus the auditor's efforts on those areas that pose an increased risk of material misstatement to the financial statements and the auditor's responses to those risks. Accordingly, the objective of this standard should more closely align with the risk assessment requirements included in Auditing Standards Nos. 12 and 13. Paragraph 4 of the proposed standard states that auditors should take into account information obtained from the performance of risk assessment procedures in identifying related parties and obtaining an understanding of relationships and transactions with related parties. Paragraph 12 states that auditors should identify and assess the risks of material misstatement at the financial statement and the assertion level, including identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties. We suggest that both of these concepts be incorporated into the objective statement of the proposed standard. Incorporating these concepts into the objective statement would also improve consistency with the stated objective of the analogous standards of the International Auditing and Assurance Standards Board.

The objective could be revised to: The objectives of the auditor are to (1) recognize risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risk of material misstatement, and conclude based on the audit evidence obtained whether the financial statements insofar as they are affected by those relationships and transactions achieve fair presentation; and (2) obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties that could have a material effect upon the financial statements have been properly identified, accounted for, and disclosed in the financial statements.

In addition to our comments regarding the objective statement, we also have comments regarding (1) the clarity of some requirements in the proposed standard and (2) redundant requirements.

Clarity of requirements

The proposed standard does not clearly articulate the auditor's responsibility in certain areas. The standard could be improved by providing guidance on both the purpose of each requirement and the auditor's specific responsibilities. For example, we noted the lack of adequate guidance for the following requirements:

Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties

- Paragraph 3 of the proposed standard does not provide clear guidance concerning the nature, timing, and extent of audit procedures that the auditor should perform to identify related parties. However, specific

requirements related to the identification of related parties are contained in the paragraphs beginning in paragraph 4. We suggest that the initial sentence in paragraph 3 parallel the language in paragraph 4 of Auditing Standard No. 12, such as follows:

Auditing Standard No. 12, paragraph 4, states that the auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud. This includes procedures to identify risks of material misstatements in the financial statements that may arise from the company's relationships and transactions with related parties, including related parties or relationships or transactions with related parties previously undisclosed to the auditor.

- Paragraph 7 of the proposed standard does not provide clear guidance concerning the extent of procedures to identify others within the company to whom inquiries should be directed. We believe that the identification of others within the company should be based on auditor judgment. Therefore, we suggest that the proposed standard indicate that such identification is based on auditor judgment.

Responding to the Risks of Material Misstatement

- Paragraph 14: The purpose of the requirement for the auditor to *“perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ”* is not clear, and the proposed standard does not provide guidance on the objectives or the nature, timing, or extent of procedures that the auditor should perform relative to intercompany account balances. The proposed standard could be improved by the addition of guidance on the procedures to be performed related to material intercompany balances, as well as guidance relative to when these procedures should be performed and some examples of the specific risks that are commonly associated with intercompany balances.

Communications with the Audit Committee

- Paragraph 20: The purpose of the requirement for the auditor to *“communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties”* should emphasize that previous communication of these matters to the audit committee by management may affect the form or timing of the auditor's communication. The proposed standard could be improved by the addition of guidance suggesting that the auditor's communication be focused on matters not

previously communicated by management and any other areas requiring significant auditor judgment.

Redundant requirements

Further, we believe the following paragraphs contain redundant requirements and should be revised. Specifically, the requirements that currently exist in other PCAOB standards should not be restated as separate requirements, but should instead refer directly to the other standard where the requirement is stated and explained.

Identifying and Assessing Risks of Material Misstatement

- Paragraph 12: The requirement that the auditor should “*identify and assess the risks of material misstatement at the financial statement level and the assertion level*” is a duplicated requirement of Auditing Standard No. 12, as noted in footnote 8 of the proposed standard. The paragraph should be restated to focus on the auditor’s responsibility relative to related parties. As revised, the paragraph would appear as follows:

Auditing Standard No. 12, paragraph 59, states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. This includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties.

Responding to the Risks of Material Misstatement

- Paragraph 13: The requirement that the auditor must “*design and implement audit responses that address the assessed risks of material misstatements*” is a duplicated requirement of Auditing Standard No. 13, as noted in footnote 9 of the proposed standard. The paragraph could be restated to focus on the auditor’s responsibility relative to related parties. As revised, the paragraph would appear as follows:

Auditing Standard No. 13, paragraph 3, states that the auditor must design and implement audit responses that address the 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.

Evaluating Financial Statement Accounting and Disclosures

- Paragraph 18: The requirement that the auditor must “*evaluate whether the financial statements are presented fairly, in all material respects, in*

conformity with the applicable financial reporting framework” is a duplicated requirement of Auditing Standard No. 14, as noted in footnote 14 of the proposed standard. The paragraph could be restated to focus on the auditor’s responsibility relative to related parties. As revised, the paragraph would appear as follows:

Auditing Standard No. 14, paragraph 30, states that the auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. This includes evaluating whether the financial statements contain the information regarding related party transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

* * * * *

Overall, we support the general premise to strengthen the existing audit requirements relating to the risks of material misstatements that may be associated with a company's related party and significant unusual transactions. We thank the PCAOB for the opportunity to provide comments on this important project.

Sincerely yours,



James R. Dalkin
Director
Financial Management and Assurance

GILBERT F. VIETS
2105 North Meridian Street, Suite 400
Indianapolis, Indiana 46202

May 30, 2012

Mr. J. Gordon Seymour
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Docket 038: Proposed Auditing Standard on Related Parties and Related Amendments to PCAOB Auditing Standards

Dear Members of the Board and Mr. Seymour:

Thank you for addressing the audit standards concerning related parties. Investors who make their decisions using audited information not transparent often make decisions that would have been different if they had been informed about obscured relationships. Your search for truth is helpful.

I believe you can provide investors and auditors with additional support in dealing with these relationships that, in some cases, cross the lines of integrity, moral values and the law. Thus, I offer four suggestions:

- 1. All audit contracts between auditors and Registrants should include language concerning responsibilities for related parties, jointly acknowledging responsibility for investor awareness.** Such language would reinforce to the company and the auditor the significance of related party activity that may produce effects about which investors need to know.
- 2. The standard should address the responsibility of Registered Public Accounting firms who provide services to non registrants where the non registrant is related to a Registrant.** In many cases, the related party in a transaction with a Registrant is audited by a Registered Public Accounting firm. The business purpose of the relationship, or lack thereof, is often more obvious to the second accounting firm than to the auditor of the Registrant. The bankruptcy examiner's reports for Enron revealed extensive involvement of major accounting firms in the affairs of Enron's off book entities, providing audit, valuation, tax and other services. I believe there are many similar situations. The new Auditing Standard is an opportunity to make clear to all Registered Public Accounting firms that they are part of a system that must appropriately address suspicious activities involving a public company. Any accounting firm that is part of the

community of Registered Public Accounting Firms should not knowingly facilitate cloaked transactions, hidden in non public entities for no business purpose other than to conceal activity of a Registrant.

- 3. *The standard should not blur the distinction between a “related party” and a “co-conspirator.”*** Appendix A, *“Examples of Information and Sources of Information That Could Indicate That Related Parties or Relationships or Transactions With Related Parties Previously Undisclosed to the Auditor Might Exist,”* includes several examples that are commonly collusive, but not necessarily what we think of as related party transactions, unless your intent is to equate all collusive activity as being with a related party. “Bill and Hold” is one example with which the other party is frequently a “co-conspirator,” but not necessarily a “related party.” Certainly all of these arrangements are proper concerns for auditors and investors, and it is possible that little is lost in mingling terms and examples; but interchangeability of the terms and their examples can lead to confusion and debate about what is really intended. Here, I suggest a final review before adoption to make the standard as concise and clear as possible.
- 4. *The standard should further distinguish the term “in a timely manner” when it refers to Communications with the Audit Committee.*** The Note to paragraph 20 says: “...in a timely manner and prior to the issuance of the auditor's report...” The language of the draft proposal is too soft and is an argument for letting the information linger until “all the facts are in,” up to the point when the audit report is released. Audit committees have a significant role to play and responsibility for getting to the bottom of such issues as soon as possible. I suggest the standard include the language “...as soon as the auditor determines there may be an undisclosed relationship...” to clearly distinguish the timely manner standard from “...prior to the issuance of the auditor’s report...”

Thank you for considering these suggestions. If you have questions, please call me at 317 513 5407.

My background for offering these comments include many years as an audit partner in a major firm, teaching auditing at a major university for two years, serving as a corporate CFO, board member and audit committee chair at various times for public entities.

Sincerely,

Gilbert F. Viets

317 513 5407
gilviets@aol.com

NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on May 17, 2012 that relates to Related Parties/Significant Unusual Transactions. The other topics discussed during the May 17, 2012 meeting are not included in this transcript excerpt.

The Public Company Accounting Oversight Board does not certify the accuracy of this unofficial transcript, which may contain typographical or other errors or omissions. An archive of the webcast of the entire meeting can be found on the Public Company Accounting Oversight Board's website at: http://pcaobus.org/News/Webcasts/Pages/05172012_SAGMeeting.aspx.

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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STANDING ADVISORY GROUP

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MEETING

+ + + + +

THURSDAY
MAY 17, 2012

+ + + + +

The Standing Advisory Group convened in the National Association of Home Builders Auditorium, 1201 15th Street, N.W., Washington, D.C. at 8:30 a.m., Martin Baumann, Chairman, presiding.

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1 MR. BAUMANN: The next subject on our agenda is
2 a recently proposed standard on related parties, which
3 included certain amendments to other standards
4 pertaining to significant unusual transactions. We
5 first turn it over to Jay Hanson for some brief
6 comments on this matter.

7 MR. HANSON: Thanks, Marty. It's been a long
8 day, and we've got a lot of road to cover in the next
9 55 minutes, and so I'll be brief. The related party
10 standard we're about to talk about we issued as a
11 proposal in February, and the original comment period
12 has ended but we're extending it a few more weeks in
13 light of this discussion today. I personally think
14 it's a really important standard for investor
15 protection. In my career, I have been involved with
16 actually detecting a fraud through diligent questioning
17 of related party transactions, and I understand the
18 importance of this. And many of the things that we put
19 into this proposed standard I believe are just common
20 sense and things that are being done today in practice.

21 And so I'm hoping that we get good feedback
22 today from all of you on this project, and I hope we

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1 get good feedback in the comment letters. So far,
2 we've only received less than ten or so comment letters
3 as of this morning.

4 And as Marty had mentioned earlier in the day,
5 there was initially, when we put this out in February,
6 some reports in the press of concern about the
7 executive compensation portion of this proposal, and I
8 was surprised by that. And we have received a few
9 comment letters that amplify those concerns that were
10 in the press. And one of the comments said that our
11 particular requirement that we're about to consider
12 could constitute an unwarranted check on management's
13 prerogative to structure executive compensation in a
14 manner that is in the best interest of shareholders.
15 And as we will explain a little bit, that is not what
16 was intended. And today auditors already need to look
17 at executive compensation arrangements because things
18 like accruals for bonuses and stock options and things
19 like that, you can't audit those without looking at
20 those arrangements. And so this is just a natural
21 extension of considering the risk effect of those
22 arrangements.

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1 So with that, I will turn it over to Greg Scates
2 and the rest of the staff to talk about this.

3 MR. SCATES: All right. Thank you, Jay. This
4 proposal includes three principal elements. It's a new
5 standard on related parties which would supersede the
6 existing standard, our AU Section 334. 334 has been
7 around a while, and it's aged quite a bit over the
8 years, and it needed to, we needed to make some
9 enhancements to it. And so we took that opportunity to
10 not only make enhancements to this standard on related
11 parties but also to take a look at another important
12 area of the audit, and that has to do with the
13 significant unusual transactions.

14 And so we took that opportunity to enhance those
15 paragraphs, particularly paragraphs 66 and 67 of AU
16 316, the fraud standard, to improve, we thought that
17 there were some improvements that we could make there.
18 We wanted to make those improvements because,
19 oftentimes, when you have related party transactions,
20 they may involve a significant unusual transaction and
21 vice versa. So as you'll see, as you noted in the
22 proposal, in the proposed standard itself, in the

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1 language, you'll see that we referred to 316,
2 paragraphs 66 and 67, the new amended ones we're
3 proposing, in the related party standard that the
4 auditor needs to be cognizant of that fact that you
5 could have significant unusual transactions in this
6 area, and those transactions need to be evaluated
7 similarly to the related party transactions in that the
8 auditor needs to understand the business rationale
9 behind those transactions.

10 Also, as Jay mentioned, as was mentioned by
11 Marty this morning, we did also propose an amendment to
12 Auditing Standard Number 12 with respect to the
13 auditor's responsibility to gain an understanding of
14 the compensation arrangements and any relationships
15 with its executive officers. The executive officers of
16 a company are related parties, and we think it's
17 important that we put that language in the risk
18 assessment standards itself so the auditor can carry
19 out an appropriate risk assessment process in order to
20 gain an understanding of any relationships that are
21 going on with its executive officers and make sure that
22 there are appropriate disclosures in that area.

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1 As Jay also mentioned, in light of the
2 discussion today, we did extend the comment period from
3 May 15th to May 31.

4 What I'd like to do now is to go ahead and open
5 the discussion up to you this afternoon, the remaining
6 minutes we have, and we can start with any of the
7 areas. We can start with related parties or, if you'd
8 prefer, we can go in to significant unusual
9 transactions and then also we can touch on, if you'd
10 like to, talk about the amendment to the risk
11 assessment standards on the executive compensation and
12 the auditor's responsibility to understand those
13 relationships.

14 So I'll open the floor up if we'd like to go
15 ahead and start talking about any particular of those
16 areas. I see one tent card up. Jamie Miller?

17 MS. MILLER: Yes. My comments relate to the
18 related parties proposal. And I think the standard as
19 written or the proposal as written appears to be okay.
20 But given the press that we've seen, and, Jay, I
21 appreciate your comments that that wasn't necessarily
22 the intent or how the standards should be read, but it

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1 may be important to clarify the words in the standard
2 to make it more clear that this is sort of a risk
3 assessment process, as opposed to an audit or some
4 other deeper, you know, sort of assurance around the
5 exec comp structure and that there isn't an expectation
6 that auditors are engaged in the compensation committee
7 process or in an audit of that process. So just a
8 thought that, you know, given the misunderstandings
9 that are out there, maybe we want to re-read the
10 proposal in that light.

11 MR. SCATES: Jamie, thank you for your comment.
12 That clearly was not our intent at all is to get into
13 the executive compensation arena. I mean, that clearly
14 resides with the board and with the compensation
15 committee. This is purely from a risk assessment
16 perspective so the auditor can appropriately carry out
17 his or her procedures in this area. And based on the
18 comments we receive on this, if we need to make some,
19 we'll certainly make some clarification in that area
20 because we certainly want to make sure that it's
21 focused only on risk assessment and then how the
22 auditor then responds to that risk assessment.

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1 Oh, Susan DeMando Scott? Susan, your mic.

2 MS. SCOTT: Thank you. Thank you very much.

3 I'd like to comment on the related parties standard.

4 Primarily, I'd like to talk about it with respect to

5 broker/dealers. I know we've talked a lot today about

6 issuers and, obviously, being from FINRA, I have an

7 interest as to how these standards might apply to

8 audits of broker/dealers.

9 Just by way of very brief background, FINRA is

10 the largest independent regulator of securities firms

11 that operate in the United States. We oversee the

12 activities of approximately 629,000 registered

13 representatives and 4400 broker/dealers. I work in the

14 Risk Oversight and Operational Regulation Department.

15 What that means is we focus on broker/dealers'

16 compliance with Net Capital Rule, Customer Protection

17 Rule with respect to safeguarding customers' cash and

18 securities, and also the Books and Records Rules. As

19 part of our work, we look at over 30,000 unaudited

20 financial filings a year and also the audited

21 financials for each of our 4400 members. And I want to

22 say that we consider them a very important tool as part

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1 of our regulatory program, and, certainly, robust
2 standards with respect to related party transactions
3 are very important.

4 I just want to mention briefly, because I think
5 when one thinks of related party transactions with
6 respect to issuers, they take on a very different
7 flavor than what one would see in the broker/dealer
8 world. So just very briefly, I want to talk about five
9 high-level scenarios, and there could be more, but I
10 will limit it to that where we see related party
11 transactions.

12 The first has to do with the use of expense
13 sharing agreements or management services agreements.
14 These are used by broker/dealers to, many times,
15 overpay for goods or services that are provided to the
16 broker/dealer by an affiliated party. The transactions
17 can be used to disguise capital withdrawals from the
18 broker/dealer. Capital withdrawals, for the most part,
19 have to be reported to the SEC. And in many cases,
20 FINRA and the SEC will actually limit capital
21 withdrawals or require that we provide approval before
22 the broker/dealer can withdraw capital.

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1 Related party transactions can also be
2 structured in an attempt to avoid the imposition of
3 higher capital requirements. A lot of people don't
4 understand that the capital rule is not static. The
5 capital rule imposes requirements based on the activity
6 that a broker/dealer is actually engaged in, so there
7 are times when arrangements are entered into so that a
8 broker/dealer with a lower capital requirement will not
9 be subject to, so that the regulators won't know really
10 that their activity should require the imposition of a
11 higher standard.

12 Related party transactions also can be
13 structured in an attempt to avoid various capital
14 charges. That means that the broker/dealers' financial
15 statements may look better than they actually are.
16 This is usually done via parking securities with an
17 affiliated entity.

18 There are two more scenarios that I'd like to
19 mention briefly. One has to do with a broker/dealer
20 structuring their business model to look smaller than
21 it is. In this way, FINRA may not know the true extent
22 of the firm's operations, which means that firm is more

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1 than likely to be on a more extended examination cycle
2 than if we were fully aware of all of its operations.

3 Also, often our members operate pursuant to a
4 membership agreement. This is a permission slip, if
5 you will, where FINRA and the broker/dealer kind of,
6 FINRA approves and the broker/dealer agrees to operate
7 within certain constructs. When a broker/dealer's
8 business is larger than it is and when we don't realize
9 that because of related party transactions, that means
10 the broker/dealer may be failing to apply to us for the
11 expanded business model and we may not be able to
12 conduct our due diligence with respect to the proposed
13 activities and whether or not we would actually approve
14 them.

15 And, finally, to the extent that related party
16 transactions are used to put a customer's assets in
17 inappropriate locations, locations that are not
18 approved pursuant to the SEC's Customer Protection
19 Rule, then those assets may be at risk.

20 I wanted to mention just briefly how we see
21 related party transactions. Again, there are other
22 examples that I won't go into over time. I will say

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1 that the common theme is that the related party
2 transactions that I've talked about today are noted
3 across broker/dealers of size and business model.

4 One final point just to make in terms of the
5 statistics. I think we tend to think of broker/dealers
6 as either clearing and carrying firms, those that
7 settle trades and hold custody, or the introducing
8 firms that act as agent and execute those trades.
9 Somewhere between, I don't have exact numbers with me
10 today, but probably somewhere between one out of eight
11 I'm going to just say for now operate businesses that
12 are totally unrelated to either the clearing and
13 carrying firm or the introducing firm model, and the
14 preponderance of those other firms are engaged almost
15 exclusively in the sale of unregistered securities.

16 So, consequently, I think these proposals are
17 very important. The audits, again, are important tools
18 to FINRA. We use them. And I think most importantly,
19 they're important tools to investors who can go into
20 the SEC's website and look at the audited statement of
21 financial condition of broker/dealers. So thank you.

22 MR. SCATES: Thank you, Susan. Thank you for

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1 those comments. Joe Carcello?

2 MR. CARCELLO: Thanks, Greg. I really liked
3 your proposed rule, and I just want to make a few
4 comments. These are relatively granular comments. On
5 page A4-15, you ask if there are other examples of
6 fraud risk factors in addition to dominant influence
7 that should be included in the proposed amendments to
8 assist the auditor when determining whether an RPT is a
9 fraud risk. I didn't see, Greg, where there had been
10 any discussion, and maybe I missed it, but transactions
11 at year-end, transactions that help the entity hit an
12 earnings target, particularly if it's processed outside
13 normal processing channels. So you might want to
14 consider that.

15 Also on page A4-15, you reference footnote six
16 of AU Section 334.09, and I'm quoting, "Until the
17 auditor understands the business sense of material
18 transactions, he cannot complete his audit," and my
19 question is has this language been removed from the
20 proposed standard? I didn't see it if it was still
21 there. This is strong language and language that
22 affects people's behavior, so I would consider adding

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1 it back.

2 On page A4-34, you talk about performing journal
3 entry testing, including inquiring of individuals
4 involved in the financial reporting process, about
5 inappropriate or unusual activity related to the
6 processing of journal entries. And that's fine, but
7 what about testing for topside adjustments, adjustments
8 that bypass the general ledger and, hence, require no
9 entry, no journal entry and go directly to the trial
10 balance or the financial statements? I didn't see any
11 discussion of that.

12 And then the last thing is on page A4-43. You
13 talk about the auditor could take into account other
14 available audit evidence, such as disclosures and SEC
15 filings that describe the company's compensation
16 policies and practices that present material risks to
17 the company and disclose fees paid to compensation
18 consultants in certain circumstances. So my reaction
19 to that is why could and not should since these SEC
20 disclosures are supposed to address how compensation
21 plans might increase risk? It's just hard for me to
22 understand why the auditor would not just automatically

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1 look at that.

2 MR. SCATES: Joe, just a follow-up on one of the
3 items there. On the journal entry testing, do you
4 think the journal entry testing is sufficient that we
5 have already in 316, or do you think we should consider
6 taking another look at that?

7 MR. CARCELLO: Greg, I didn't re-read 316 as I
8 was reading this, so I'd have to look at 316.

9 MR. SCATES: Okay. That's fine. Okay. Roman
10 Weil?

11 MR. WEIL: Here I don't have anything to add
12 except seeking clarity. I figure if I don't understand
13 something there might be somebody else who doesn't, as
14 well. So this is a really dense document, and the way
15 I think about this is like a taxonomy of three things.
16 One, what is a related party transaction? I don't
17 think there's an attempt here to redefine what that is.
18 Number two, how do we spot them? And, number three,
19 once we've spotted one, is it a risk? What should we
20 do about it?

21 Now, the way I read this document, and this is
22 where I want clarification if I'm wrong, this is mostly

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1 about number three. They're not new definitions and no
2 new attempts to figure out where management is hiding
3 them. That's like finding the side letters. If you
4 can figure out how to find them when they're trying to
5 hide them, then we ought to be writing a side letter
6 revenue recognition fraud one, too.

7 So if it is just about number three, I'd just
8 like you to somehow for this document to make clear
9 that that's what it's about. I think that's what I get
10 out of it. Not a new definition, not new help in
11 finding them, but once you've found them how to
12 evaluate them; is that right?

13 MR. SCATES: Well, the related parties
14 themselves are defined by the applicable framework.
15 Related parties are defined in IFRS, as well as in US
16 GAAP. The standard itself indicates what the auditor
17 should do in order to identify related parties and
18 transactions or relationships with those related
19 parties, and then once they're aware, which management,
20 when they inquire of management, management should
21 obviously inform the auditor of all the related parties
22 and the transactions they have with those related

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1 parties, and then the auditor is required then to audit
2 those transactions that are required to be disclosed in
3 the financial statements or they are a significant
4 risk. And so those procedures are outlined in the
5 standard.

6 But in addition, the auditor, though, is
7 required to, if they become aware of any transactions,
8 any related parties or transactions or relationships
9 with related parties that were not disclosed to the
10 auditor, then the auditor has an additional
11 responsibility to then audit those particular items.
12 And then, of course, it's a huge red flag, and then
13 they need to bring that to the attention of the audit
14 committee. So the standard is about identifying and
15 evaluating those transactions with related parties.

16 MR. BAUMANN: Greg, to Roman's question, the
17 standard does go further, this proposed standard goes
18 further than 334 in connection with your number two.
19 Number two was largely in 334, I don't want to say
20 exactly, but it was inquire of management about related
21 parties and obtain a list from management of related
22 parties primarily. This still acknowledges to do that

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1 step, but it tells the auditor to do more and it spells
2 out a number of other sources where the auditor might
3 find indications that there are related parties that
4 were previously unidentified. So it does attempt to do
5 more with respect to the second point you made about
6 how to spot those related parties that were not
7 previously identified to the auditor.

8 MR. SCATES: Lynn Turner?

9 MR. TURNER: Marty, just back to the comment you
10 just made and maybe I had, as I went through it, I had
11 some of the same thoughts as Roman did. But when I
12 went through, for example, in paragraph four up-front
13 where it talks about identifying related party
14 transactions, and I started looking through it and
15 noticed, chewing on through four, five, six, it's got
16 the auditor should inquire in paragraph six, paragraph
17 seven the auditor should inquire. I got to paragraph
18 eight, the auditor should inquire. And I started to
19 get this feeling that this was an audit by inquiry, and
20 if people are doing bad things with related party,
21 because there are legitimate related party transactions
22 and there are illegitimate related party transactions.

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1 But when there's been a problem inquiry has turned out
2 to be a woefully, if not totally, ineffective
3 procedure. And so I think you've got to come back in
4 and do something other than inquiry. I agree with you
5 this an improvement over 334. I think this is headed
6 in the right direction. But to Joe's point, for
7 example, related party transactions have shown up in
8 quarterly or year-end closing entries and were done to
9 make the earnings, and we created the related party
10 just to do that. It seems to me you've got to, part of
11 this has got to be, you've got to do more than just ask
12 people about it. You've got to look at those
13 transactions, you've got to look for transactions in
14 the general ledger that may raise questions about
15 things, you need to look at transaction where there's
16 no fee, which would raise the question why are you
17 doing this for free, those type of things.

18 So I think you've got to go beyond the inquiry,
19 and maybe I just didn't study it enough before, but I
20 came back away from reading that section that this is
21 going to be an audit by inquiry. And in this area,
22 that's never proved to solve the problem.

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1 MR. SCATES: Lynn, I agree with your point about
2 the inquiry. But in the standard itself, though,
3 particularly paragraph 11, refers the auditor to the
4 appendix, to the standards at Appendix A where the
5 auditor is cognizant or should be cognizant of the
6 information coming to his or her attention, sources of
7 information throughout the audit. And once that
8 information comes to the auditor's attention, the
9 auditor cannot just sit on it. The auditor then has to
10 react to that information when it indicates that there
11 are transactions with these type of parties.

12 MR. TURNER: I think that's a fundamental
13 problem where we're finding problems with audits. And
14 back to the point that Brian has made at times, how
15 that we don't necessarily agree on it all the time,
16 when you look at these that have popped up, auditors
17 missed it because the information didn't come to their
18 attention. In audits today, all too often we get a set
19 of numbers and we go audit those numbers and we audit
20 for information to support those numbers. What the
21 Muddy Waters and hedge funds and research firms are
22 doing is going beyond that and looking for information

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1 that says those numbers may be wrong, and
2 fundamentally, we don't do that in an audit. I think
3 we should. I think just doing an audit tells you you
4 should do that. You can't just look for supporting,
5 you've got to look for contrary type information. And
6 certainly that's true with respect to related parties,
7 and I think, unless you tell the auditors you've got to
8 go look for information that may be available on a
9 public domain that you haven't been provided that may
10 raise questions with related parties, then you're not
11 done yet. And I think that's the piece that's
12 seriously missing here.

13 Now, I'll go back through it and maybe I
14 misread, you know. Maybe it's better than what I
15 think. But I think that's the piece that's missing
16 here, and until you put that piece in you'll never
17 solve the problem with related parties, to Brian's
18 point, and it won't get you there. I think you ought
19 to go back and look at some examples where we had
20 serious related parties, be it Enron or, you know,
21 who's a classic case, or some of the others, and see if
22 this would have actually been using these procedures

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1 that would have turned around and should have resulted
2 in the auditor detecting the issue. And I just don't
3 know that it does at this point in time.

4 MR. BAUMANN: Lynn, those are really valuable
5 comments. I mean, one of the very important things we
6 struggled with in this proposal and, clearly, as you
7 said, it does go further than existing 334, and
8 paragraph 11 tells the auditor to, aside from the
9 additional inquiries, tells the auditor to evaluate
10 information that comes to their attention as part of
11 the audit and directs them to Appendix A, which is a
12 whole long list there.

13 But having said all of that, your reading of it,
14 you're saying is that enough and should the auditor do
15 even more to identify undisclosed related party
16 transactions? And that's an important comment for us
17 to take back and consider and think about are there
18 other ways that the auditor should go about doing that.
19 And, again, we thought about that and we thought about
20 how far do we want to have an auditor go and what's the
21 appropriate extent of those procedures of digging a
22 needle in a haystack kind of thing but performing more

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1 procedures.

2 So I think your comment is I think right on
3 point with one of the critical issues of this standard,
4 and that is how deep should we make the procedures, to
5 what Roman brought up, and you're bringing up
6 identifying undisclosed related parties.

7 MR. TURNER: Don't get me wrong because I think
8 you've got a very good start here, Marty, and I think
9 it is a good improvement. I'm still not convinced, to
10 Brian's point, though, that it's actually going to
11 solve the problem, and I think that's really what you
12 want to do at the end of the day is make sure you solve
13 the problem with this standard and we aren't back here
14 in ten years at the table.

15 But I think the other piece of that that I go
16 with is as the information comes to you and you start
17 to see more and more question marks, I think I'd make
18 it very clear you've got to go further because we've
19 always held in the auditing profession that we're not
20 responsible for and we don't have to go audit the
21 related party. And in court cases, the firms have
22 always argued that under 334, you know, you make sure

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1 the disclosure is okay, but you don't have to go audit
2 the related party. I would tell you that's, you know,
3 as you dig down and you find more and more trouble,
4 that you need to make it clear then to the auditor that
5 mere disclosure doesn't resolve the issue, that if, in
6 fact, as you dig down, you start to find more
7 information that raises a question about the business
8 nature of the transaction or the purpose or why we're
9 doing this that you may have to go further and it could
10 ultimately, if it's really an ugly thing, you may
11 actually have to go down to where you actually audit
12 down to the related party. I think that wouldn't be
13 the case in most cases, but certainly one could argue
14 that in the Enron case perhaps the auditors, the
15 standards should have said if it's that type of
16 situation and that bad you need to go audit the
17 Raptors. And unless you can audit and get your hands
18 around what was going on with the Raptors, you couldn't
19 issue an opinion on Enron.

20 And so I think it's not only do you have to look
21 at information that might not have come to your
22 attention, you have to make a positive search for

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1 information on related parties. But then also, as you
2 dig down and it becomes more and more questionable,
3 then you've got to keep digging down, and disclosure
4 alone won't solve that problem.

5 MR. BAUMANN: Again, sorry, Greg, but I think
6 you've gone to the heart of the key question in this
7 proposal, and that is have we gone far enough? And
8 you're suggesting think about going further and how to
9 do that. So thanks for those comments.

10 MR. SCATES: One thing I would add, Lynn, to the
11 comment about the disclosure, you're right with respect
12 to the existing standard today. But under this new
13 proposal, when there is a disclosure of related party
14 transactions, it's mandatory, that's going to have to
15 be audited today. That transaction is going to have to
16 be audited, and the auditor is going to have to
17 understand the business rationale behind the
18 transaction and read the arrangements or contracts in
19 place with respect to those transactions. So that one,
20 I think we took care of that area with respect to the
21 disclosure. It's now going to be audited, all that
22 information, and supported with the relevant audit

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1 evidence.

2 MR. DEGANO: One other thing to consider is that
3 the additional procedures that are being proposed for
4 significant unusual transactions would also be helpful
5 in identifying previously undisclosed related parties.
6 Significant unusual transactions could end up being an
7 undisclosed related party transaction, so by improving
8 the auditor's identification of significant unusual
9 transactions and their evaluation of the business
10 purpose of those transactions, that could also help to
11 inform the auditor's consideration of whether there's
12 previously undisclosed related parties.

13 In the evaluation section, like Greg was
14 mentioning, the auditor is going to be asked to look at
15 each related party transaction or type of transaction
16 that requires disclosures. And part of the proposed
17 standard reminds the auditor that they should be
18 performing other procedures, as appropriate, depending
19 on the nature of the related party transaction and the
20 related risk of material misstatement to meet the
21 objective of the standard. And in the release, in the
22 appendix, which goes into more detail, it gives

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1 examples of additional procedures which might be
2 necessary that the auditor could consider. And one of
3 those would be performing other procedures at the
4 related party, if possible.

5 So the release gives more information to the
6 auditor about what they might do, depending on the
7 nature of the risks that they're seeing, and tries to
8 put them in a better position to think about what they
9 might need to do to meet the objective of the standard.

10 MR. SCATES: Okay. We have some more tent cards
11 up. Jeff Mahoney?

12 MR. MAHONEY: Thank you. I'll be brief. The
13 Council did submit a letter in response. I hope you
14 received it. I hope I hit the right button when I sent
15 it. We focused on your proposed enhancements to
16 Auditing Standard 12, and we support those. Executive
17 compensation is obviously a key element of corporate
18 governance. And when it's poorly structured, it can
19 result in a number of risks, as was evidenced in the
20 financial crisis. So certainly it makes sense to us
21 that looking at executive compensation can help an
22 auditor assess a risk of material misstatement, as well

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1 as fraud risk.

2 With respect to Jamie's earlier comment about
3 clarification, I don't have any objection to that. I
4 understood it when I read it, but maybe others didn't.
5 But my experience from reading a lot of comment letters
6 in my prior job led me to conclude that, in some cases,
7 commentators don't read the proposal, and maybe that's
8 the case here. So when you clarify, you have to take
9 into account the fact that some commentators don't
10 read.

11 MR. SCATES: Scott Showalter?

12 MR. SHOWALTER: Thanks. Hopefully I read. So
13 your question, two, Greg, asked about the objective
14 stated in the standard. By the way, I think that's
15 great. I would encourage you to do that. I think it
16 helps the auditors, as they go in the standard, to
17 understand why they're there. And my comment is going
18 to actually going to tie back to what Lynn just talked
19 about and that this is a chance to educate a little bit
20 along the way to the practitioner as they read this.
21 And if you read this, you could do what Lynn just said.
22 You could stop by identifying accounting for and

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1 disclosing without going to that next step that we had
2 that conversation was how are you going to extend your
3 audit procedures because of what you found?

4 So if you just read that the way you said it, I
5 could stop with disclosure. So I would encourage you
6 to think about adding on to that sentence a little bit
7 about any other impact it may have on the remaining
8 audit procedures because you reference it all through
9 the document, so it's there in the footnotes. But this
10 is a chance for you to kind of communicate it right up-
11 front. And, again, it's tying back into Lynn's
12 comment, but I liked the objective.

13 MR. SCATES: Thank you, Scott. I appreciate
14 that comment. Denny Beresford?

15 MR. BERESFORD: It's certainly appropriate to
16 ask whether this has gone far enough. It's also, I
17 think, appropriate to ask whether it's gone too far in
18 certain respects. As Roman pointed out, this is a
19 pretty complicated document, and the inspection group
20 will be following up with accounting firms to challenge
21 aspects of it.

22 From an audit committee perspective, I'm a

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1 little concerned about two aspects. One of them is the
2 paragraph 10A of the proposed amendments to Auditing
3 Standard Number 12, which would require the auditor to
4 obtain an understanding of the company's financial
5 relationships and transactions with its executive
6 officers, requiring reading of employment and
7 compensation contracts, reading proxy statements and
8 other relevant company filings, and then a related
9 reference to officers' expense accounts. And as a
10 general comment, I think that's all well and good. My
11 concern is how much detail that involves. Certainly,
12 audit committees often ask internal auditors and
13 sometimes external auditors to take a look at officers'
14 expense accounts, particularly if there's some issues,
15 like the Best Buy situation recently. But as a general
16 matter, these are not material to the overall financial
17 statements. And I'm a little concerned, again, coupled
18 with the inspection results, that if it results in lots
19 of detailed procedures and if the outside auditors
20 believe that they will be challenged if they don't go
21 through and look at every employment contract and do a
22 test of all of the officers' expense accounts they're

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1 going to be challenged that this is going to be busy
2 work that's really not contributing to the
3 representation or the fair presentation of the
4 financial statements.

5 The other point I wanted to make is related to
6 the report to the audit committee. Again, I think it's
7 a question of keeping things in balance. Certainly,
8 audit committees would like to know about things that
9 haven't been brought to their attention previously,
10 unusual things and so forth. And I recognize that the
11 wording of the document is emphasizing those, but it
12 starts off by talking about reporting about the
13 procedures that have been followed and so forth, and I
14 think it's very important, Marty, to emphasize that
15 we're talking about exception reporting there. As I
16 indicated in my comments about the auditors' report to
17 the audit committee, I am very concerned and I know a
18 lot of the letters were concerned about that becoming
19 more and more boilerplate, that, as we have a checklist
20 of 27 or 37 or 370 items that have to be reported to
21 audit committees, it loses its meaningfulness and the
22 communications just don't become really that

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1 communicative I guess is the best way of putting it.
2 And this is just one more item that possibly could have
3 caused the trees to lose the focus of the forest.

4 MR. SCATES: Denny, one comment I'd like to
5 make. With respect to the, you mentioned about the
6 officers and reading the contracts and reviewing the
7 proxy information statement and reviewing the expense
8 accounts. Remember, this proposal, though, is confined,
9 though, only to the executive officers. So this is a
10 much smaller population than in a lot of the issuers
11 today.

12 I'll give you an example. If you look at, like
13 if you look at GE's 10-k, they have ten executive
14 officers. Xerox has nine. So, I mean, it's a very
15 small population, so it's not like the auditor is going
16 to be required to do an enormous amount of work in this
17 area. The population is well defined, and it's a
18 pretty small population. So I don't think we're really
19 going out on a limb here requiring the auditor to do an
20 extra amount of work here in this area because the
21 population, like I said, is well defined and it's a
22 relatively small population and number of people in

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1 these companies.

2 And the next one, Gail Hanson?

3 MS. HANSON: I'd just like to point out in your
4 paper you talk about looking at the procedures and
5 seeing if the related party transactions are consistent
6 with the procedures and their approval levels. I would
7 suggest that a good audit would be to go look at the
8 internal controls over related party transactions. I
9 would presume in a number of these cases where there
10 have been issues, that controls were not adequate, so
11 there weren't written procedures, it wasn't taken to
12 the audit committee or to a committee of the board to
13 vet. I know in certain cases they were, but that would
14 be a good place to start.

15 MR. SCATES: Thank you, Gail. And Steve
16 Rafferty?

17 MR. RAFFERTY: Maybe to Lynn's point, I would
18 perhaps suggest, before you get too far into what
19 procedures you might want to add to identify related
20 parties, you go back to the source of this issue and
21 ask yourself what was the primary problem? Is it
22 identifying the related parties, or is it how do you

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1 deal with them once you identify them? And my
2 experience in my own career has been the more difficult
3 issue is do you deal with them correctly once you
4 identify them. I know there are probably circumstances
5 where auditors fail to identify the related parties,
6 but there's no end to the things you could do to go on
7 a witch hunt and look for those, as well, and you have
8 to find an appropriate balance here.

9 My take was that, you know, this was, in
10 general, this is an important issue for the PCAOB to
11 address, and I personally thought it was pretty well
12 done.

13 MR. SCATES: Thank you, Steve. And you are
14 right, we're trying to find the right balance here, as
15 we are obviously with a lot of our standards because
16 you don't want anyone going on some wild fishing
17 expedition. Arnie Hanish?

18 MR. HANISH: Greg, I think you're trying to
19 achieve the right balance. But to maybe build upon
20 Denny's point, while it may be a small population, I
21 think in our case it might be about 12 or 13 executive
22 officers, maybe 14, I don't know, but every little bit

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1 of incremental work adds up and you still have to focus
2 on, in my view, the material issues, the material risk.
3 And so I'd just, I don't personally want you to dismiss
4 what Denny was trying to communicate because I think
5 what we hear all the time from our auditors, when you
6 try to push back on certain things, well, it's not
7 material or it's not a lot of work, it's not a lot of
8 incremental work, but it all adds up when you're really
9 trying to focus on things that create a material
10 misstatement or create awareness where there could be a
11 material misstatement. And maybe there's other
12 procedures or processes, as opposed to trying to insist
13 that -- and if you're insisting that they look at all
14 these documents for all the executive officers, I mean,
15 I could see a junior auditor or a senior auditor
16 spending however many hours. And then you've got your
17 manager that has to review it and your senior manager
18 that has to review it, your partner that has to review
19 the documents. You add all those incremental hours up
20 for documentation purposes to meet your inspection
21 requirements, you're talking about potentially a lot of
22 hours.

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1 MR. SCATES: Thanks, Arnie. And we do take
2 those comments and Denny's very seriously, and we're
3 going to look and see what comments come in on this
4 area and see if we need to have some further
5 clarification or further amendments to this particular
6 area. Walter Ricciardi?

7 MR. RICCIARDI: Thanks. I notice that if
8 management makes representations that the terms are
9 consistent with arms length then there is a requirement
10 to see if that's justified. If there is no such
11 representation, is there any suggestion that the
12 auditor should still look at whether it appears to be
13 consistent with arms length?

14 The reason why I ask is, in my experience, a
15 number of times the problem was you found related party
16 and the auditors took that statement in the current
17 literature, I think it's consistent with current
18 literature, to mean, well, not my job to look at
19 whether a price is right or not. But, often, it's the
20 mismatching the price which is used to hide a fraud, so
21 it's something to consider.

22 MR. SCATES: Well, under the proposal, the

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1 auditor must have sufficient appropriate audit evidence
2 to support an assertion, if management is going to make
3 an assertion, that the transactions were at arms length
4 or similar to an arms length transaction. Then the
5 auditor has to obtain that evidence to support that
6 assertion.

7 MR. RICCIARDI: But what I've seen is management
8 carefully does not make such a representation, and then
9 the auditor then feels like, well, they haven't made a
10 representation that it's equivalent to arms length, so
11 I don't need to even look at whether it was or not.
12 For example, one where two related companies, one was
13 non-profit and one was profitable, and the rates are
14 regulated at the non-profit and they were selling
15 things to the non-profit and jacking up the price, and
16 it was sucking money out of the non-profit to avoid the
17 regulatory issue on the pricing is a big fraud, and the
18 auditors just felt, well, they disclosed, I don't need
19 to look at whether prices are reasonable, and they were
20 pointing to that language. And had there been some
21 suggestion that maybe, in determining whether there's
22 earmarks of fraud, one thing to look at may be whether

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1 the price appears to be -- and, often, that's very
2 difficult to assess, but one thing to look at is
3 perhaps the price is not arms length and that's
4 evidence that could be indicative of impropriety.

5 MR. SCATES: No, I agree. I appreciate what
6 you're saying, Walter, because the auditor, at the end
7 of the day, when you've got a transaction like you
8 described, has to understand the business rationale,
9 and that business rationale has to go to the elements
10 of the transaction and it has to be, you know, was it
11 at a reasonable price between the parties? And if not,
12 then you need to dig deeper, the auditor should be
13 digging deeper and has to because they've got to, at
14 the end of the day, understand and be able to be
15 satisfied that it was a transaction and it makes
16 business sense to the parties that are involved in the
17 transaction. And that's in the proposal today.

18 MR. BAUMANN: I think it's another good point to
19 take another look at in terms of addressing, you know,
20 have we appropriately advised the auditor that even if
21 management isn't making such an assertion about the
22 importance of understanding the transaction, whatever

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1 the pricing might be, understand it anyway and what the
2 impact of that might be on the financial statement. So
3 your point is well made, and we'll think about that.

4 MR. SCATES: Thank you, Walter. Jay Hanson?

5 MR. HANSON: I just wanted to, further to
6 Walter's comments, which I think are good, the other
7 thing to mention is, Greg, you mentioned that part of
8 the requirement is understand the business purpose of
9 the transaction, but another part is understanding why
10 the transaction was entered into with a related party.
11 And so I guess, thinking about that one broadly, I
12 would hope that considerations about under- or over-
13 market pricing would come into that if the auditor was
14 trying to pull that thread about why, why, why did you
15 do this with a related party? But your points are well
16 taken.

17 MR. SCATES: Thanks, Jay. Lisa Lindsley?

18 MS. LINDSLEY: Thank you. We are finalizing our
19 comment letter, so we'll be submitting it shortly.
20 And, you know, we're very pleased that the PCAOB has
21 taken up the issue of understanding the relationship
22 between executive compensation and risk of

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1 misstatement, and there are a number of academic
2 studies supporting this.

3 We also don't think that it will add to the cost
4 of an audit because, as you know I'm not an auditor,
5 but I understand that Auditing Standard Number 12
6 requires or provides that an auditor will "obtain an
7 understanding of compensation arrangements with senior
8 management, including incentive compensation
9 arrangements and other aspects of compensation." So it
10 seems like the proposal just clarifies and makes more
11 specific the understanding that the auditor will have.

12 MR. SCATES: Thank you, Lisa. Jerry De St. Paer?

13 MR. DE ST. PAER: Thank you. I just wanted to
14 take the point that you've given that you're only
15 dealing with executive officers, and I think,
16 consistent with the point that Lisa just made, having
17 been a chief financial officer of a public company for
18 a long time, my own view always was that it was prudent
19 to, in fact, to review the expense account on an annual
20 basis of those people, including myself at that time,
21 because even whether or not it demonstrated a possible
22 risk, it demonstrates that there's no independence

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1 problem, that the views of the executive officers of
2 the company are, indeed, you can see the compensation
3 and you can understand the risk factors that are
4 embedded in that.

5 What I want to give is an example that,
6 hopefully, would lead you to think that maybe there
7 should be some additional wording. I want to go to
8 AIG. I think what I'm going to say is a matter of the
9 public record. There were two very significant
10 compensation structures at AIG before the company
11 encountered its difficulty. One was the Financial
12 Products Group, and the other was the Aircraft Leasing
13 Company. In both of those cases, the individuals in
14 question were receiving annual compensation in excess
15 of \$100 million. That should be a number, even in the
16 size of the numbers of AIG, that would attract some
17 attention.

18 In the one case of the Aircraft Leasing Company,
19 that was because the company was hugely successful, had
20 a dominant position. They were not taking unusual
21 risks, but, in fact, when somebody is making \$100
22 million it's probably worthwhile to at least take a

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1 review to understand that there is not some untoward
2 risk involved. And I believe that it would have been
3 fairly quick to determine that wasn't the case.

4 In the other case, in Financial Products, that's
5 also a matter of public record, and, indeed, it was
6 indicative that there was an incentive that, if one had
7 dug just a little bit deeper into what that was leading
8 to do to put volume on the books, it might well have
9 created the opportunity to understand the concentration
10 of risk that was being created as a result in part of
11 that compensation structure. They were incented to put
12 that business on the books.

13 So I just want to flag that just the executive
14 officers are not the only place. In a very, very large
15 company, there are often many people below the
16 executive officers who make more than the executive
17 officers and have production-related compensation
18 structures that could well indicate risk.

19 So I laud you in response to Denny's comment
20 about let's not make sure this doesn't go too far. I
21 think your idea of restricting it to executive officers
22 is very good. But I would suggest that there should be

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1 some judgment aspect applied, especially if when in a
2 company you can have a couple of people making \$100
3 million a year. Maybe somebody ought to understand
4 what the risks could be contingent with that
5 compensation structure.

6 MR. SCATES: Thank you, Jerry. There were other
7 tent cards up. Joe, did you want -- okay. Any other
8 comments? If not, just a reminder that our comment
9 period is coming up. We extended it to May 31, and
10 we're looking forward to getting the comment letters in
11 as we move forward on this project.

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PROPOSED AUDITING STANDARD –)	
)	
RELATED PARTIES)	PCAOB Release No. 2013-004
)	May 7, 2013
PROPOSED AMENDMENTS TO CERTAIN)	
PCAOB AUDITING STANDARDS REGARDING)	PCAOB Rulemaking
SIGNIFICANT UNUSUAL TRANSACTIONS)	Docket Matter No. 038
)	
AND OTHER PROPOSED AMENDMENTS TO)	
PCAOB AUDITING STANDARDS)	
)	
)	

Summary: The Public Company Accounting Oversight Board is reproposing: (i) an auditing standard, *Related Parties*; (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions; and (iii) other amendments to PCAOB auditing standards. The proposed auditing standard would supersede the Board's auditing standard AU sec. 334, *Related Parties*.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 038 in the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on July 8, 2013.

Board Contacts: Greg Scates, Deputy Chief Auditor (202/207-9114, scatesg@pcaobus.org), Brian F. Degano, Associate Chief Auditor (202/207-9113, deganob@pcaobus.org), and Nicholas Grillo, Assistant Chief Auditor (202/207-9104, grillon@pcaobus.org).

I. Introduction

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is reproposing a new auditing standard, *Related Parties* (the "reproposed standard");



amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "reproposed amendments regarding significant unusual transactions"); and other amendments to PCAOB auditing standards (the "other reproposed amendments").^{1/} The reproposed standard would supersede the Board's existing auditing standard on related parties, AU sec. 334, *Related Parties* (the "existing standard").

Related party transactions have been contributing factors in numerous prominent financial reporting frauds over the last few decades.^{2/} Financial reporting frauds also have involved 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"); and a company's financial relationships and transactions with its executive officers. Corporate scandals involving these areas, such as financial reporting frauds at Enron Corporation, Tyco International, Ltd., Refco, Inc., and WorldCom, Inc., undermined investor confidence, resulted in significant losses for investors, as well as the loss of many jobs for employees. These critical areas have continued to be a contributing factor in more recent cases.^{3/} The reproposed standard and amendments would update and strengthen auditor performance requirements in these critical areas, which could pose significant risks of material misstatement in company financial statements. The critical areas addressed by the reproposed standard and amendments include:

^{1/} The reproposed amendments regarding significant unusual transactions and the other reproposed amendments are collectively referred to in this release as the "reproposed amendments." In addition, all the Board's repropoals contained in this release may be referred to globally as the "reproposed standard and amendments" or as the Board's "reproposal."

^{2/} See *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2012-001 (Feb. 28, 2012), (the "proposing release"), available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx> for a discussion of these financial reporting frauds.

^{3/} See e.g., Securities and Exchange Commission ("SEC") v. Keyuan Petrochemicals, Inc. and Aichun Li, SEC Accounting and Auditing Enforcement Release ("AAER") No. 3447 (Feb. 28, 2013), and SEC v. China Natural Gas, Inc. and Qinan Ji, AAER No. 3385 (May 14, 2012).



Relationships and Transactions with Related Parties: Relationships and transactions with related parties can pose increased risks of material misstatement, as their substance might differ materially from their form. Related party transactions also may involve difficult measurement and recognition issues that can lead to errors in financial statements. Moreover, in some instances, related party transactions have been used to engage in fraudulent financial reporting and to conceal misappropriation of assets – misstatements that are relevant to the auditor's consideration of fraud.^{4/} The importance to investors of auditing related party transactions is recognized by Section 10A of the Securities and Exchange Act of 1934 ("Exchange Act"), which requires each audit of financial statements of an issuer to include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."^{5/}

The repropoed standard would strengthen existing audit performance requirements by setting forth new, specific audit procedures that would include: (i) obtaining an understanding of the company's relationships and transactions with its related parties; (ii) performing specific procedures for related party transactions that require disclosure in the financial statements or that are determined to be a significant risk; (iii) evaluating whether the company has properly identified its related parties and relationships and transactions with related parties; and (iv) communicating with the audit committee. The repropoed standard would supersede the existing auditing standard, AU sec. 334.

^{4/} See paragraph .06 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, which states that two types of misstatements are relevant to the auditor's consideration of fraud – misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. Misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the financial statements not to be presented, in all material respects, in conformity with generally accepted accounting principles ("GAAP"). Misstatements arising from misappropriation of assets (sometimes referred to as theft or defalcation) involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented, in all material respects, in conformity with GAAP.

^{5/} See Section 10A(a)(2) of the Exchange Act, 15 U.S.C. §78j-1(a)(2), which was added to the Exchange Act by the Private Securities Litigation Reform Act, enacted by Congress in 1995.



Significant Unusual Transactions: A company's significant unusual transactions can create complex accounting and financial statement disclosure issues posing increased risks of material misstatement. In some instances, significant unusual transactions have been used to engage in fraudulent financial reporting. For example, significant unusual transactions, especially those close to period end that pose difficult "substance-over-form" questions, may have been entered into to obscure a company's financial position or operating results.^{6/} In such cases, management may place more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction. Existing auditing standards relating to significant unusual transactions are principally contained in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. The repropoed amendments regarding significant unusual transactions are designed to focus the auditor's identification and evaluation of a company's significant unusual transactions, and, among other things, enhance the auditor's evaluation of (i) whether such transactions have been appropriately accounted for and adequately disclosed in company financial statements; and (ii) whether the lack of a business purpose indicates that they may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

Financial Relationships and Transactions with Executive Officers: A company's executive officers are in a unique position to influence a company's accounting and disclosures. A company's financial relationships and transactions with its executive officers (as one example, executive compensation) can create incentives and pressures for executive officers to meet financial targets, which can result in risks of material misstatement to a company's financial statements. Other repropoed amendments would modify Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, to require the auditor to perform specific procedures to obtain an understanding of the potential risks of material misstatement posed by incentives and pressures arising from a company's financial relationships and transactions with its executive officers. For issuers, the term "executive officer" is the definition contained in Rule 3b-7 under the Exchange Act, while for brokers and dealers, the term "executive officer" is based on a list in Schedule A of Form BD (as required by Item 2(a) of the schedule). In response to comments, the repropoed amendments have been revised to clarify that the auditor's procedures in this area would be performed as part of the auditor's risk assessment process^{7/} and would not require the auditor to make any

^{6/} See, e.g., *In the Matter of Dynegy Inc.*, AAER No. 1631 (Sept. 24, 2002), and *In the Matter of Michael Lowther*, CPA AAER No. 2775 (Jan. 28, 2008).

^{7/} In 2010, the Board adopted Auditing Standards Nos. 8-15 on assessing and responding to risk in an audit (the "risk assessment standards"), which cover the entire audit process, from initial planning activities to evaluating audit evidence to



determination regarding the reasonableness of compensation arrangements or recommendations regarding compensation arrangements.

The Board notes that the existing auditing requirements that address these critical areas warrant updating. Since the issuance of the existing standard, AU sec. 334, significant financial reporting frauds involving related party transactions have occurred.^{8/} The need to update AU sec. 334 has been supported by a number of prominent studies, including one produced by the auditing profession.^{9/} Moreover, the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the AICPA ("ASB") revised their auditing standards on related parties in 2008 and 2011, respectively. In addition, AU sec. 334 does not reflect the enactment in 2010 of the risk assessment standards, which provide an overall

forming the opinion to be expressed in the auditor's report. See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release No. 2010-004 (Aug. 5, 2010).

^{8/} In 1983, AU sec. 334 replaced AU sec. 335, *Related Party Transactions*, which was issued in July 1975. AU sec. 334 removed guidance in AU sec. 335 relating to accounting considerations and disclosure standards for related parties (in response to the issuance of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*) and included other related technical changes. Thus, the nature and extent of the auditor's responsibilities and procedures pertaining to related parties reflected in AU sec. 334 have not changed since 1975.

^{9/} See the Report of the Quality Control Inquiry Committee ("QCIC") of the AICPA's SEC Practice Section ("SECPS"), which analyzed more than 200 alleged audit failures from December 1997 to October 2002 and recommended that, among other things, "required audit procedures be broadened to help ensure the auditor gains a more complete understanding of related-party transactions, including the business aspects of the transactions." See, AICPA SEC Practice Section, Memo to Managing Partners of SECPS Member Firms, "Recommendations for the Profession Based on Lessons Learned from Litigation" (Oct. 2002). The QCIC report and other reports and studies supporting the need for improvements to existing auditing standards in these three critical areas are discussed in the proposing release. See PCAOB Release No. 2012-001.



framework for the auditor's assessment of and response to the risk of material misstatement.^{10/}

The Board is proposing changes in these three critical areas contemporaneously because it believes that the auditor's efforts in these areas complement each other. For example, focusing the auditor's identification and evaluation of significant unusual transactions might assist the auditor in identifying related parties or relationships or transactions with related parties that management has not previously disclosed to the auditor. Similarly, performing procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers might provide the auditor with information that indicates the existence of related party relationships or transactions previously undisclosed to the auditor. Both the auditor and the investor benefit from a comprehensive and consistent examination of these areas, not only because of the risk of material misstatement due to fraud, but also because these transactions, due to their nature, pose a risk of material misstatement due to error.

The repropoed standard and amendments would update the Board's standards and focus the auditor's efforts on these critical areas that could pose significant risks of material misstatement to company financial statements. In the Board's view, this update is particularly appropriate due to the number and magnitude of financial reporting frauds, and resulting investor losses, associated with these areas.

II. Background and Considerations in Developing the Repropoed Auditing Standard and Amendments

On February 28, 2012,^{11/} the Board proposed an auditing standard, *Related Parties* (the "proposed standard"), proposed amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "proposed amendments regarding significant unusual transactions"), and other proposed amendments to PCAOB auditing standards (the "other proposed amendments").^{12/}

^{10/} See PCAOB Release No. 2010-004.

^{11/} See PCAOB Release No. 2012-001.

^{12/} The proposed amendments regarding significant unusual transactions and the other proposed amendments are collectively referred to in this release as the "proposed amendments." In addition, the proposed standard and proposed amendments may be globally referred to as the "proposed standard and amendments" or as the Board's "proposal."



The Board's proposal reflected several years of careful consideration. For example, the issue of related parties was discussed with the Board's Standing Advisory Group ("SAG") on several occasions prior to the Board's decision to issue the proposed standard.^{13/} The Board discussed with its SAG a variety of issues and alternative approaches relevant to developing the proposed standard and proposed amendments.

The Board developed its proposed standard and amendments after receiving input from its SAG and considering current audit requirements and developments, including the work of other standard setters and international developments.^{14/} In addition, the Board took note of observations from the PCAOB's oversight activities, including that the facts underlying a significant number of the Board's settled disciplinary actions to date involved auditors' failures to perform sufficient procedures regarding related party transactions. These observations from the PCAOB's oversight activities primarily relate to audits of financial statements performed by triennially-inspected firms.^{15/}

The Board's goal – both in developing its proposal as well as its reproposal – has been to develop an approach that promotes audit quality and investor protection, while at the same time considering economic considerations, including avoiding unnecessary costs and implementation issues. Before developing its proposal, the Board considered whether it could achieve sufficient improvements in audit quality through its inspection and enforcement programs without amending its standards and requirements.^{16/}

^{13/} The SAG discussed the topic of related parties at a number of its meetings prior to the issuance of the Board's proposal, including at meetings occurring on: October 14-15, 2009; June 21, 2007; and September 8-9, 2004. See the SAG meeting archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>.

^{14/} These matters are discussed in detail in Section III. of the proposing release. See PCAOB Release No. 2012-001.

^{15/} See, e.g., *Report On 2007-2010 Inspections Of Domestic Firms That Audit 100 Or Fewer Public Companies* PCAOB Release No. 2013-001, (Feb. 25, 2013) at 29, available at: http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf.

^{16/} For example, before deciding to issue its proposal, the Board issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010), available at http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf, which discusses a range of auditor practice issues identified by the PCAOB staff pertaining to significant unusual transactions.



However, the existing standards allow the auditor significant latitude in auditing these critical areas. Thus, since the nature and extent of audit procedures can vary widely, the Board concluded that new requirements were appropriate as these critical areas could pose significant risks of material misstatement. The Board also concluded that it was appropriate to propose a new auditing standard regarding related parties rather than to amend the existing standard because of, among other things, the nature and extent of changes necessary to align the existing standard with the risk assessment standards. On the other hand, the Board concluded that appropriate improvements in audit quality could be achieved by amending its existing requirements regarding significant unusual transactions as opposed to issuing a new separate standard.

As noted above, the Board issued the proposed standard and amendments for public comment on February 28, 2012.^{17/} The Board received 37 comment letters on the proposal.^{18/} In addition, the Board discussed the proposed standard and amendments with its SAG at a May 17, 2012 meeting.^{19/} The comment period was extended to May 31, 2012 to allow commenters an opportunity to consider the SAG's discussion. Comments received from the SAG members were considered together with the comment letters received. The Board took all comments received (from both comment letters and the SAG discussion) into consideration in developing the repropoed standard and amendments.

In general, commenters were supportive of the Board's efforts to enhance the auditor's efforts regarding related party and significant unusual transactions and agreed that improvements to the auditing standards were appropriate at this time. While the proposed changes regarding financial relationships with a company's executive officers drew support from a range of commenters, some commenters raised concerns that performing such procedures could have unintended consequences, including impacting the design of compensation arrangements. Commenters also identified a number of areas in which the proposed standard and amendments could be clarified or improved.

^{17/} See PCAOB Release No. 2012-001.

^{18/} The comment letters are available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>.

^{19/} The transcript of the SAG's discussion of the proposed standard and proposed amendments is available at http://pcaobus.org/Rules/Rulemaking/Docket038/2012-05-17_Transcript-Related_Parties.pdf.



In response, the Board has revised its proposal and is now seeking comment on a repropoed standard and amendments. Although the overall approach and many of the performance requirements remain the same in the repropoed standard and amendments, the Board is proposing certain changes to align more closely with the risk assessment standards and to respond to some commenters' suggestions. The Board is issuing the repropoed standard and amendments to provide an opportunity for commenters to provide input on the changes reflected in the repropoal.

The Board also is requesting comments on the potential economic implications of the repropoed standard and amendments. In addition, subsequent to the publication of the Board's proposal, the Jumpstart Our Business Startups Act ("JOBS Act") was enacted.^{20/} The Board therefore is specifically requesting comments on considerations raised by the JOBS Act, including the application of the repropoed standard and amendments to audits of emerging growth companies ("EGCs").

Appendix 4 of this release describes the Board's consideration of significant comments received as well as changes reflected in the repropoed standard and amendments. Appendix 4 also contains questions for commenters related to specific aspects of the repropoed standard and amendments.

The Board's Approach for Promoting Audit Quality in These Critical Areas

In developing its approach to promote audit quality, the Board made a number of key decisions to make its auditing standards in these critical areas more effective. The Board also was mindful of the need for standards that can be implemented efficiently. The following discussion summarizes the Board's approach and highlights its considerations in the choices made and alternatives considered, both in crafting its proposal as well as its repropoal.

Overall Approach: The repropoed standard and amendments would establish new requirements designed to sharpen the auditor's focus on critical areas prone to material misstatements of the financial statements, including material misstatements associated with fraudulent financial reporting, with the goal of promoting the auditor's ability to identify, assess, and respond to such risks. Thus, the performance requirements could improve audit quality, help protect the interests of investors, and

^{20/} Pub. L. No. 112-106 (April 5, 2012). See Section 103(a)(3)(C) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. §7213(a)(3)), as added by Section 104 of the JOBS Act.



further the public interest in the preparation of informative, accurate, and independent audit reports.

Opportunity for Scalability: The repropoed standard and amendments would establish basic required procedures that would be supplemented by more in-depth procedures, as needed, commensurate with the auditor's evaluation of the risks posed by the company's facts and circumstances. Relevant facts and circumstances include the nature, size, or complexity of the transaction and the related risk of material misstatement in the financial statements. This provides the opportunity for the auditor to scale the audit and focus his or her attention on the most critical aspects of the audit.

Alignment with the Risk Assessment Standards: The repropoed standard and amendments have been designed to align with and build upon the requirements in the risk assessment standards.^{21/} The repropoed standard would require the auditor to perform specific risk assessment procedures to obtain an understanding of the company's relationships and transactions with its related parties. Performing these risk assessment procedures required by the repropoed standard in conjunction with the auditor's risk assessment procedures is intended to provide the auditor with a basis for identifying and assessing risks of material misstatement associated with related parties and related party transactions. This cohesive approach would provide opportunities to integrate audit effort, where appropriate, and, at the same time, position the auditor to identify areas in which there may be increased risks of material misstatement of financial statements posed by a company's related party relationships and transactions. Similarly, the repropoed amendments also would include amendments to the Board's existing standards intended to focus the auditor's attention, in a targeted way, on potential issues associated with a company's significant unusual transactions and its financial relationships and transactions with its executive officers as part of the auditor's risk assessment process.

Complementary Audit Areas: The repropoed standard and amendments are complementary and offer opportunities for efficient implementation as well as more effective audits. For example, obtaining an understanding of financial relationships and transactions with executive officers can help the auditor identify incentives and pressures that could cause management to use related party or significant unusual transactions to meet financial goals.

^{21/} The risk assessment standards include a focus on the auditor's responsibilities to consider the risks of, and possibilities for, material misstatement, whether due to error or fraud, throughout the entire audit process. See PCAOB Release No. 2010-004.



Retaining Existing Concepts and Procedures: The repropoed standard and amendments would incorporate, and where appropriate, strengthen many of the audit procedures rooted in existing auditing standards and common in practice today. For example, the repropoed standard would include as new requirements certain procedures that are included in AU sec. 334 as procedures for the auditor to consider, such as obtaining an understanding of the business purpose of the transaction and reading the underlying documentation. This approach would permit auditors that have such procedures as part of their existing methodologies to build upon their existing knowledge and training. As a result, this approach could minimize their incremental costs of implementing the repropoed standard and amendments.

Improving the Auditor's Communication with the Audit Committee: The repropoed standard and amendments would establish new requirements relating to the auditor's communications with the company's audit committee regarding related parties. The communications requirements in the repropoed standard would work in concert with Auditing Standard No. 16, *Communications with Audit Committees*, to ensure that the auditor has a forum to discuss the auditor's evaluations regarding the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. In addition, the repropoed amendments regarding significant unusual transactions would complement the recently enacted auditor communication requirements regarding significant unusual transactions in Auditing Standard No. 16.

III. Overview of Reproposal and Improvements from Existing Standards

This section provides an overview of the repropoed standard and amendments, and key proposed improvements from existing standards. This section also summarizes certain changes from the proposed standard and amendments based upon comments received. Appendix 4 of this release contains a more detailed discussion of these matters.

Relationships and Transactions with Related Parties

Overview of the Repropoed Standard: The repropoed standard would strengthen existing auditing procedures associated with identifying, assessing, and responding to the risks of material misstatement associated with a company's relationships and transactions with its related parties. Among other things, the repropoed standard would require the auditor to:

- Perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties, including 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



transactions involving related parties. The new procedures are intended to be performed in conjunction with the auditor's risk assessment procedures pursuant to Auditing Standard No. 12.

- Evaluate whether the company has properly identified its related parties and its relationships and transactions with related parties. In making that evaluation, the auditor should take into account information gathered during the audit. As part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. If the auditor identifies information that indicates that related parties or relationships or transactions with a related party previously undisclosed to the auditor might exist, the auditor would perform procedures necessary to determine whether undisclosed relationships or transactions with related parties, in fact, exist.
- Perform specific procedures if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists.
- Perform specific procedures regarding each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk. Focusing the auditor's attention on these transactions is intended to enhance the effectiveness of the auditor's evaluation of whether the company's related party transactions are properly accounted for and disclosed.
- Communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, and other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

The Existing Standard: As previously noted, the existing requirements for auditing relationships and transactions with related parties are contained primarily in AU sec. 334.

AU sec. 334 recognizes that the auditor performs procedures to identify and evaluate a company's relationships and transactions with its related parties as part of performing an audit of financial statements. In doing so, AU sec. 334 provides "guidance" and examples of procedures, for the auditor's consideration for identifying and evaluating related party transactions. Examples of procedures in AU sec. 334



include procedures to obtain information from management (such as obtaining the names of all related parties and inquiring whether there were any transactions with these parties during the period) as well procedures intended to assist the auditor in identifying related parties that have not been disclosed to the auditor by management (such as reviewing filings with the Securities and Exchange Commission ("SEC"), reviewing company accounting records and certain invoices, and making inquiries of other auditors). Notably, AU sec. 334 provides that the procedures set forth in AU sec. 334 should not be considered all-inclusive and that not all of them may be required in every audit. Further, AU sec. 334 states that, in the absence of evidence to the contrary, related party transactions should not be assumed to be outside the ordinary course of business.^{22/} Finally, AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions.

Key Improvements from the Existing Standard: The reproposed standard retains certain concepts and procedures from AU sec. 334 that relate to identifying and evaluating related parties and related party transactions. However, the reproposed standard differs from AU sec. 334 in a number of key respects.

- *Enhanced Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties:* Unlike AU sec. 334 which includes limited direction for obtaining an understanding of the company's relationships and transactions with its related parties (e.g., AU sec. 334.05), the reproposed standard would require the performance of specific procedures in this area, including obtaining an understanding of the terms and business purposes (or the lack thereof) of related party transactions.
- *Alignment with the Risk Assessment Standards:* Since the adoption of AU sec. 334, the Board has adopted and amended several auditing standards, including its risk assessment standards. The reproposed standard would align with and build upon the risk assessment framework. This alignment could provide an opportunity for efficient implementation. For example, the auditor could perform the inquiries that would be required by the reproposed standard contemporaneously with inquiries required by the risk assessment standards.

^{22/} Thus, AU sec. 334 could be misunderstood to create a "presumption of validity" for the business purpose of related party transactions in situations where experience suggests a need for heightened scrutiny.



- *Addition of Basic Requirements:* AU sec. 334 suggests procedures for the auditor's consideration, noting that the suggested procedures should not be considered all-inclusive and not all of them may be required in every audit. As noted above, the repropoed standard would require basic procedures for the auditor's assessment of and response to risks of material misstatement. The repropoed standard also would require more in-depth procedures commensurate with the auditor's assessment of the risks posed by the company's facts and circumstances.
- *Broader Focus on Accounting:* As noted above, AU sec. 334.02 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions. The repropoed standard would require that the auditor evaluate the accounting for and disclosure of related party transactions.

Key Changes from the Proposed Standard: The repropoed standard reflects clarifying changes and improvements in response to comments received. Some of the changes address the following:

- *Clarifying the Relationship between the Repropoed Standard and the Risk Assessment Standards:* In response to requests to clarify the relationship between the proposed standard and the risk assessment standards, the Board made several revisions to better integrate the proposed requirements with those standards. For example, the revisions would clarify, among other things, that the risk assessment procedures performed to obtain an understanding of the company's relationships and transactions with its related parties are performed in conjunction with the risk assessment procedures performed pursuant to Auditing Standard No. 12. In addition, the repropoed standard would add a number of references to other auditing standards that may be relevant to the auditor's consideration of related parties and related party transactions.
- *Responsibility of the Auditor to Evaluate the Company's Identification of Related Parties:* Some commenters suggested that the Board clarify the auditor's responsibility to perform procedures to identify the company's related parties. In response, the repropoed standard has been revised to focus more directly on a key aspect of the audit objective, that is, whether relationships and transactions with related parties have been properly identified by the company under audit.

As repropoed, the standard would include a new requirement for the auditor to evaluate whether the company has properly identified its related parties.



Evaluating whether a company has properly identified its related parties involves more than assessing the process used by the company to identify its related parties. The new evaluation contained in the repropoed standard would require the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company. The repropoed standard would include focused audit procedures intended to support the auditor's required evaluation. Such steps, which closely mirror the auditor's risk assessment process, would include: (i) performing risk assessment procedures to obtain an understanding of the company's relationships and transactions with its related parties; (ii) identifying and assessing risks relating to a company's relationships and transactions with its related parties, including whether the company has properly identified its related parties; (iii) designing and performing audit procedures that address and respond to the risks of material misstatement associated with the company's related parties and transactions; and (iv) performing enhanced procedures that address related party relationships or transactions identified by the auditor that were previously undisclosed by company management.

In the Board's view, the clarifications in the repropoed standard represent a more effective audit approach that recognizes that the company is responsible for the preparation of its financial statements, including, in the first instance, the identification of the company's related parties, and that the auditor begins the audit with information obtained from the company.^{23/}

- *Requests for Additional Auditor Judgment:* Several commenters suggested that the proposed standard allow more room for the use of auditor judgment.

^{23/} To further assist the auditor's efforts in identifying related parties, the repropoed other amendments include a complementary provision that would expand existing management representations contained in AU sec. 333, *Management Representations*, to state that the company has provided the names of all related parties and all relationships and transactions with its related parties to the auditor. However, the auditor may not rely solely on management's representations. Representations from management are not a substitute for the application of those audit procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit. The auditor's new required evaluation should be supported by auditing procedures and evidence obtained from procedures designed to test the accuracy and completeness of the related parties and transactions disclosed by the company to the auditor.



In response, the Board has revised a number of the requirements, including: (i) clarifying that the auditor exercises discretion in making inquiries of certain individuals within the company regarding the company's relationships and transactions with its related parties and (ii) removing the requirement that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk.

The Board is seeking comment on whether the repropoed standard is appropriate, including proposed revisions that have been made, and has included specific questions for respondents at the end of Section I. of Appendix 4 to this release.

Significant Unusual Transactions

Overview of the Repropoed Amendments Regarding Significant Unusual Transactions: The repropoed amendments regarding significant unusual transactions would revise AU sec. 316 and other PCAOB auditing standards to strengthen the auditor's identification and evaluation of significant unusual transactions.

Among other things, the repropoed amendments regarding significant unusual transactions would:

- Require the auditor to perform procedures to identify significant unusual transactions;
- Require the auditor to perform procedures to obtain an understanding of, and evaluate, the business purpose (or the lack thereof) of identified significant unusual transactions; and
- Add factors for the auditor to consider in evaluating whether significant unusual transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

The repropoed amendments regarding significant unusual transactions would include substantive enhancements to AU sec. 316, as well as amendments to Auditing Standard Nos. 12 and 13. The repropoed amendments regarding significant unusual transactions also would include conforming changes to other Board auditing standards to provide for consistency in the use of the term "significant unusual transactions" throughout the Board's standards.

Existing Standards Regarding Significant Unusual Transactions: Existing auditing requirements regarding significant unusual transactions are principally contained in AU



sec. 316.^{24/} Specifically, AU sec. 316.66 recognizes that during a financial statement audit, the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment. AU sec. 316.66 also requires that, if the auditor becomes aware of significant unusual transactions during the course of an audit, the auditor should gain an understanding of the business rationale of such transactions and evaluate whether that rationale (or the lack thereof) suggests that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.

In addition, the risk assessment standards also anticipate that the auditor will consider risks of material misstatement that are posed by significant unusual transactions. For example, one factor to be considered currently in the auditor's risk assessment is whether a risk involves a significant transaction outside the normal course of business for the company or otherwise appears to be unusual due to its timing, size, or nature.^{25/}

Key Improvements from the Existing Standards: The repropoed amendments regarding significant unusual transactions constitute targeted changes to existing Board standards in a number of areas.

- *Descriptions of Significant Unusual Transactions:* The repropoed amendments regarding significant unusual transactions would amend paragraph 66 of AU sec. 316 to describe significant unusual transactions as 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. The repropoed amendments regarding significant unusual transactions also would include conforming changes to introduce a uniform description of "significant unusual transaction" throughout the Board's standards.
- *Enhancing Requirements for Identifying Significant Unusual Transactions:* The repropoed amendments regarding significant unusual transactions would require the performance of specific procedures intended to improve the auditor's identification of significant unusual transactions, for example, by making inquiries of management and others.

^{24/} See AU secs. 316.66-.67.

^{25/} See paragraph 71.g. of Auditing Standard No. 12.



- *Enhancing Requirements for Evaluating Significant Unusual Transactions:* The repropoed amendments to AU secs. 316.66-.67A would include basic procedures, which may be expanded based upon the auditor's identification and assessment of the risks of material misstatement, for evaluating the business purpose (or the lack thereof) of significant unusual transactions.

The basic procedures would include: (i) reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction; (ii) determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures; and (iii) evaluating the financial capability of the other parties with respect to significant uncollected balances, guarantees, and other obligations. Further, the repropoed amendments to AU secs. 316.66-.67 would enhance the auditor's evaluation of the business purpose of significant unusual transactions by, among other things, expanding the factors considered by the auditor in evaluating whether the business purpose (or the lack thereof) of significant unusual transactions indicates that such transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

- *Emphasizing Accounting and Disclosure:* The repropoed amendments to AU sec. 316.67 regarding significant unusual transactions would heighten the auditor's attention to accounting matters relative to significant unusual transactions by emphasizing that existing requirements include evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

Key Change from the Proposed Amendments Regarding Significant Unusual Transactions: The repropoed amendments regarding significant unusual transactions reflect certain changes made in response to comments received. The key change from the proposed amendments would enhance the linkage between the repropoed standard and the repropoed amendments in the area of significant unusual transactions. Specifically, the repropoed amendments regarding significant unusual transactions would add:

- (i) a note to AU sec. 316.66 that would state that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions;



(ii) a note to the repropoed standard that would state that, for a related party transaction that is also a significant unusual transaction pursuant to AU secs. 316.66-.67A, the auditor should evaluate whether the business purpose (or the lack thereof) of the transaction indicates that the transaction was entered into to engage in fraudulent financial reporting or conceal asset misappropriation; and

(iii) a footnote to the repropoed standard that would state that information obtained from identifying and evaluating a company's significant unusual transactions (as well as from obtaining an understanding of a company's financial relationships and transactions with its executive officers) could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

The Board is seeking comment on whether the repropoed amendments regarding significant unusual transactions are appropriate, including proposed revisions that have been made, and has included specific questions for respondents at the end of Section II. of Appendix 4 to this release.

Financial Relationships and Transactions with Executive Officers

Overview of Other Repropoed Amendments: The other repropoed amendments provide for improved audit procedures in complementary areas, such as a company's financial relationships and transactions with its executive officers.^{26/} The other repropoed amendments would require that the auditor perform procedures, as part of the auditor's risk assessment, to obtain an understanding of the company's financial relationships and transactions with its executive officers (including executive compensation arrangements). The other repropoed amendments would establish new procedures to heighten the auditor's attention to incentives or pressures for the

^{26/} For issuers, the term "executive officer" is based on the definition contained in Rule 3b-7 under the Exchange Act. This definition includes a company's president, any vice president of the company in charge of a principal business unit, division, or function (such as sales, administration or finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the company. Executive officers of subsidiaries may be deemed executive officers of the company if they perform such policy making functions for the registrant. For brokers and dealers, the term "executive officer" is based on the list in Schedule A of Form BD, which includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions.



company to achieve a particular financial position or operating result, recognizing the key role that a company's executive officers may play in the company's accounting decisions or in a company's financial reporting. The other repropoed amendments would not require the auditor to assess the appropriateness or reasonableness of a company's compensation arrangements with its executive officers.

The Existing Standards and Key Improvements: The risk assessment standards require the auditor to consider obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses, as part of obtaining an understanding of the company.

The other repropoed amendments would strengthen existing requirements in the risk assessment standards by requiring the auditor, as part of the audit risk assessment process, to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers, a group that, because of their position in the company, can exert influence over the company's accounting and financial statement presentation.

Key Change from the Other Proposed Amendments: The other repropoed amendments relating to executive officers reflect certain changes made in response to comments received. The key change from the other proposed amendments would clarify that procedures regarding a company's financial relationships and transactions with its executive officers would be performed as part of the auditor's risk assessment process and would not require the auditor to make any determination regarding the appropriateness or reasonableness of a company's compensation arrangements with its executive officers or recommendations regarding such compensation arrangements.

The Board is seeking comment on whether the repropoed amendments regarding a company's financial relationships and transactions with its executive officers are appropriate, including proposed revisions that have been made, and has included specific questions for respondents at the end of Section III. of Appendix 4 to this release.

Other Repropoed Amendments to PCAOB Auditing Standards

In addition to the other repropoed amendments relating to financial relationships and transactions with executive officers, the other repropoed amendments would revise other auditing standards to conform them to the repropoed standard and amendments and, where appropriate, include new requirements that complement the repropoed standard and repropoed amendments regarding significant unusual transactions. For example, among other things, the other repropoed amendments



would require the auditor to obtain written representations from management (a) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor; and (b) if the company's financial statements include assertions that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction. In addition, the repropoed amendments also would include changes to management's written representations to provide that they have made available the names of all related parties and relationships and transactions with related parties. The other repropoed amendments are discussed in detail in Appendix 4 of this release.

The Board is seeking comment on whether the other repropoed amendments are appropriate, including proposed revisions that have been made, and has included specific questions for respondents at the end of Section III. of Appendix 4 to this release.

IV. Economic Considerations, Including Audits of Emerging Growth Companies

As described above, the repropoed standard and amendments are designed to address critical areas that warrant heightened scrutiny by auditors. As previously described, the Board's approach for promoting audit quality in these critical areas takes into account both the effectiveness of the auditing standards and the potential efficiency of implementation. Appendix 4 of this release provides additional discussion regarding the need for improvements to the existing standards, the Board's approach for promoting audit quality, and how the Board's approach reflects economic considerations. The discussion in Section IV. of Appendix 4 builds on the discussion of the repropoed standard and amendments in Sections I. through III. of Appendix 4 and seeks input on the potential economic implications of the repropoal.

Further, pursuant to Section 104 of the JOBS Act, any rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs (as defined in Section 3(a)(80) of the Exchange Act) unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."^{27/}

The repropoed standard and amendments are being issued by the Board for public comment, in part, to solicit views of commenters on the application of the

^{27/} See Section 103(a)(3)(a) of the Sarbanes-Oxley Act of 2002.



reproposed standard and amendments to audits of EGCs. The Board specifically requests comments, including empirical data, regarding (1) whether the application of the reproposed standard and amendments to audits of EGCs would promote efficiency, competition, and capital formation and (2) whether there are unforeseen consequences of the reproposed standard and amendments of which the Board should be aware. The Board also requests comments, including empirical data, regarding incremental costs that may be imposed by the reproposed standard and amendments, and in particular, their application to audits of EGCs.

Section IV. of Appendix 4 contains specific questions for commenters regarding economic considerations more generally, as well as questions regarding the application of the reproposed standard and amendments to audits of EGCs.

V. Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")^{28/} gave the Board explicit oversight authority over audits of brokers and dealers that are required under SEC rules. In light of the authority granted to the Board by the Dodd-Frank Act to establish standards governing audit reports to be included in broker-dealer filings with the Commission, the Commission issued transitional interpretive guidance in September 2010 to clarify that references in Commission rules, staff guidance, and in the federal securities laws to generally accepted auditing standards ("GAAS"), which are established by the ASB, or to specific standards under GAAS, as they relate to non-issuer brokers or dealers, should continue to be understood to mean auditing standards generally accepted in the U.S., in addition to any applicable rules of the Commission. The guidance also stated that the Commission intended to revisit this interpretation in connection with a rulemaking project to update the audit and attestation requirements under the federal securities laws for brokers and dealers. On June 15, 2011, the SEC proposed to amend its rules, including SEC Rule 17a-5 under the Exchange Act, to require, among other things, that audits of brokers' and dealers' financial statements and examinations of reports regarding compliance with SEC requirements be performed in accordance with the standards of the PCAOB.^{29/}

^{28/} Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

^{29/} SEC, *Broker-Dealer Reports*, Exchange Act Release No. 64676 (June 15, 2011).



The Board requested comments on the application of the proposed standard and amendments to audits of brokers and dealers in its proposing release. As discussed in Appendix 4, a number of commenters stated that the proposed standard and amendments were appropriate for audits of brokers and dealers. The Board is continuing to solicit comments regarding issues that may be raised by the application of the Board's reproposal to audits of brokers and dealers in view of the revisions that are being proposed.

The Board requests comments from auditors of brokers and dealers and others regarding the application of the repropoed standard and amendments to audits of brokers and dealers. Specific questions are included at the end of Section V. of Appendix 4 to this release.

VI. Effective Date

The repropoed standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2013. The Board seeks comment regarding the feasibility of this date in Section VI. of Appendix 4 to this release.

VII. Appendices

The release contains the following appendices:

- Appendix 1 to this release contains the text of the repropoed standard, *Related Parties*.
- Appendix 2 to this release contains the repropoed amendments to certain PCAOB auditing standards regarding significant unusual transactions.
- Appendix 3 to this release contains the other repropoed amendments to PCAOB auditing standards.
- Appendix 4 provides additional discussion of the repropoed standard and amendments. Appendix 4 also includes discussion of the existing standards and discussion of significant comments and Board responses. This Appendix further contains information regarding the applicability of the repropoed standard and amendments to audits of brokers and dealers and audits of EGCs. Appendix 4 also contains questions that solicit comments regarding specific provisions in the repropoed standard and amendments, including the potential costs associated with the implementation of those provisions. Questions are included in each of the following sections of Appendix 4:



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<ul style="list-style-type: none"> • Appendix 5 to this release discusses certain significant differences between the objectives and requirements of the repropose standard and the amendments and the analogous standards of the IAASB and the ASB. 	

VIII. Opportunity for Public Comment

The Board solicits comments on any and all aspects of its reproposal, as well as seeking specific comments on the repropose standard, the repropose amendments regarding significant unusual transactions, and other repropose amendments to other PCAOB auditing standards. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's Web site at: www.pcaobus.org. All comments should refer to the PCAOB Rulemaking Docket Matter No. 038 on the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on July 8, 2013.

The Board will consider carefully all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are rules of the Board under the Act.



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On the 7th day of May, in the year 2013, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary
May 7, 2013



APPENDIX 1

Proposed Auditing Standard, *Related Parties*

Introduction

1. This standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.^{1/}

Objective

2. The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.^{2/}

Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties

3. The auditor should 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 in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. The procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company's process (paragraph 4);

^{1/} The auditor should look to the requirements of the U.S. Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties" and the financial statement disclosure requirements with respect to related parties.

^{2/} See, e.g., paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*. See also paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.



- b. Performing inquiries (paragraphs 5-7); and
- c. Communicating with the audit engagement team and other auditors (paragraphs 8-9).

Note: 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.

Note: Performing the risk assessment procedures described in paragraphs 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 related parties and relationships and transactions with related parties.

Obtaining an Understanding of the Company's Process

4. In conjunction with obtaining an understanding of internal control over financial reporting, the auditor should obtain an understanding of the company's process for:^{3/}
- a. Identifying related parties and relationships and transactions with related parties;
 - b. Authorizing and approving transactions with related parties; and
 - c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

^{3/} See, e.g., paragraph 18 of Auditing Standard No. 12 which requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures. See *also* paragraph 20 of Auditing Standard No. 12, which states that obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.



Performing Inquiries

5. The auditor should inquire of management regarding:^{4/}
- a. The names of the company's related parties during the period under audit, including changes from the prior period;
 - b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);
 - c. The nature of any relationships, including ownership structure, between the company and its related parties;
 - d. The transactions entered into, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;
 - e. The business purpose for entering into a transaction with a related party versus an unrelated party;
 - f. 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; and
 - g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.
6. The auditor should inquire of others within the company regarding their knowledge of the matters in paragraph 5 of this standard. The auditor should identify others within the company to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding:

^{4/} See also AU sec. 333, *Management Representations*. Obtaining such representations from management complements the performance of procedures in paragraph 5 and is not a substitution for those inquiries.



- a. The company's related parties or relationships or transactions with related parties;
 - b. The company's controls over relationships or transactions with related parties; and
 - c. The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.^{5/}
7. The auditor should inquire of the audit committee,^{6/} or its chair, regarding:
- a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
 - b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

Communicating with the Audit Engagement Team and Other Auditors

8. The auditor should communicate to engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.^{7/}

^{5/} For purposes of this standard, the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties.

^{6/} The term "audit committee" has the same meaning as the term used in Auditing Standard No. 16, *Communications with Audit Committees*.

^{7/} This communication complements the discussion among engagement team members regarding risks of material misstatement in accordance with paragraph 49 of Auditing Standard No. 12. See also, paragraph 5 of Auditing Standard No. 10, *Supervision of the Audit Engagement*, which establishes requirements regarding supervision of the engagement team members, including directing engagement team members to bring significant accounting and auditing issues arising during the audit to



9. 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.^{8/} The auditor also should inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.

Identifying and Assessing Risks of Material Misstatement

10. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level.^{9/} This includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties.

Note: In identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4-9 of this standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

the attention of the engagement partner or other engagement team members performing supervisory activities.

^{8/} See AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements.

^{9/} See paragraph 59 of Auditing Standard No. 12.



Responding to the Risks of Material Misstatement

11. The auditor must design and implement audit responses that address the identified and assessed risks of material misstatement.^{10/} This includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.^{11/}

Note: The auditor also should look to the requirements in proposed paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). For such related party transactions, AU sec. 316.67 requires 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.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk

12. For each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:

- a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

^{10/} See paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

^{11/} See *generally*, Auditing Standard No. 13 and paragraph 17 of Auditing Standard No. 15, *Audit Evidence*, which provides that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.



- b. 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;
- c. Determine whether any exceptions to the company's established policies or procedures were granted;^{12/}
- d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;^{13/} and
- e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Note: 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 in paragraph 12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

Intercompany Transactions

13. The auditor should perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

^{12/} Information gathered while obtaining an understanding of the company also might assist the auditor in identifying agreements prohibiting or restricting related party transactions (for example, loans or advances to related parties).

^{13/} Examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.



Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties

14. The auditor should evaluate whether the company has properly identified its related parties and relationships and transactions with related parties.^{14/} In making that evaluation, the auditor should take into account the information gathered during the audit.^{15/} As part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

Note: Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

15. If the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist.^{16/} These procedures should extend beyond inquiry of management.

^{14/} Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

^{15/} Information obtained from identifying and evaluating a company's significant unusual transactions and obtaining an understanding of a company's financial relationships and transactions with its executive officers could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

^{16/} See paragraph 29 of Auditing Standard No. 15, which states that if audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.



16. If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;^{17/}
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of this standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;
- f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
- g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
- h. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related

^{17/} See AU sec. 333.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.



party indicates that fraud or an illegal act may have occurred. If the auditor determines that it is likely that an illegal act has or may have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

Evaluating Financial Statement Accounting and Disclosures

17. The auditor must evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. This includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.^{18/}

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions

18. If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.^{19/}

Note: Transactions with related parties might not be conducted on terms equivalent to those prevailing in arm's-length transactions (e.g., a company may receive services from a related party without cost). Except for routine transactions, it may not be possible for management to determine whether a particular transaction would have taken place, or

^{18/} See paragraph 31 of Auditing Standard No. 14.

^{19/} See proposed paragraph .06.l. of AU sec. 333, which would require the auditor to obtain written representations from management if the financial statements include such an assertion. Representations from management alone are not sufficient appropriate audit evidence. See also paragraphs .35-.36 of AU sec. 508, *Reports on Audited Financial Statements*.



what the terms and manner of settlement would have been, if the parties had not been related. Accordingly, it may be difficult for the auditor to obtain sufficient appropriate audit evidence to substantiate management's assertion that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. A preface to a statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

Communications with the Audit Committee

19. The auditor should communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.^{20/} The auditor also should communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and
- e. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

^{20/} See Auditing Standard No. 16 regarding the timing of the communications to the audit committee.



APPENDIX A – Examples of Information and Sources of Information That Could Indicate That Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor Might Exist

A1. This Appendix contains examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Specifically, paragraph A2 of this Appendix contains examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, and paragraph A3, similarly, contains examples of sources that could contain such information. The examples contained in this Appendix are not intended to represent a comprehensive listing.

A2. The following are examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Buying or selling goods or services at prices that differ significantly from prevailing market prices;
- Sales transactions with unusual terms, including unusual rights of return or extended payment terms generally not offered;
- "Bill and hold" type transactions;
- Borrowing or lending on an interest-free basis or with no fixed repayment terms;
- Occupying premises or receiving other assets or rendering or receiving management services when no consideration is exchanged;
- Engaging in a nonmonetary transaction that lacks commercial substance;
- Sales without economic substance (e.g., funding the other party to the transaction to facilitate collection of the sales price, or entering into a transaction shortly prior to period end and unwinding that transaction shortly after period end);
- Loans to parties that, at the time of the loan transaction, do not have the ability to repay and possess insufficient or no collateral;
- Loans made without prior consideration of the ability of the party to repay;



- A subsequent repurchase of goods that indicates that at the time of sale an implicit obligation to repurchase may have existed that would have precluded revenue recognition or sales treatment;
- Advancing company funds that are used directly or indirectly to pay what would otherwise be an uncollectible loan or receivable;
- Sales at below market rates to an intermediary whose involvement serves no apparent business purpose and who, in turn, sells to the ultimate customer at a higher price, with the intermediary (and ultimately its principals) retaining the difference;
- Guarantees and guarantor relationships outside the normal course of business; or
- Transactions between two or more entities in which each party provides and receives the same or similar amounts of consideration (e.g., round-trip transactions).

A3. The following are examples of sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies;
- Confirmation responses and responses to inquiries of the company's lawyers;
- Tax filings and related correspondence;
- Invoices and correspondence received from the company's professional advisors, for example, attorneys and consulting firms;
- Relevant internal auditors' reports;
- Conflicts-of-interest statements from management and others;
- Shareholder registers that identify the company's principal shareholders;
- Life insurance policies purchased by the company;
- Records of the company's investments, pension plans, and other trusts established for the benefit of employees, including the names of the officers and trustees of such investments, pension plans, and other trusts;
- Contracts or other agreements (including, for example, partnership agreements and side agreements or other arrangements) with management;



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- Contracts and other agreements representing significant unusual transactions;
- Significant contracts renegotiated by the company during the period under audit;
- Records from a management, audit committee, or board of directors' whistleblower program;
- Expense reimbursement documentation for executive officers; or
- The company's organizational charts.



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APPENDIX 2 – Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

A. Identifying Significant Unusual Transactions (Section II.A. of Appendix 4)

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

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, as amended, is amended as follows:

In paragraph 14:

- The first bullet point is replaced with:

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 those that result in late or unusual journal entries;^{10A/} and

- Footnote 10A is added at the end of the first bullet:

^{10A/} See paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

Auditing Standard No. 9, *Audit Planning*

Auditing Standard No. 9, *Audit Planning*, as amended, is amended as follows:

In paragraph 12, subparagraph a. is replaced with:

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.^{14/}



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Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

a. In paragraph 13:

- The fifth bullet point is replaced with:

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");^{7A/} and

- Footnote 7A is added after the semicolon (;) at the end of the fifth bullet:

^{7A/} See AU secs. 316.66-.67A.

b. In paragraph 56.a.:

- In item (6), delete the word "and" at the end of the item.
- In item (7), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
- Add Item (8):

(8) Whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties.^{31A/}

- Add footnote 31A at the end of item (8):

^{31A/} See AU secs. 316.66-.67A.

c. In paragraph 56.b.:



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- In item (3), delete the word "and" at the end of the item.
 - In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add item (5):
 - (5) Whether the company has entered into any significant unusual transactions.
- d. In paragraph 56.c.:
- In item (3), delete the word "and" at the end of the item.
 - In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add item (5):
 - (5) Whether the company has entered into any significant unusual transactions.
- e. In paragraph 57, the third bullet point is replaced with:
- Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements, a significant unusual transaction, or a significant related party transaction;
and
- f. Paragraph 71.g., is replaced with:
- Whether the risk involves significant unusual transactions.
- g. Paragraph 73A is added after paragraph 73:
- 73A. The auditor should obtain an understanding of the controls that management has established to identify, authorize and approve, and account for and disclose significant unusual transactions in the financial statements, if the auditor has not already done so when



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obtaining an understanding of internal control, as described in paragraphs 18-40 and 72-73 of this standard.

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, as amended, is amended as follows:

- a. The second sentence of footnote 3 to paragraph 5.d. is replaced with:

See also paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and paragraphs .04 and .06 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

- b. Paragraph 15.c. is replaced with:

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 may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. (AU secs. 316.66-.67A).

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. The first item in paragraph .85A.2, section a., under "Opportunities" is replaced with the following two items:
- Related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business)
 - Significant transactions with related parties whose financial statements are not audited or are audited by another firm



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- b. The fourth item in paragraph .85A.2, section a., under "Opportunities" is replaced with:
 - o Significant or highly complex transactions or significant unusual transactions, especially those close to period end, that pose difficult "substance-over-form" questions
- c. The following item is added as the last item to paragraph .85A.2, section a., under "Opportunities":
 - o Contractual arrangements lacking a business purpose

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

- a. In paragraph .55, Appendix B, paragraph B1., the tenth bullet is replaced with:
 - The occurrence of infrequent or significant unusual transactions

B. Evaluating Significant Unusual Transactions (Section II.B. of Appendix 4)

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, as amended, is amended as follows:

- a. Paragraph 11A is added after paragraph 11:
 - 11A. *Responding to Risks Associated with Significant Unusual Transactions.* Paragraph 71.g. of Auditing Standard No. 12 indicates that one of the factors to be evaluated in determining significant risks is whether the risk involves significant unusual transactions. Also, AU secs. 316.66-.67A establish requirements for performing procedures to respond to fraud risks regarding significant unusual transactions. Because significant unusual transactions can affect the risks of material misstatement due to



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error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-.67A.

Auditing Standard No. 16, *Communications with Audit Committees*

Auditing Standard No. 16, *Communications with Audit Committees*, is amended as follows:

- a. In paragraph 13.d., the phrase "rationale for" is replaced with the phrase "purpose (or the lack thereof) of."

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. Paragraph .66 is replaced with:

.66 Evaluating whether the business purpose for significant unusual transactions indicates that the transactions may have been entered into to engage in fraud. 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.

Note: The auditor's identification of significant unusual transactions should take into account information obtained from: (a) the risk assessment procedures required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial



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reporting) and (b) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

Note: The auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. See paragraphs 14-16 of proposed auditing standard, *Related Parties*. Appendix A of proposed auditing standard, *Related Parties*, includes examples of such information and examples of sources of such information.

b. Paragraph .66A is added after paragraph .66:

.66A The auditor should design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. The procedures should include:

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;
fn 24A and



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- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

Note: Paragraph 11A of Auditing Standard No. 13 requires the auditor to take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures.

- c. Footnote 24A is added after subparagraph c. of paragraph.66A

^{fn 24A} Examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

- d. Paragraph .67 is replaced with:

.67 The auditor should evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. In making that evaluation, the auditor should evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);
- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor; ^{fn 25A}
- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company;



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- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);
- 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 other, more clearly independent, parties on an arm's-length basis;
- The transaction enables the company to achieve certain financial targets;
- 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); and
- Management has discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Note: Paragraphs 20-23 of Auditing Standard No. 14, *Evaluating Audit Results*, provide requirements regarding the auditor's evaluation of whether identified misstatements might be indicative of fraud.

- e. Footnote 25 is deleted and footnote 25A is added at the end of the third bullet in paragraph .67:

^{fn 25A}

Related parties or relationships or transactions with related parties previously undisclosed to the auditor includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties. Proposed auditing standard, *Related Parties*, requires the auditor to perform certain



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procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

f. Paragraph .67A is added after paragraph 67:

.67A 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 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.^{fn 25B}

Note: The auditor considers management's disclosure regarding significant unusual transactions in other parts of the company's Securities and Exchange Commission filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

g. Footnote 25B is added at the end of paragraph.67A:

^{fn 25B} See paragraph 31 of Auditing Standard No. 14.



APPENDIX 3 – Other Proposed Amendments to PCAOB Auditing Standards

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

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

- a. The following sentence is added to the end of footnote 3 of paragraph 4:

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.

- b. In paragraph 10, the note following the final bullet is deleted.

- c. Paragraph 10A is added after paragraph 10:

10A. To assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's financial relationships and transactions with its **executive officers** (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the Securities and Exchange Commission and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.

- d. In paragraph 11:

- The third bullet is replaced with:



Obtaining an understanding of compensation arrangements with senior management other than executive officers referred to in paragraph 10A, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses;

- In the fourth bullet, delete the period (.) and add a semicolon (;) at the end of the bullet.

- Add a fifth bullet:

Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and

- Add a sixth bullet:

Obtaining an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

- e. In Appendix A, paragraph A3A is added after paragraph A3:

A3A. Executive officer – For issuers, the president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policy-making functions for the company. (See Rule 3b-7 under the Exchange Act.) For brokers and dealers, the term "executive officer" includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions. (See Schedule A of Form BD.)



Auditing Standard No. 16, *Communications with Audit Committees*

Auditing Standard No. 16, *Communications with Audit Committees*, is amended as follows:

- a. The phrase "AU sec. 334, *Related Parties*" in footnote 25 is replaced with the phrase "proposed auditing standard, *Related Parties*."
- b. The following bullet is inserted after the third bullet in Appendix B:
 - Proposed auditing standard, *Related Parties*, paragraphs 7 and 19.

AU sec. 315, "Communications Between Predecessor and Successor Auditors" (Section III.B. of Appendix 4)

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows:

- a. The following bullet is added to the end of paragraph .09:
 - The predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions.^{fn 5A}
- b. Add the following footnote to the end of paragraph .09:

^{fn 5A} Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, describes significant unusual transactions.
- c. In paragraph .11, replace the fifth sentence with:

The predecessor auditor should ordinarily permit the successor auditor to review working papers, including documentation of planning, internal control, audit results, and other matters of continuing accounting and auditing significance, such as the working papers containing an analysis of balance sheet accounts, those relating to contingencies, related parties, and significant unusual transactions.



AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"
(Section III.C. of Appendix 4)

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. The heading before paragraph .79 is replaced with:

Communication about Possible Fraud to Management, the Audit Committee, the Securities and Exchange Commission, and Others^{fn 37}

- b. Paragraph .81A is added after paragraph .81:

.81A The auditor has a responsibility, under certain conditions, to disclose possible fraud to the Securities and Exchange Commission to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change and the fraud or related risk factors constitute a reportable event or are the source of a disagreement, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required pursuant to Section 10A(b) of the Securities Exchange Act of 1934 relating to an illegal act that the auditor concludes has a material effect on the financial statements.

- c. For paragraph .82:

- Footnotes 39 and 41 are deleted.
- The paragraph is replaced with:

.82 The auditor also may have a duty to disclose the existence of possible fraud to parties outside the entity in the following circumstances:

- a. To a successor auditor when the successor makes inquiries in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors*.^{fn 40}



- b. In response to a subpoena.
- c. To a funding agency or other specified agency in accordance with requirements for the audits of companies that receive governmental financial assistance.
- d. The following item is added to paragraph .85A.2, section b., under "Opportunities":
 - o The exertion of dominant influence by or over a related party

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), as amended, is amended as follows:

- a. Footnote 2 to paragraph .27 is replaced with:

Proposed auditing standard, *Related Parties*, establishes requirements regarding the auditor's evaluation of relationships and transactions between the company and its related parties.

AU sec. 333, "Management Representations" (Section III.D. of Appendix 4)

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

- a. The third sentence of paragraph .03 is replaced with:

For example, after the auditor performs the procedures described in proposed auditing standard, *Related Parties*, the auditor should obtain a written representation that management has no knowledge of any relationships or transactions with related parties that have not been properly accounted for and adequately disclosed. The auditor should obtain this written representation even if the results of those procedures indicate that relationships and transactions with related parties have been properly accounted for and adequately disclosed.

- b. In paragraph .06:
 - Subparagraph c. is replaced with:



Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Subparagraph f. is replaced with:

Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.

- Subparagraph l. is replaced with:

Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.^{fn9}

- c. Footnote 9 to paragraph .06 is replaced with:

See paragraph 18 of proposed auditing standard, *Related Parties*.

- d. The second sentence in paragraph 4 of Appendix A is replaced with:

Examples are fraud, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in proposed auditing standard, *Related Parties*.

- e. In paragraph 6 of Appendix A:

- Item 2.a. is replaced with:

Financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Item 11.d. is added:

Side agreements or other arrangements (either written or oral) that have not been disclosed to you.



AU sec. 334, "Related Parties"

SAS No. 45, Omnibus Statement on Auditing Standards — 1983 (AU sec. 334, "Related Parties"), as amended, is superseded.

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," as amended, is superseded.

AU sec. 336, "Using the Work of a Specialist"

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336, "Using the Work of a Specialist"), as amended, is amended as follows:

- a. Footnote 6 of paragraph .10 is replaced with:

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.

AU sec. 560, "Subsequent Events" (Section III.E. of Appendix 4)

SAS No. 1, "Codification of Auditing Standards and Procedures," section 560, "Subsequent Events" (AU sec. 560, "Subsequent Events"), as amended, is amended as follows:

- a. In paragraph .12b.:

- Item (v) is added:

Whether there have been any changes in the company's related parties or whether there have been any significant new related party transactions.

- Item (vi) is added:

Whether the company has entered into any significant unusual transactions.



AU sec. 722, "Interim Financial Information" (Section III.F. of Appendix 4)

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

- a. In paragraph .24:
 - Subparagraph g. is replaced with:

Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
 - Subparagraph j. is replaced with:

Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.
 - Subparagraph m. is replaced with:

Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.
- b. The second sentence of paragraph C5 of paragraph .56 is replaced with:

Examples are fraud, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in proposed auditing standard, *Related Parties*.
- c. Within paragraph C6 of paragraph .56, within the second illustrative representation letter (2.) for a review of interim financial information (statements):
 - Item 2.a. is replaced with:

All financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
 - Item 12.d. is added:



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Side agreements or other arrangements (either written or oral) that have not been disclosed to you.



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APPENDIX 4 – Additional Discussion of the Reproposed Standard and Amendments and Questions for Public Comment

The Board is reproposing a new auditing standard, *Related Parties* (the "reproposed standard"); amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "reproposed amendments regarding significant unusual transactions"); and other amendments to PCAOB auditing standards (the "other reproposed amendments").^{1/} This Appendix discusses the reproposed standard in Appendix 1, the reproposed amendments regarding significant unusual transactions in Appendix 2, and the other reproposed amendments in Appendix 3.

The Board previously issued a proposed auditing standard, *Related Parties* (the "proposed standard"), proposed amendments regarding significant unusual transactions (the "proposed amendments regarding significant unusual transactions") and the other proposed amendments (the "other proposed amendments").^{2/} The comment period ended on May 31, 2012. The Board received 37 comment letters. The Board also discussed the proposed standard and amendments with its Standing Advisory Group ("SAG") on May 17, 2012 ("the SAG discussion").^{3/}

^{1/} The reproposed amendments regarding significant unusual transactions and the other reproposed amendments are collectively referred to as the "reproposed amendments." The reproposed standard and reproposed amendments are collectively referred to as the "reproposed standard and amendments" or the "reproposal."

^{2/} See *Proposed Auditing Standard, Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2012-001 (Feb. 28, 2012) (the "proposing release"), available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>. The proposed amendments regarding significant unusual transactions and the other proposed amendments are collectively referred to as the "proposed amendments." The proposed standard and proposed amendments are collectively referred to as the "proposed standard and amendments" or the "proposal."

^{3/} The SAG transcript is available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>.



This Appendix provides additional background information regarding the reproposal and includes a discussion of the Board's consideration of significant comments received on its February 28, 2012 proposal.^{4/} Each section of this Appendix includes questions for commenters regarding the reproposal. The Board also is seeking input and comment on economic considerations, including audits of emerging growth companies ("EGCs"), audits of brokers and dealers as well as on the appropriate effective date for the repropose standard and amendments. This Appendix includes the following sections:

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I. Reproposed Auditing Standard, <i>Related Parties</i>	A4-2
II. Reproposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions	A4-58
III. Other Reproposed Amendments to PCAOB Auditing Standards	A4-73
IV. Economic Considerations, Including Audits of Emerging Growth Companies	A4-96
V. Audits of Brokers and Dealers	A4-117
VI. Effective Date	A4-119

I. Reproposed Auditing Standard, *Related Parties*

Overall, commenters were generally supportive of the need to improve the existing auditing standard, AU sec. 334, *Related Parties*. However, some commenters suggested that the proposed standard could benefit from additional clarification and suggested changes. In response to comments received, the Board has made revisions to clarify and refine various aspects of the proposed standard. These comments and the

^{4/} See PCAOB Release No. 2012-001.



proposed revisions are discussed in the following topical areas that address specific paragraphs of the repropoed standard:

	<u>Page</u>
A. Introduction (Paragraph 1)	A4-4
B. Objective (Paragraph 2)	A4-6
C. Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 – 9)	A4-9
D. Identifying and Assessing Risks of Material Misstatement (Paragraph 10)	A4-23
E. Responding to the Risks of Material Misstatement (Paragraphs 11 – 13)	A4-26
F. Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14 – 16)	A4-37
G. Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17 – 18)	A4-46
H. Communications with the Audit Committee (Paragraph 19)	A4-52
I. Other Considerations	A4-56

Relevant information is provided for each topical area, including a description of the proposed standard and existing requirements, a description of the repropoed standard, and a discussion of significant comments received and Board responses. Following the "Other Considerations" discussion is a list of questions for commenters regarding the repropoed standard. Commenters are encouraged not only to respond to those questions but also to provide input on all aspects of the repropoed standard.



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A. Introduction (Paragraph 1 of the Reproposed Standard in Appendix 1)

The Proposed Standard and Existing Requirements

Paragraph 1 of the proposed standard stated that this standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. In contrast, the existing standard, AU sec. 334, indicates that the standard provides guidance on procedures that should be considered by the auditor to identify related party relationships and transactions, and to satisfy himself concerning the required financial statement accounting and disclosures.^{5/}

A footnote to paragraph 1 of the proposed standard stated that the auditor should look to the requirements of the U.S. Securities and Exchange Commission ("SEC") for the company under audit with respect to the accounting principles applicable to that company, including the definition of related parties and the financial statement disclosure requirements with respect to related parties (the "framework-neutral approach").^{6/} This approach reflects the fact that applicable financial reporting frameworks may contain different definitions of the term "related party." Likewise, applicable financial reporting frameworks also may contain different disclosure requirements regarding relationships and transactions with related party transactions. AU sec. 334 refers auditors to the U.S. generally accepted accounting principles ("U.S. GAAP") definition of a "related party" and to the disclosure requirements in U.S. GAAP.^{7/}

^{5/} See AU sec. 334.01.

^{6/} For SEC filings that include financial statements prepared in accordance with or reconciled to U.S. GAAP, see, e.g., Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") Topic 850, Related Party Disclosures. For SEC filings that include financial statements prepared in accordance with International Financial Reporting Standards ("IFRS"), see, e.g., International Accounting Standard No. 24, *Related Parties*.

^{7/} See footnote 1 of AU sec. 334.01 for the definition of the term "related party" and AU secs. 334.02-.03 for discussion of U.S. GAAP disclosure requirements.



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As more fully described below, after consideration of the comments received, the Board did not substantively revise the introduction to the proposed standard.

The Reproposed Standard

The introduction in the reproposed standard, like the introduction in the proposed standard, states that the standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. As reproposed, the introduction retains the footnote that refers the auditor to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties" and the financial statement disclosure requirements with respect to related parties.

Significant Comments and Board Responses

Several commenters supported the use of a framework-neutral approach. Some commenters provided suggestions on how to further clarify the standard. In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

Defining the Term "Related Party": Some commenters suggested replacing the reference to the SEC in footnote 1 with a direct reference to the applicable financial reporting framework. One of these commenters suggested that the footnote appears to imply that the SEC has its own definition of a related party. Another commenter suggested including a definition of a "related party" in an Appendix to the standard that would refer to the definition of a "related party" contained in the applicable financial reporting framework. The Board observed that the SEC determines the accounting principles applicable to issuers (for example, U.S. GAAP or IFRS) and other reporting requirements for SEC filings, as noted in footnote 1 of the proposed standard. The Board considered the comments received, noting that commenters generally agreed with the proposed framework-neutral approach. Accordingly, the Board is not proposing to revise the introduction for these comments.

Including Examples of Related Party Transactions: Another commenter recommended including examples of related party transactions. The Board considered this comment and noted that applicable financial reporting frameworks may contain different definitions and examples of related party transactions. Thus, including



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examples in the repropoed standard might create inconsistencies and confusion. Consequently, this suggestion has not been incorporated into the repropoed standard.

Providing Additional Context of the Risks Associated with Related Party Transactions: The Board received some comments requesting additional context regarding the risks associated with related party transactions. One commenter recommended including an introductory discussion to focus the auditor's attention on the risks associated with related party transactions and to emphasize the importance of the use of professional skepticism. In contrast, another commenter suggested including language similar to that contained in International Standard on Auditing ("ISA") 550, *Related Parties*, which states that many related party transactions are in the normal course of business and, in such circumstances, may carry no higher risk of material misstatement of the financial statements than with similar transactions with unrelated parties. The Board considered these comments and did not include such discussion in the repropoed standard. However, the Board notes that the revisions made to clarify the relationship with the risk assessment standards could assist in providing context regarding potential risks of material misstatement due to error or fraud.^{8/} The Board further noted that the propoing release included a discussion regarding the nature of the risks associated with related party transactions.

B. Objective (Paragraph 2 of the Repropoed Standard in Appendix 1)

An objective provides an overarching concept that can be especially helpful when an auditor is considering procedures and evaluating audit evidence during the course of an audit.^{9/}

^{8/} See e.g., *In the Matter of the Application of Wendy McNeeley, CPA*, SEC Accounting and Enforcement Release No. 3427, at 10-12 (Dec. 13, 2012), which states that related party transactions alert auditors that "heightened scrutiny" is warranted. See also the discussion entitled "Clarifying the Relationship with the Risk Assessment Standards" in Section I.C. of this Appendix.

^{9/} The propoing release described the Board's considerations of the use of an objective in the propoed standard. See PCAOB Release No. 2012-001 at A4-4, available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>.



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The Proposed Standard and Existing Requirements

The proposed standard stated that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements. In contrast, the existing standard, AU sec. 334, does not specifically describe an objective for the auditor's work regarding a company's relationships and transactions with its related parties.

As more fully described below, after consideration of the comments received, the Board did not substantively revise the objective.

The Reproposed Standard

Consistent with the proposed standard, the reproposed standard states that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

Like the proposed standard, a footnote refers the auditor to examples of other relevant standards and rules, including paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*, and paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

Significant Comments and Board Responses

Several commenters expressed support for the objective described in the proposed standard. Other commenters suggested expanding the objective, or expressed concern regarding the nature of the objective. In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

Expanding the Objective to Include Other Matters: One commenter suggested including the auditor's communication with the audit committee in the objective. Another commenter suggested including a statement in the objective that the auditor should take into account information obtained from the performance of risk assessment procedures. The Board considered these comments, noting that the intent of the objective of the proposed standard was to focus the auditor on the end result — obtaining sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and



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disclosed in the financial statements. Therefore, the Board is not proposing to revise the objective for these comments.

Including the Consideration of "Fraud" as an Explicit Objective: Some commenters recommended that the objective should explicitly refer to the risk of fraud. In particular, one commenter noted that there were only two references to fraud in the proposed standard, and that the auditor's use of judgment would be more informed by reinforcing references to fraud in the objective. The Board believes that related party transactions deserve special attention by the auditor, in part, because of their historic association with fraudulent financial reporting.^{10/} However, because the proposed standard was designed to align with and build upon the risk assessment standards, and because those risk assessment standards emphasize that the auditor's responsibilities for assessing and responding to fraud risks are an integral part of the audit process rather than a separate, parallel process, the Board is not proposing to revise the objective.

Clarifying the Nature of the Objective: The Board received comments regarding the nature of the objective of the proposed standard and the usefulness of the release text in elucidating the Board's objectives and expectations. For example, one commenter recommended clarifying how the requirements of the proposed standard relate to and support the objective. That commenter suggested explaining how the requirements of the proposed standard provide a sufficient basis to achieve the objective and how the objective ensures that sufficient appropriate evidence is obtained in all circumstances. Another commenter noted that the release text suggested that the auditor must exercise judgment to meet the objective over and above complying with the requirements of the proposed standard. This commenter further observed that such a statement is misplaced in the text of a proposing release and stated that the release would require open, thorough, and transparent due process before being articulated as a policy as the notions articulated appear to open the door to enabling PCAOB inspections to generate deficiencies and to otherwise extend auditor liability.

The Board considered these comments and notes that the objective stated in the proposed standard provides that the auditor's work takes place within the context of the

^{10/} The proposing release contained a discussion of related party transactions that have resulted in material misstatements and fraud. See, e.g., PCAOB Release No. 2012-001 at 9-11, available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>.



Board's overall requirement that the auditor obtain sufficient appropriate evidence to support the auditor's opinion.^{11/} The Board, therefore, is not proposing to revise the objective to add specific statements regarding how the requirements in the standard relate to, or assure the achievements, of the objective.

C. Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 – 9 of the Reproposed Standard in Appendix 1)

In an audit performed in accordance with PCAOB standards, the identification and assessment of, and response to, risks of material misstatement in the financial statements underlie the entire audit process, including the procedures that the auditor performs to support the opinion expressed in the auditor's report. Performing risk assessment procedures to obtain an understanding of a company's relationships and transactions with its related parties is important because such relationships and transactions could pose increased risks of material misstatement.

The Proposed Standard and Existing Requirements

The requirements in paragraphs 3 and 4 of the proposed standard built upon the foundational risk assessment requirements contained in Auditing Standard No. 12, *Identifying and Assessing the Risks of Material Misstatement*. Specifically, paragraph 3 of the proposed standard would have required that the auditor perform procedures to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes (or the lack thereof) of the types of transactions involving related parties. Paragraph 4 of the proposed standard would have required that the auditor take into account information obtained from the performance of risk assessment procedures required by Auditing Standard No. 12 in identifying related parties and obtaining an understanding of relationships and transactions with related parties.

The existing standard, AU sec. 334, states that in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor

^{11/} See paragraph 33 of Auditing Standard No. 14.



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should obtain an understanding of management responsibilities and the relationship of each component of the entity to the total entity.^{12/}

As more fully described below, after consideration of the comments received, the Board substantially revised paragraphs 3 and 4. In particular, in response to comments received that requested clarification of the relationship between the proposed standard and the risk assessment standards, the Board made revisions to better integrate the proposed requirements with the risk assessment standards.

The Reproposed Standard

As reproposed, paragraph 3 of the reproposed standard would require 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 in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12. Paragraph 3 of the reproposed standard specifies that the procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include: obtaining an understanding of the company's process; performing inquiries; and communicating with the audit engagement team and other auditors.

A note to paragraph 3 of the reproposed standard states that 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.

A second note would clarify that performing the risk assessment procedures described in paragraphs 4-9 of the reproposed 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 related parties and relationships and transactions with related parties.

In clarifying the relationship to the risk assessment standards, the Board's reproposal would remove the second note to paragraph 10 of Auditing Standard No. 12.

^{12/} See AU sec. 334.05.



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That note states that the auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties in accordance with AU sec. 334. As described previously, the procedures in paragraphs 4-9 of the repropoed standard would be performed in conjunction with the risk assessment procedures in Auditing Standard No. 12.

The repropoed amendments would add a new sentence to footnote 3 of paragraph 4 of Auditing Standard No. 12 that states that 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.

Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comments:

Clarifying the Relationship with the Risk Assessment Standards: Some commenters suggested that the Board take steps to more closely align the proposed standard with the risk assessment standards. One commenter noted that the omission of clear linkage to the concept of auditor risk assessment in paragraph 3 may result in an overly burdensome requirement for the auditor to identify and assess risks of material misstatement, and then perform appropriate audit procedures. Another commenter suggested revising paragraph 3 to include a preface that would refer to Auditing Standard No. 12. This commenter also suggested clarifying the relationship of paragraph 3 to the procedures set out in paragraphs 4-11 by incorporating discussion in the proposing release into the standard. Other commenters were concerned that certain requirements in the proposed standard appeared overly prescriptive and were inconsistent with the approach described in the risk assessment standards.

After considering these comments, the Board included changes in the repropoed standard that clarify that the auditor would perform the risk assessment procedures required by the repropoed standard in conjunction with the risk assessment procedures required by Auditing Standard No. 12. This would provide opportunities for an auditor to integrate audit effort, where appropriate. The specific risk assessment procedures that would be required by the repropoed standard, which are necessary for the auditor's identification and assessment of the risks of material misstatement associated with a company's related party transactions, would build upon the procedures being performed under Auditing Standard No. 12.



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Also, as further described in Section I.F. of this Appendix, the Board revised its proposal to include a new section that would clarify the auditor's responsibilities for evaluating whether the company has properly identified its related parties and relationships and transactions with related parties.

Identifying Contradictory Information: At the SAG discussion, the point was raised that the auditor should search public information regarding a company's related parties and transactions and, in particular, to search for contradictory information to test representations provided by management. The point was also raised that such contradictory information would not come to the auditor's attention unless the auditor looked for it, and, without a requirement to do so, the auditor might place too much reliance on management for the identification of the company's related parties.

The Board considered these points and is not proposing to include requirements for the auditor to search public information indiscriminately as this could result in unnecessary costs. The Board anticipates however, that, in appropriate situations, the auditor might review public documents for information regarding a company's related parties and transactions, particularly when it is readily available. For example, a review of relevant available public information might be appropriate in situations in which information comes to the auditor's attention that suggests that related parties previously undisclosed to the auditor might exist. In addition, existing standards require that as part of obtaining an understanding of the company the auditor should consider reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements.^{13/}

Evaluating the Materiality of Related Party Transactions: One commenter recommended deleting the footnote to paragraph 3 of the proposed standard, which referenced paragraph 7 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*. That commenter expressed concern that this reference implied that all related party transactions represent transactions for which lesser amounts than the materiality level for the financial statements taken as a whole would influence the judgment of a reasonable investor.

The Board considered this comment and noted that applicable financial reporting frameworks require the disclosure of material related party transactions. The footnote to paragraph 3 of the proposed standard noted that lesser amounts of misstatements

^{13/} See paragraph 11 of Auditing Standard No. 12.



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could influence the judgment of a reasonable investor because of qualitative factors, such as conflicts of interest in related party transactions. While the Board continues to support the statement in this footnote, it has reconsidered the need for it in light of other revisions to the repropoed standard that clarify the relationship between the repropoed standard and the risk assessment standards. Accordingly, the repropoed standard does not include that footnote. The Board has also removed the other footnote to paragraph 3 of the propoed standard, which referred to paragraph 16 of Auditing Standard No. 9, *Audit Planning*.

Obtaining an Understanding of the Company's Process (Paragraph 4 of the Repropoed Standard in Appendix 1)

Obtaining an understanding of the company's process regarding identifying, authorizing, approving, accounting for, and disclosing transactions between the company and its related parties is an important procedure to assist the auditor in obtaining an understanding of the company's relationships and transactions with its related parties.

The Propoed Standard and Existing Requirements

Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatement, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.^{14/} AU sec. 334.05, issued before the adoption of the risk assessment standards, is similar, but not as specific. Among other things, AU sec. 334.05 states that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities. AU sec. 334.05 further states that the auditor should consider controls over management activities.

Paragraph 5 of the propoed standard was intended to align with and build upon the requirements in Auditing Standard No. 12. Specifically, paragraph 5 of the propoed standard would have required that the auditor obtain an understanding of the controls that management has established to: (a) identify related parties and relationships and transactions with related parties; (b) authorize and approve transactions with related

^{14/} See paragraph 18 of Auditing Standard No. 12.



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parties; and (c) account for and disclose relationships and transactions with related parties in the financial statements.

In response to comments, the Board made revisions to better integrate the proposed requirements with the risk assessment standards. In addition, the repropoed standard contains new references to relevant paragraphs in Auditing Standard No. 12.

The Repropoed Standard

Paragraph 4 of the repropoed standard would state that, in conjunction with obtaining an understanding of internal control over financial reporting, the auditor should obtain an understanding of the company's process for: (a) identifying related parties and relationships and transactions with related parties; (b) authorizing and approving transactions with related parties; and (c) accounting for and disclosing relationships and transactions with related parties in the financial statements.

A new footnote would refer the auditor to paragraphs 18 and 20 of Auditing Standard No. 12 to emphasize that the procedures required by paragraph 4 of the repropoed standard would be performed in conjunction with the auditor's risk assessment process.

Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comments:

Providing Additional Context Regarding Internal Control: Some commenters suggested that the Board provide additional context with respect to the auditor's understanding of internal control. For example, one commenter suggested explaining that, in certain situations controls over related party relationships and transactions may be deficient, may more readily be overridden by senior management, or may not exist, and, in those situations, the auditor may not be able to rely on internal controls in designing audit procedures to obtain sufficient audit evidence. Another commenter urged the Board to clarify that the quality of internal controls over the identification of related parties, transactions with related parties, and related disclosures is critical.

The Board considered these comments and is not proposing to include additional context regarding internal controls in the repropoed standard. However, the Board notes that the revisions to better integrate and clarify the relationship of the repropoed standard with existing requirements in the risk assessment standards regarding



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obtaining an understanding of internal control over financial reporting should address these concerns.

Performing Inquiries (Paragraphs 5-7 of the Reproposed Standard in Appendix 1)

Appropriately focused inquiries can inform the auditor's understanding of the nature of the relationships between the company and its related parties, and the terms and business purposes (or the lack thereof) of transactions involving related parties. In addition, inquiries can assist the auditor in determining the extent of audit procedures that should be performed to determine whether the company has identified its related parties and relationships and transactions with its related parties.

The Proposed Standard and Existing Requirements

Paragraphs 6-8 of the proposed standard would have required the auditor to make specific inquiries of company management, others within the company likely to have additional knowledge regarding the company's related parties or relationships or transactions with the company's related parties, and of the company's audit committee.

The existing standard, AU sec. 334, describes a variety of specific audit procedures for the auditor's consideration in determining the existence of related parties.^{15/} These specific procedures include requesting from appropriate management personnel the names of all related parties and inquiring whether there were any transactions with these parties during the period.

The Board has made revisions to the proposed standard in response to a number of comments regarding the use of additional auditor judgment, including to clarify whether inquiry of certain individuals is necessary in all instances and with respect to the nature and extent of inquiries of others.

The Reproposed Standard

Paragraph 5 of the repropoed standard is substantially similar to paragraph 6 of the proposed standard. As repropoed, paragraph 5 would require the auditor to inquire of management regarding: the names of the company's related parties during the period under audit, including changes from the prior period; background information concerning the related parties (for example, physical location, industry, size, and extent

^{15/} See AU sec. 334.07.



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of operations); the nature of any relationships, including ownership structure, between the company and its related parties; the transactions entered into, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions; the business purpose for entering into a transaction with a related party versus an unrelated party; 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; and any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

A new footnote to paragraph 5 of the repropoed standard would clarify that obtaining representations from management pursuant to AU sec. 333 complements the auditor's inquiries under paragraph 5 and is not a substitute for them.^{16/}

Paragraph 6 of the repropoed standard would clarify the auditor's responsibilities when performing inquiries of others. As revised by the Board, paragraph 6 of the repropoed standard would require the auditor to inquire of others within the company regarding their knowledge of the matters in paragraph 5 of the repropoed standard. Pursuant to paragraph 6 of the repropoed standard, the auditor would be required to identify others within the company to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding: (a) the company's related parties or relationships or transactions with related parties; (b) the company's controls over relationships or transactions with related parties; and (c) the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

As described in further detail below, the examples of "others" within the company are not included in the repropoed standard. In addition, the Board added a footnote to paragraph 6 of the repropoed standard, which states that for purposes of this standard the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties. As

^{16/} See Section III.D. of this Appendix for discussion of amendments the Board is proposing to AU sec. 333, *Management Representations*.



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reproposed, this footnote clarifies the meaning of the phrase previously described in the note to paragraph 3 of the proposed standard.

Paragraph 7 of the reproposed standard is substantially the same as paragraph 8 of the proposed standard and includes changes to a footnote to reflect the adoption of Auditing Standard No. 16, *Communications with Audit Committees*.

Specifically, paragraph 7 of the reproposed standard would require the auditor to inquire of the audit committee, or its chair, regarding: the audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns. As reproposed, a footnote to paragraph 7 of the reproposed standard would refer the auditor to Auditing Standard No. 16 for the definition of the term "audit committee."

The inquiries in paragraphs 5 through 7 of the reproposed standard could be performed at the same time as the inquiries about the risks of material misstatement, including fraud risks, that are required by paragraphs 54 through 58 of Auditing Standard No. 12.^{17/} These inquiries also would provide an opportunity for the auditor to discuss the company's financial relationships and transactions with its executive officers with the audit committee, or its chair, as part of the auditor's procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers.^{18/}

Significant Comments and Board Responses

Some commenters suggested making revisions to allow more room for the use of auditor judgment. Other commenters made suggestions pertaining to specific inquiries required by the proposed standard. In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

^{17/} Paragraph 8 of Auditing Standard No. 16, *Communications with Audit Committees*, also requires the auditor to make certain inquiries of the audit committee; see *Communications with Audit Committees* PCAOB Release No. 2012-004 (Aug. 15, 2012).

^{18/} See the reproposed amendments in Section III.A of this Appendix.



Allowing Judgment When Performing Inquiries of Management: Some commenters suggested revising the proposed standard to allow for the exercise of auditor judgment in determining which inquiries should be made of management and noted that certain inquiries may not be relevant depending on the facts and circumstances. Another commenter suggested combining certain of the inquiries listed in the proposed standard to better allow for the use of auditor judgment in determining the nature and extent of information regarding the identity of the company's related parties, including changes from the prior period. The Board considered these comments and believes the matters identified in the list of inquiries of management consist of basic information that the auditor should obtain as part of obtaining an understanding of the company's financial relationships and transactions with its related parties. Accordingly, the Board is not proposing to make revisions for these comments.

Allowing Judgment When Performing Inquiries of Others within the Company: Several commenters suggested revising the paragraph of the proposed standard that addresses inquiries of others within the company to include the phrase "as appropriate" or "as applicable" to allow auditors judgment in both identifying appropriate individuals within the company to whom inquiries should be made and to determine the extent of the inquiries to be made. Another commenter suggested that the auditor should inquire of any individuals from whom relevant information may be obtained and noted that some individuals who would respond to inquiries of management under paragraph 6 of the proposed standard also were included in the list of examples of "others" in paragraph 7 of the proposed standard.

The Board considered these comments and is proposing a number of revisions to clarify the auditor's responsibilities when performing inquiries of others. The revisions clarify that the auditor's inquiries of others within the company relate to their knowledge of the same matters that are the subject of the auditor's inquiries of management. These matters are identified in paragraph 5 of the repropoed standard. In addition, it was not the Board's intent to require the auditor to inquire of others within the company regarding matters that the auditor did not believe were reasonably within their knowledge. To remove the notion that the auditor should make inquiries in each audit of all the individuals that were listed in paragraph 7 of the proposed standard and to address the observation that some individuals included in the list of examples of "others" might also be members of management, the Board has removed the list of individuals. Revisions have also been made to clarify that the auditor should inquire of others within the company likely to have knowledge regarding the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.



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Identifying Related Party Transactions Not Authorized or Approved: One commenter raised a concern regarding whether smaller issuers would have formalized policies and procedures pertaining to authorizing and approving transactions with related parties. While this comment was directed at the paragraph of the proposed standard related to the auditor's communications with the audit committee, the Board's consideration of this comment prompted a change to the paragraph of the repropoed standard related to inquiries of management. The commenter stated that, while the requirement to communicate significant related party transactions to the audit committee may be appropriate, such a communication requirement may imply a level of formality that does not exist for smaller issuers and, thus, may create uncertainty for auditors of those issuers as to their responsibility to assess the issuer's policies and procedures and the level of communication required.

The Board considered this comment, recognizing that material features of companies' procedures and policies for the review, approval or ratification of related party transactions will vary depending on both the size and complexity of the company and the types of transactions covered by such policies and procedures. The Board does not mean to imply that such policies and procedures should be in writing or adhere to any particular framework. The Board, however, believes that gaining an understanding of the policies and procedures, regardless of their formality or nature, is important to an auditor's consideration of the risks that relationships and transactions with related parties may pose for material misstatement of the company's financial statements.

The Board also revised the inquiry that had been in paragraph 6.f. of the proposed standard (which is now in paragraph 5.f. of the repropoed standard) to remove the word "significant" so that the auditor would inquire of management regarding any such related party transactions. Auditor communications with the audit committee of such matters, as would be required by paragraph 19.b.-c. of the repropoed standard, would maintain a focus on such significant transactions identified by the auditor. Accordingly, the repropoed standard would require the auditor, rather than management, to make the determination as to which transactions are significant.

Expanding the Inquiry of the Audit Committee: One commenter suggested requiring the auditor to inquire of the audit committee, or its chair, about the audit committee's understanding of the business purpose or business reasons of related party transactions to corroborate management's responses. The Board considered this comment and is not proposing to expand the list of required inquiries, given concerns expressed by other commenters who suggested that the Board allow the use of additional auditor judgment to avoid potentially unnecessary costs. In the Board's view, the required inquiries of the audit committee, or its chair, in concert with the auditor's



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communications with the audit committee in the repropoed standard would provide an opportunity for corroboration of management's responses.

In considering this comment, the Board noted that in the proposed standard it had used the terms "business purpose" and "business reasons" in the list of auditor inquiries of management. To avoid confusion, the repropoal would change the phrase "business reasons" to "business purpose."

Communicating with the Audit Engagement Team and Other Auditors (Paragraphs 8-9 of the Repropoed Standard in Appendix 1)

Communicating information to engagement team members regarding a company's related parties and relationships and transactions with related parties might increase the likelihood that the engagement team will identify related parties or relationships or transactions with related parties previously undisclosed to the auditor. Effective communication to engagement team members might also highlight evidence that corroborates or contradicts information provided by management about relationships and transactions with related parties. Additionally, effective communication to engagement team members could enhance the auditor's understanding of the company's relationships and transactions with its related parties.

In addition, under PCAOB standards, a principal auditor may use the work and reports of other auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the company's financial statements.^{19/} Exchanging relevant information about related parties with the other auditor can assist the principal auditor in understanding the overall nature of the company's relationships and transactions with related parties and in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor.

The Propoed Standard and Existing Requirements

Paragraphs 9 and 10 of the propoed standard would have required the auditor to communicate to engagement team members and, if applicable, other auditors relevant information about related parties, including the names of the related parties and

^{19/} See paragraph .01 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.



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the nature of the company's relationships and transactions with those related parties. Further, paragraph 10 of the proposed standard would have required the auditor to make certain inquiries of the other auditor regarding related parties.

The existing standard, AU sec. 334.08, contains audit procedures intended to provide guidance for identifying material transactions that may be indicative of the existence of previously unidentified related party relationships. One such procedure is to provide audit personnel performing segments of the audit, or auditing and reporting separately on the accounts of related components of the reporting entity, with the names of known related parties so that they may become aware of transactions with such parties during their audits. Further, AU sec. 334.07.g., suggests a number of audit procedures for determining the existence of related party relationships, including making inquiries of other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions. Finally, AU sec. 9334.13 states that the principal auditor and the other auditor should obtain from each other the names of known related parties and that, ordinarily, the exchange should be made at an early stage of the audit.

As more fully described below, after consideration of the comments received, the Board did not make substantive revisions to the communication requirements, other than to refer the auditor to relevant paragraphs of the risk assessment standards.

The Reproposed Standard

Paragraph 8 of the repropoed standard would require the auditor to communicate to engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.

The requirement in paragraph 8 of the repropoed standard would complement the existing requirement in paragraph 49 of Auditing Standard No. 12 that key engagement team members discuss the susceptibility to material misstatement due to error or fraud. Paragraph 52 of Auditing Standard No. 12 provides that the discussion, in part, includes the susceptibility of the financial statements to material misstatement through related party transactions.

A new footnote to paragraph 8 of the repropoed standard observes that the communication that would be required by the repropoed standard complements the discussion among engagement team members, required by Auditing Standard No. 12, regarding risks of material misstatement. In addition, the new footnote includes an



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expanded discussion of Auditing Standard No. 10, *Supervision of the Audit Engagement*, which establishes requirements regarding supervision of the engagement team members, including directing engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities.

Paragraph 9 of the repropoed standard states that, 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 9 would also require the auditor to inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.^{20/}

Like the proposed standard, a footnote to paragraph 9 of the repropoed standard refers the auditor to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements.

Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comments:

Clarifying the Responsibilities of "Other Auditors": One commenter stated that the Board should address the responsibility of other auditors to communicate with the principal auditor, particularly other auditors auditing equity method investees who are not subject to control by the reporting investor entity. Another commenter suggested that all audit engagement letters acknowledge a joint responsibility to inform investors of

^{20/} The Board has not proposed a similar inquiry of engagement team members because existing standards already require engagement team members to bring relevant matters to the attention of the audit engagement partner. See, e.g., paragraph 5 of Auditing Standard No. 10.



material related party transactions, to reinforce to the company and the auditor the significance of informing investors of the effects of related party activity. That commenter also suggested that the proposed standard represents an opportunity to clarify that all registered firms must appropriately address suspicious activities involving a public company and should not knowingly facilitate transactions with non-public entities that have no business purpose other than to conceal activity of a registrant. The Board considered these comments and noted that they generally raise important issues that may be considered in other projects that are outside the scope of this project.

D. Identifying and Assessing Risks of Material Misstatement (Paragraph 10 of the Reproposed Standard in Appendix 1)

Identifying and appropriately assessing the risks of material misstatement provide a basis for designing and implementing responses to the risks of material misstatement.

The Proposed Standard and Existing Requirements

Paragraph 12 of the proposed standard aligned with the risk assessment requirements contained in Auditing Standard No. 12 for the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level.^{21/} Paragraph 12 of the proposed standard stated that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties.

Under the risk assessment standards, the auditor is also required to determine whether any of the identified and assessed risks of material misstatement are fraud risks or other significant risks.^{22/} Depending on the facts and circumstances, risks of material misstatement associated with related parties and relationships and transactions with related parties might also represent fraud risks or other significant risks. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, provides examples of fraud risk factors, including some relating to related parties.^{23/}

^{21/} See paragraph 59 of Auditing Standard No. 12.

^{22/} See paragraphs 59.f. and 70-71 of Auditing Standard No. 12.

^{23/} See AU sec. 316.85.A.2, section a., under "Opportunities."



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AU sec. 334 does not provide specific guidance for the auditor regarding the identification and assessment of risks of material misstatement associated with related party transactions. AU sec. 334.06 provides that, in the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business.

As more fully described below, after consideration of the comments received, the Board made revisions to further clarify the auditor's responsibilities for identifying and assessing the risks of material misstatement.

The Reproposed Standard

Like the proposed standard, paragraph 10 of the repropoed standard would remind the auditor of the requirement in Auditing Standard No. 12 to identify and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 10 of the repropoed standard would expand on the proposed standard by stating that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties or relationships or transactions with related parties. The addition of the clause "including whether the company has properly identified, accounted for, and disclosed its related parties or relationships or transactions with related parties" would highlight, among other things, that the auditor's assessment of risk includes a focus on risks related to the company's less than complete identification of its related parties or relationships or transactions with related parties. Such a focus helps support the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties.^{24/}

A new note to paragraph 10 would state that in identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information

^{24/} See the footnote to paragraph 14 of the repropoed standard, which states that evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.



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obtained from performing the procedures in paragraphs 4-9 of the repropoed standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comments:

Presuming Significant Risks or Fraud Risks: Some commenters noted that the proposed standard creates the presumption that all related party transactions are significant risks. Moreover, some commenters stated that the proposed standard should not deem certain related party transactions as significant risks as that determination should be based upon facts and circumstances. Other commenters suggested expanding the examples of fraud risk factors regarding related party transactions. The Board considered these comments and agrees that not all related party transactions should be presumed to be significant risks. Like the proposed standard, the repropoed standard would not mandate that all related party transactions be presumed to be or deemed to be significant risks, or designated as a fraud risk. Under the risk assessment approach, the auditor's assessment is scalable and based on the facts and circumstances of the audit, including the facts and circumstances of a company's relationships and transactions with related parties.

Incorporating the Proposing Release Discussion Regarding Dominant Influence into the Standard: One commenter recommended that those factors identified as "factors that may signal dominant influence" in Appendix 4 of the proposing release be incorporated into the standard. The Board notes that the other proposed amendments would revise AU sec. 316.85.A.2 to include the exertion of dominant influence by or over a related party as an example of a fraud risk factor and would expand that concept to encompass all related parties outside of management of the company. Accordingly, the Board is not proposing to include a discussion regarding dominant influence in the related party standard.

Providing Additional Guidance on Identifying and Assessing Risks of Material Misstatement: One commenter recommended that the Board provide specific guidance as to how to relate risk, materiality, and other circumstantial considerations to the selection of appropriate procedures to be employed, rather than a "one-size-fits-all" approach in the proposed standard. That commenter also noted that smaller, closely-held issuers engage in frequent related party transactions, that are often less subject to controls but, because of their significance, can be detected by auditors with fewer



procedures than would be required by the proposed standard. The Board considered this comment and, as described previously, has taken steps to further align the repropoed standard with the requirements in the risk assessment standards, which are scalable based on a company's size or complexity.

E. Responding to the Risks of Material Misstatement (Paragraphs 11-13 of the Proposed Standard in Appendix 1)

As noted in the release, relationships and transactions with related parties can pose increased risks of material misstatement in company financial statements and have been a contributing factor in prominent corporate scandals.^{25/} As discussed in more detail below, similar to the proposed standard, the repropoed standard would establish specific procedures for responding to risks of material misstatement associated with the company's related parties and relationships and transactions with related parties.

The Proposed Standard and Existing Requirements

Paragraph 13 of the proposed standard aligned with the foundational risk assessment requirements contained in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, which require the auditor to design and implement audit responses that address the identified and assessed risks of material misstatement.^{26/} Paragraph 13 of the proposed standard stated that 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.

A note to paragraph 13 of the proposed standard referred the auditor to AU secs. 316.66-.67A for related party transactions that are also significant unusual transactions. This note was intended to remind auditors that certain related party transactions also might be subject to the proposed amendments regarding significant unusual transactions.

^{25/} See also, *In the Matter of the Application of Wendy McNeeley, CPA, SEC Accounting and Auditing Enforcement Release ("AAER") No. 3427*, at 10-12 (Dec. 13, 2012).

^{26/} See paragraph 3 of Auditing Standard No. 13.



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As described more fully below, after consideration of the comments received, the Board made revisions to better clarify the relationship between the repropoed standard and the risk assessment standards. The Board also expanded the note to paragraph 13 of the proposed standard to further describe the auditor's work regarding related parties that are significant unusual transactions.^{27/}

The Repropoed Standard

Similar to paragraph 13 of the proposed standard, paragraph 11 of the repropoed standard would remind the auditor of the requirement in Auditing Standard No. 13 to design and implement audit responses that address the identified and assessed risks of material misstatement. Paragraph 11 of the repropoed standard states that this includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties. A new footnote refers the auditor to relevant paragraphs of the risk assessment standards, including paragraph 17 of Auditing Standard No. 15, *Audit Evidence*, which provides that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

The note to this paragraph has been expanded to further clarify the auditor's responsibilities for related party transactions that are also significant unusual transactions. As repropoed, the note states that the auditor also should look to the requirements in proposed paragraphs .66-.67A of AU sec. 316 for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). The revised note would clarify that, for such related party transactions, AU sec. 316.67 requires the auditor to evaluate whether the business purpose (or the lack thereof) of the transactions indicates that the transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

^{27/} See *also* the discussion in Section II.A. of this Appendix that describes the linkage between the repropoed standard and the repropoed amendments regarding significant unusual transactions.



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Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comment:

Clarifying the Reference to Significant Related Party Transactions Outside the Normal Course of Business: One commenter questioned whether a related party transaction that, although within the normal course of business, otherwise appears to be unusual due to its timing, size, or nature could be a related party transaction that is also a significant unusual transaction. That commenter based their question on an example of a related party transaction that is also a significant unusual transaction that was contained in a note to paragraph 13 of the proposed standard. The Board considered this comment and notes that the example of a significant related party transaction outside the normal course of business represents just one example of a related party transaction that is also a significant unusual transaction. Accordingly, the Board is not proposing revisions for this comment.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk (Paragraph 12 of the Repropoed Standard in Appendix 1)

Securities regulators expect that auditors will provide "heightened scrutiny" of a company's related party transactions.^{28/} Similar to the Board's proposal, the repropoed standard would require the auditor to perform certain basic procedures (supplemented by more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances) regarding related party transactions that are either required to be disclosed in the financial statements or determined to be a significant risk. In the Board's view, focusing the auditor's attention on these related party transactions is intended to enhance the effectiveness of the auditor's evaluation of whether the company's related party transactions are properly accounted for and disclosed.

^{28/} See, *In the Matter of the Application of Wendy McNeeley, CPA*, SEC AAER No. 3427, at 10-12 (Dec. 13, 2012), which states in part that the SEC and Courts have repeatedly held that related party transactions require heightened scrutiny by auditors, and notes the importance of the auditor understanding the business purpose of material related party transactions.



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The Proposed Standard and Existing Requirements

Paragraph 15 of the proposed standard would have required the auditor to perform specific procedures for each related party transaction, or type of related party transaction, that is either required to be disclosed in the financial statements or determined to be a significant risk.

The existing standard, AU sec. 334, contains procedures that the auditor should consider performing when responding to risks arising from related party relationships and transactions. For example, AU sec. 334.11 requires that, for each material related party transaction that requires disclosure, the auditor should consider whether he or she has obtained sufficient appropriate evidential matter to understand the related party relationship and the effects of the related party transactions on the financial statements. AU secs. 334.09-.10 describe procedures for examining identified related party transactions. Those paragraphs direct the auditor to apply the procedures the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of identified related party transactions and their effect on the financial statements, noting that those procedures should extend beyond inquiry of management. Footnote 6 of AU sec. 334.09 states that "[u]ntil the auditor understands the business sense of material transactions, he cannot complete his audit."

As described more fully below, after consideration of the comments received, the Board made several revisions intended to more clearly articulate the nature and extent of the required procedures, including changes intended to clarify the auditor's responsibility when related party transactions are aggregated for disclosure purposes.

The Reproposed Standard

Paragraph 12 of the repropoed standard would require the auditor to perform specified procedures for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk. For such transactions, the repropoed standard would require the auditor to:

- a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. 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;
- c. Determine whether any exceptions to the company's established policies or procedures were granted;
 - d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
 - e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

As reproposed, paragraph 12.a. would clarify that the auditor should read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction.

As reproposed, paragraph 12.d. would be expanded to require the auditor's evaluation of the financial capability of the related party to include significant loan commitments and supply arrangements.

Paragraph 12.e., was revised in response to comments to remove the reference to the objective of the standard and to clarify the auditor's responsibilities. Like the proposed standard, paragraph 12.e. of the reproposed standard would provide an opportunity for the auditor to scale the audit by requiring the auditor to supplement the basic required procedures with more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. Specifically, as revised, paragraph 12.e. would require the auditor to perform other procedures as necessary to address the identified and assessed risks of material misstatement.

In response to comments, a note to paragraph 12 of the reproposed standard has been added to clarify the auditor's responsibility for aggregated related party disclosures. Specifically, the note would state that 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 in paragraph 12 of the reproposed standard for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement. The Board notes that a "selection of



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transactions" could be the selection of one transaction from the aggregation in the appropriate circumstances.

A footnote to paragraph 12.c. of the repropoed standard states that information gathered while obtaining an understanding of the company also might assist the auditor in identifying agreements prohibiting or restricting related party transactions (for example, loans or advances to related parties).

A footnote to paragraph 12.d. of the repropoed standard states that examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.

Significant Comments and Board Responses

Although some commenters expressed general support for the procedures required by the proposed standard, others made specific suggestions regarding the nature and extent of the auditor's procedures.

Clarifying the Auditor's Responsibility for Aggregated Related Party Disclosures: Some commenters stated that the required procedures could be interpreted to suggest that all transactions comprising a "type" of related party transaction must be subject to the required procedures. One commenter suggested clarifying that testing transactions from each "type" of related party transaction is sufficient. Other commenters recommended clarifying the proposed standard by incorporating additional discussion from the proposing release into the standard. The Board considered these comments and, as previously discussed, added a note to paragraph 12 of the repropoed standard to clarify that testing each related party transaction that the company has aggregated for disclosure purposes is not required.

Allowing More Room for the Use of Auditor Judgment: Some commenters stated that the proposed audit procedures do not allow for sufficient application of auditor judgment when responding to the risks of material misstatement arising from a company's relationships and transactions with related parties required to be disclosed in the financial statements or determined to be a significant risk. The Board considered this comment and noted that the proposed standard established basic procedures that would be supplemented by more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. These facts and circumstances include the size and complexity of the transactions, the nature of a company's



relationships or transactions with its related parties, and the related risk of material misstatement in the financial statements. This approach permits auditor judgment, within a framework that assures that basic requirements are met and the interests of investors are protected.

Referencing the Objective of the Standard: Some commenters recommended clarifying the requirement in the proposed standard that the auditor "perform other procedures as appropriate, depending on the nature of the related party transaction and the related risks of material misstatement, to meet the objective of this standard."

The Board considered this comment, noting that the Board's auditing standards require the auditor to obtain sufficient appropriate audit evidence to support their audit opinion on the company's financial statements. Depending on the facts and circumstances of the audit, an auditor might determine that additional procedures beyond those required by paragraphs 12.a.-d. of the repropoed standard are necessary to obtain sufficient appropriate audit evidence regarding related party transactions that either are required to be disclosed in the financial statements or that are determined to be a significant risk. The Board made revisions to require the auditor to perform other procedures "as necessary to address the identified and assessed risks of material misstatement." The Board believes that this approach is more clearly linked to the auditor's responsibilities to obtain sufficient audit evidence to support his or her audit opinion.

Understanding the Business Purpose (or the Lack Thereof) of a Related Party Transaction: One commenter noted that more emphasis could be given to the importance of the auditor's understanding of the business purpose of related party transactions. At the SAG discussion, the point was raised that some auditors believe that as long as management has not asserted that the terms of the related party transaction are equivalent to those available on an arm's-length basis, the auditor has no obligation beyond determining whether management has disclosed the transaction.

Another commenter recommended deleting the phrase "(or the lack thereof)" from the proposed standard. That commenter agreed that auditors should be aware of the possibility that transactions with related parties may not have a business purpose but did not believe that the requirements in the proposed standard would provide the auditor with evidence about a lack of a business purpose.

In the Board's view, performing the procedures in paragraphs 3-9 of the repropoed standard in conjunction with the risk assessment procedures required by Auditing Standard No. 12 should inform the auditor's understanding of the company's



relationships and transactions with its related parties. That understanding would include the terms and business purposes (or the lack thereof) of the transactions involving related parties. Understanding the business purpose of related party transactions is an important consideration in assessing and responding to risks of material misstatement and requires the auditor to understand other factors underlying the transaction. For example, although a company may assert that it has utilized a related party transaction to achieve a particular goal, the company may, in fact, have used the transaction for some other purpose.^{29/} Obtaining an understanding of the terms and business purpose of a related party transaction includes understanding why the company entered into the transaction with a related party versus an unrelated party.

The inclusion of the phrase "(or the lack thereof)" is intended to promote a questioning and skeptical approach by the auditor when obtaining an understanding of the business purpose of related party transactions. Sharpening the auditor's focus on evaluating the business purpose of related party transactions is particularly appropriate in view of the risk of material misstatement involving related party transactions.^{30/} The importance of identifying transactions that appear to lack a business purpose is reinforced in other parts of the Board's proposal. For example, the repropoed standard, like the proposed standard, would require the auditor to communicate to the audit committee the identification of significant related party transactions that appear to the auditor to lack a business purpose. In addition, the other repropoed amendments to AU sec. 316.85 would add "contractual arrangements lacking a business purpose" as a new example of a fraud risk factor. Accordingly, the Board is not proposing to revise the

^{29/} For example, a broker or dealer might use related party transactions to make the size of their operations appear smaller to avoid regulatory requirements. See the discussion entitled "Related Party Transactions at Brokers and Dealers" in Section V. of this Appendix.

^{30/} See, e.g., paragraph 15 of FASB Statement No. 57, *Related Parties*, which states "[w]ithout disclosure to the contrary, there is a general presumption that transactions reflected in financial statements have been consummated on an arm's-length basis between independent parties. However, that presumption is not justified when related party transactions exist because the requisite conditions of competitive, free-market dealings may not exist. Because it is possible for related party transactions to be arranged to obtain certain results desired by the related parties, the resulting accounting measures may not represent what they usually would be expected to represent."



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proposal for these comments. However, as described above, the Board is proposing revisions in paragraph 12.a. of the repropoed standard to clarify the auditor's procedures.

Evaluating the Financial Capability of the Related Party: Some commenters expressed concern regarding the proposed requirement to evaluate the financial capability of the related party. One commenter noted that while evaluating the financial capability of the related party is an important consideration, sufficient information may not be available to do so. That commenter recommended that the Board acknowledge such circumstances and the related auditor response. Another commenter stated that evaluating financial capability may be difficult to perform when the related party is privately held and not controlled by the audit client and further stated that the assessment that the audit client has the ability to exercise significant influence over a related party (or vice versa) for accounting purposes does not necessarily equate to management of the audit client having sufficient influence over the related party to demand the receipt of non-public information.

The Board considered these comments, noting that the proposed requirement would have applied only to items that are individually or collectively significant. In the Board's view, obtaining evidence to evaluate the financial capability of a related party can inform the auditor's evaluation of the business purpose (or the lack thereof), including whether the substance of that transaction differs materially from its form.^{31/} The Board notes that auditors are currently performing procedures to evaluate the financial capability of counterparties in a variety of audit areas today, regardless of whether the counterparty is a related party. For example, auditors might examine the company's support regarding the financial capability of another party as part of evaluating the company's decision to recognize revenue on a particular transaction. Accordingly, the Board is not proposing to make revisions for this comment.

^{31/} See, e.g., *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005), noting "among transactions calling for close inspection are related-party transactions, including transactions between a company and its officers or directors. Such dealings are viewed with extreme skepticism in all areas of finance...The reason for this is apparent: Although in an ordinary arms-length transaction, one may assume that parties will act in their own economic self-interest, this assumption breaks down when the parties are related. A company that would perform a thorough credit-risk assessment before extending a loan might not do so if the loan were to one of its officers or directors."



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Performing Procedures at the Related Party: At the SAG discussion, the point was raised that the auditor should consider performing audit procedures at the premises of the related party. In considering this comment, the Board notes that its auditing standards require the auditor to obtain sufficient appropriate audit evidence to support his or her audit opinion. In certain circumstances, an auditor may decide that performing audit procedures at the related party is appropriate. The Board, however, is not proposing to require that procedures be performed at the related party's premises because the related party may not allow the auditor to perform such procedures. In some circumstances, such a requirement might place an unreasonable burden on the auditor and the company under audit.

Including Examples from the Proposing Release in the Standard: Several commenters recommended incorporating the additional discussion and examples of procedures that the auditor might perform pursuant to paragraph 15.d. of the proposed standard included in Appendix 4 of the proposing release into the standard. The Board considered these comments and determined, as it has done in other projects, to include performance requirements in the standard and to provide additional discussion and examples in an appendix to the release. This approach promotes a clear separation between the required procedures in the standard and the Board's discussion regarding the potential application of the standard. As such, the examples of procedures and other discussion in the proposing release have not been incorporated into the repropoed standard.

Intercompany Transactions (Paragraph 13 of the Reproposed Standard in Appendix 1)

Applicable financial reporting frameworks require the elimination of intercompany transactions in the preparation of consolidated financial statements. Based on a company's facts and circumstances, intercompany transactions could result in risks of material misstatement.

The Proposed Standard and Existing Requirements

Paragraph 14 of the proposed standard would have required the auditor to perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ. As such, paragraph 14 incorporated an existing procedure contained in AU sec. 334. Specifically, AU sec. 334.09.e. states that the auditor should consider arranging for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.



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Other existing standards also reference the importance of the auditor's review of consolidating accounts, such as AU sec. 543, which states that, regardless of whether the principal auditor decides to make reference to the audit of the other auditor, the principal auditor should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.^{32/}

As more fully described below, after consideration of the comments received, the Board is not proposing revisions to this paragraph. However, the Board is seeking additional comment on the auditor's responsibility for performing procedures on intercompany account balances, and has included a specific question at the end of this section.

The Reproposed Standard

As reproposed, paragraph 13 would require the auditor to perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

Significant Comments and Board Responses

The Board considered all comments received, including the following significant comments:

Providing Expanded Guidance Regarding Intercompany Account Balances: Several commenters suggested that the Board clarify the auditor's responsibility regarding intercompany account balances. For example, some commenters suggested including examples of the risks associated with intercompany balances and guidance regarding the nature, timing, and extent of risk assessment procedures and related responses. Another commenter indicated that, when fiscal years differ, testing of intercompany transactions could be performed at a concurrent interim date and noted

^{32/} See AU sec. 543.10, which provides that those measures may include ascertaining through communication with the other auditor that a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.



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that, in their view, the requirement in the proposed standard might be read to imply that testing is required as of period end.

The Board considered these comments, noting that the preparation of consolidated financial statements could involve complex matters regarding intercompany transactions. For example, a company could consolidate a subsidiary that has a different year-end. Further, some intercompany transactions that are eliminated in consolidation could include related party transactions that may not require disclosure under the applicable financial reporting framework, yet might give rise to significant risks of material misstatement.^{33/} Such related party transactions would be subject to the procedures described in paragraph 12 of the repropoed standard. The Board is not proposing to revise the proposal for these comments, but has included a question at the end of Section I. of this Appendix seeking additional input from commenters in this area.

F. Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14-16 of the Repropoed Standard in Appendix 1)

While management has the primary responsibility for preparing the company's financial statements, the auditor should be sensitive throughout the audit to the possibility that management may not have informed the auditor of all related parties or relationships or transactions with related parties.

The Proposed Standard and Existing Requirements

The proposed standard would have addressed the auditor's responsibility to identify a company's related party transactions in paragraph 3 (duty to perform procedures), paragraph 11 (evaluating whether information that comes to the auditor's attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist), paragraph 16 (determining whether related parties or relationships or transactions with related parties previously undisclosed to the auditor, in fact, exist), and paragraph 17 (performing audit procedures on related parties or relationships or transactions with related parties previously undisclosed).

^{33/} See paragraphs 59.f. and 70-71 of Auditing Standard No. 12.



AU sec. 334.07 describes a number of procedures for determining the existence of related parties, while AU sec. 334.08 provides examples of procedures for identifying material transactions with known related parties and for identifying material transactions that may be indicative of the existence of previously undetermined related party relationships. AU sec. 334.04 also states that during the course of his audit, the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and of common ownership or management control relationships that require disclosure even though there are no related party transactions. AU sec. 334.03 describes transactions that because of their nature may be indicative of the existence of related parties.

As more fully described below, after consideration of the comments received, the Board substantially revised paragraphs 3, 11, 16, and 17 of the proposed standard. As part of these revisions, the Board consolidated the auditor's responsibilities for evaluating whether the company has properly identified its related parties and relationships and transactions with related parties into a single section of the repropoed standard. In addition, as discussed in more detail below, the Board made revisions in response to commenters who suggested that the Board clarify the auditor's responsibility to identify the company's related parties and to allow more room for auditor judgment by removing the requirement that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk.

The Repropoed Standard

Paragraph 14 of the repropoed standard would focus the auditor more directly on a key aspect of the auditor's objective by requiring the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties.^{34/} Paragraph 14 of the repropoed standard anticipates that, while the auditor would start its work regarding related parties with the names of related parties and relationships and transactions with related parties identified by the company, the auditor may not merely rely on management's representations as to the

^{34/} Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.



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accuracy and completeness of the information provided to the auditor.^{35/} A new footnote to paragraph 14 of the reposed standard would state that evaluating whether a company has properly identified its related parties involves more than assessing the process used by the company to identify its related parties. It is the role of the auditor to go beyond management's representations and perform audit procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

Paragraph 14 of the reposed standard would require the auditor to take into account the information gathered during the audit in evaluating whether the company has properly identified its related parties and relationships and transactions with related parties. Paragraph 14 would also require that as part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. A new footnote to paragraph 14 of the reposed standard would state that information obtained from identifying and evaluating a company's significant unusual transactions and obtaining an understanding of a company's financial relationships and transactions with its executive officers could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Like the proposed standard, a note refers the auditor to Appendix A which describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Many of the examples contained in Appendix A of the reposed standard are contained in AU secs. 334.07-.08.

The reposed standard would not require an auditor to perform procedures with respect to each source of information referenced in Appendix A. However,

^{35/} The auditor's procedures to evaluate whether the company has properly identified its related parties should extend beyond the inquiries pursuant to paragraphs 5-7 of the reposed standard. Paragraph 10 of Auditing Standard No. 15 requires that when using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to: test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and evaluate whether the information is sufficiently precise and detailed for purposes of the audit.



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evaluating whether a company has properly identified its related parties and relationships and transactions with related parties requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company. Further, an auditor may be required to perform auditing procedures with respect to certain of those sources (for example, reading confirmation responses and responses to inquiries of the company's lawyers) by other auditing standards or through the performance of auditing procedures in other areas.^{36/} Appendix A also states that the examples contained in that Appendix are not intended to represent a comprehensive listing.

The auditor's efforts to identify and evaluate a company's significant unusual transactions might also assist the auditor in identifying information that might indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Among other things, Appendix A states that contracts and other agreements representing significant unusual transactions are an example of a source of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

According to paragraph 15 of the reproposed standard, if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor would be required to perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Like the proposed standard, the reproposed standard also would require that these procedures extend beyond inquiry of management.

A footnote to paragraph 15 would refer the auditor to paragraph 29 of Auditing Standard No. 15, which states that if audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

^{36/} See, e.g., AU sec. 330, *The Confirmation Process*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.



Paragraph 16 of the repropoed standard would require that if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify additional relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of the repropoed standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;
- f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
- g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
- h. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor determines that it is likely that an illegal act has or may have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

The requirements of paragraph 16 of the repropoed standard would, in large part, mirror those required by the proposed standard. Notably however, in response to



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comments, revisions have been made to allow more room for auditor judgment. As repropoed, paragraph 16 would not require that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk.

Like the proposed standard, a footnote to paragraph 16 of the repropoed standard would refer the auditor to AU sec. 333.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.

Significant Comments and Board Responses

The Board received several comments regarding the auditor's responsibility for evaluating information and performing procedures regarding related parties or relationships or transactions with related parties previously undisclosed to the auditor. In developing the repropoed standard the Board considered all comments received, including the following significant comments:

Clarifying the Auditor's Responsibility for Evaluating the Company's Identification of Its Related Parties: Some commenters suggested that the Board clarify the auditor's responsibility to perform procedures to identify the company's related parties. In response, the repropoed standard has been revised to focus more directly on a key aspect of its objective, that is, whether related parties and relationships and transactions with related parties have been properly identified by the company under audit.

As repropoed, the standard would include a new requirement for the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties, as well as more focused audit steps intended to support the auditor's required evaluation. Such steps, which closely mirror the auditor's risk assessment process, include: (i) performing risk assessment 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; (ii) identifying and assessing risks associated with a company's relationships and transactions with its related parties, including whether the company has properly identified its related parties and relationships and transactions with related parties; (iii) designing and performing audit procedures that address and respond to the risks of material misstatement associated with the company's related parties and transactions; and (iv) performing specific procedures that



address related party relationships or transactions identified by the auditor that were previously undisclosed by company management.

In the Board's view, the clarifications in the repropoed standard represent a more effective audit approach that recognizes that the company is responsible for the preparation of its financial statements, including, in the first instance, the identification of the company's related parties and relationships and transactions with related parties, and that the auditor begins the audit with information obtained from the company.^{37/}

Allowing More Room for the Use of Auditor Judgment: Several commenters stated that the proposed standard should allow more room for the use of auditor judgment when the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Some of these commenters expressed concern over the proposed requirement that all previously undisclosed related party transactions identified by the auditor be treated as a significant risk. Some of these commenters noted that an undisclosed related party transaction could be inconsequential in nature, and, in such circumstances, treating the transaction as a significant risk, and performing all of the procedures set forth in the proposed standard would be unnecessary. Other commenters suggested it might be appropriate to perform some, but not all, of the related procedures in the proposed standard.

In the Board's view, certain basic procedures should be performed by the auditor when an undisclosed related party transaction comes to the auditor's attention. For example, because of the potential for fraud, paragraph 16.b. of the repropoed standard would require the auditor to evaluate why the related party or relationship or transactions with a related party was previously undisclosed to the auditor. However, in response to the concerns expressed by some commenters, the Board has removed the requirement that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk. As repropoed, the auditor would only be required to perform the more extensive procedures required by paragraph 12 of the

^{37/} To further assist the auditor's efforts in identifying related parties, the repropoed other amendments include a complementary provision that would expand existing management representations contained in AU sec. 333, *Management Representations*, to state that the company has provided the names of all related parties and all relationships and transactions with its related parties to the auditor. However, the auditor may not solely rely on management's representations.



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reproposed standard when the undisclosed related party transaction is either required to be disclosed in the financial statements or determined to be a significant risk.

Evaluating Information That Comes to the Auditor's Attention: Paragraph 11 of the proposed standard would have required the auditor to evaluate whether information that comes to the auditor's attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. One commenter indicated that this may infer a separate evaluation of all information obtained by the auditor. The commenter suggested that, alternatively, the auditor should be required to "remain alert" for information or other conditions that indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. The Board considered this comment, noting that it had considered the "remain-alert" approach contained in International Auditing and Assurance Standards Board ("IAASB") and AICPA Auditing Standards Board ("ASB") standards in developing the proposed standard. The Board believes, however, that "remain alert" may be too passive given the need for the heightened level of scrutiny associated with related party transactions. Accordingly, the Board is not proposing to replace the "evaluate-whether" language with a requirement to "remain alert."

Clarifying the Auditor's Responsibility Regarding Appendix A: Several commenters suggested that the Board clarify the auditor's responsibility regarding the examples of information and sources of information included in Appendix A of the proposed standard. For example, some commenters thought the auditor's responsibility with respect to Appendix A was not clear, others thought that Appendix A appeared too prescriptive, and one commenter expressed concern that PCAOB inspectors may interpret Appendix A to require the auditor to perform specific procedures. The Board considered these and similar comments and noted that many commenters generally requested that the Board provide additional guidance regarding the information, and sources of information that could indicate relationships or transactions with related parties. Appendix A to the proposed standard was included to assist the auditor's identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor. The information and sources relevant to a particular audit would depend on the facts and circumstances of the audit and, thus, not all of the information or sources of information in Appendix A would need to be considered in every audit. Other auditing standards, however, might require the auditor to examine certain items listed in Appendix A. The Board is proposing to retain Appendix A but seeks commenters' views on whether the addition of Appendix A is helpful to auditors or whether it should be removed.



Further, one commenter recommended requiring the auditor to read the minutes of the board of directors and its compensation committee, if any. While this comment was directed at the requirement to obtain an understanding of the company's financial relationships and transactions with its executive officers, the Board's consideration of this comment prompted a change to the paragraph of the repropoed standard related to evaluating whether the company has properly identified its related parties and relationships and transactions with related parties.

In the Board's view, reading minutes of meetings of the board of directors is an important procedure for identifying information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. The Board also noted that existing standards already require the auditor to read minutes of meetings of the board of directors and appropriate committees for other purposes^{38/} and AU sec. 334 includes reading minutes as an example of a procedure for identifying transactions with related parties.^{39/}

Consequently, the Board made revisions that would require that, as part of the auditor's evaluation whether the company has properly identified its related parties and relationships and transactions with related parties, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. Performing this procedure may also inform the auditor's understanding of the company's financial relationships and transactions with its executive officers.

Determining Whether Previously Undisclosed Related Parties Exist: One commenter noted that the proposed standard would have required the auditor to perform procedures that extend beyond inquiry of management in order to determine whether undisclosed relationships or transactions with related parties that might exist do, in fact exist, but that the Board provided no examples of such procedures. That commenter noted that if the Board has specific procedures in mind, then examples of such procedures should be provided. The Board considered these comments and noted that the risk assessment standards require the auditor to perform audit procedures to

^{38/} See, e.g., AU sec. 560, *Subsequent Events*, AU sec. 722, *Interim Financial Information*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

^{39/} See AU sec. 334.08b.



resolve inconsistencies in, or doubts about the reliability of, audit evidence.^{40/} If the auditor identifies information that creates a doubt about the completeness of the company's identification of its related parties, the auditor should perform the audit procedures necessary to resolve the matter. For example, in resolving the matter, the auditor might review relevant available public information about the party in question, or inquire of other parties with knowledge about the party in question (e.g., banks, guarantors, agents, or attorneys). Because the nature of those procedures would depend upon the facts and circumstances of the audit, the Board is not proposing to make revisions for these comments.

Including the Discussion Contained in AU sec. 334.04: Some commenters expressed concern that the proposed standard could create an expectation that the auditor will always identify all of the company's related party transactions. One commenter recommended that the Board include language in the standard that is similar to that in AU sec. 334.04, which states that an audit cannot be expected to provide assurance that all related party transactions will be discovered.

In the Board's view, an audit performed in accordance with PCAOB auditing standards should provide reasonable assurance that the financial statements are free of material misstatements whether caused by fraud or error.^{41/} This includes reasonable assurance regarding accounting for and disclosure of related party transactions. The auditor should perform such specific procedures to obtain sufficient appropriate evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the company's financial statements.

G. Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17-18 of the Reproposed Standard in Appendix 1)

The auditor's evaluation of a company's accounting and disclosure of relationships and transactions with related parties is important to the protection of investor interests because the substance of related party transactions might differ materially from their form. Furthermore, related party transactions not only may involve

^{40/} See paragraph 29 of Auditing Standard No. 15.

^{41/} See paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.



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difficult measurement and recognition issues, but may also be used to engage in financial statement fraud and conceal misappropriation of assets.

The Proposed Standard and Existing Requirements

Paragraph 18 of the proposed standard would have required the auditor to evaluate whether the financial statements contain the information regarding related party transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

AU sec. 334.02 states that the auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure. AU sec. 334.02 also states that "the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form." Auditing Standard No. 14 describes the auditor's responsibility for evaluating the presentation of financial statements, including disclosures, more generally. Auditing Standard No. 14 requires the auditor to evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.^{42/} Furthermore, AU sec. 411.06 requires the auditor to consider whether the substance of transactions or events differs materially from their form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. Like the proposed standard, the repropoed standard aligns with, and builds upon, the requirements in Auditing Standard No. 14 and AU sec. 411.

As more fully discussed below, after consideration of the comments received, the Board made revisions to clarify the auditor's responsibility for evaluating whether related party transactions have been properly accounted for and disclosed in the financial statements.

The Reproposed Standard

Paragraph 17 of the repropoed standard would require the auditor to evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. This would include evaluating whether the financial statements

^{42/} See paragraph 30 of Auditing Standard No. 14.



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contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework. A new footnote to paragraph 17 would direct the auditor to paragraph 31 of Auditing Standard No. 14.

As repropoed, paragraph 17 is intended to align the auditor's evaluation with the objective of the standard and to focus the auditor on both the accounting and disclosure of the company's relationships and transactions with related parties.

Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comment:

Evaluating Financial Statement Accounting and Disclosure: One commenter expressed concern that the substance-over-form issue discussed on page A4-20 of Appendix 4 of the proposing release could require auditors to challenge the appropriateness of the accounting standards and recommended changes to the proposed standard to focus the auditor's requirements only on the disclosure of related party transactions.

The Board considered this comment. The Board, however, does not agree that the proposed standard would have required the auditor to challenge accounting standards. Footnote 1 to paragraph 1 of the proposed standard stated that the auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company. The discussion in Appendix 4 of the proposing release is consistent with AU sec. 334.02, which notes that the auditor should be aware that the substance of a related party transaction could be significantly different from its form. This concept was not included in the proposed standard as it is already contained in AU sec. 411.06.

The Board further notes that financial statements may not be presented fairly if they do not include information about the matters that affect their use, understanding and interpretation.^{43/} For example, to improve the appearance of its financial condition, a company and a related party could attempt to "dress up" the appearance of the company's balance sheet at period-end. Some period-end "window-dressing"

^{43/} See AU sec. 411.04.



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transactions might involve side agreements undisclosed to the auditor, while others might represent transactions, that the auditor is aware of, in which management placed more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction. As repropoed, paragraph 12.e. would require the auditor to obtain the audit evidence necessary to address risks of material misstatement identified and assessed by the auditor, including risks of material misstatement associated with these matters.

To further clarify the auditor's responsibility for evaluating whether related party transactions (including related party transactions that pose difficult substance-over-form considerations or that appear to lack a business purpose) have been properly accounted for and disclosed in the financial statements, the Board is also proposing revisions in paragraph 17 of the repropoed standard. Those revisions would require the auditor to evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements.

This commenter also expressed concern that the proposed standard implied that the auditor's evaluation of the fair presentation of financial statements occurs in a piecemeal fashion and that auditors evaluate individual disclosures in isolation. The Board considered this comment, noting that, like the proposed standard, the repropoed standard would require that the auditor perform procedures for each related party transaction that requires disclosure in the financial statements. Similarly, the auditor's evaluation pursuant to paragraph 17 of the repropoed standard would encompass each related party transaction that requires disclosure.^{44/} The Board is not proposing to revise the requirement in this paragraph for this suggestion.

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (Paragraph 18 of the Repropoed Standard in Appendix 1)

Financial reporting frameworks allow management to assert that a related party transaction was consummated on terms equivalent to those prevailing in arm's-length

^{44/} Like the proposed standard, footnote 2 of the repropoed standard refers the auditor to examples of other relevant standards and rules, including paragraph 31 of Auditing Standard No. 14 and paragraph .04 of AU sec. 411.



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transactions only when management can substantiate that assertion.^{45/} However, those financial reporting frameworks do not discuss what information is required to substantiate such an assertion or how management is to determine the terms and conditions that would prevail in an arm's-length exchange, including, for example, whether there would be a guarantee or an extension of credit.

The Proposed Standard and Existing Requirements

Paragraph 19 of the proposed standard would have required that if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. AU sec. 334 includes requirements regarding the auditor's evaluation of assertions that related party transactions occurred on terms equivalent to those occurring on an arm's length basis. For example, AU sec. 334.12 states that, except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been.

As more fully discussed below, after consideration of the comments received, the Board is reproposing paragraph 19 without revision.

The Reproposed Standard

Paragraph 18 of the reproposed standard would require that, if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. The reproposed standard also would state that if the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's

^{45/} See FASB ASC paragraph 850-10-50-5. Paragraph 23 of International Accounting Standard ("IAS") 24 also states that disclosures "that related party transactions were made on terms equivalent to those that prevail in arm's length transactions are made only if such terms can be substantiated."



assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.^{46/}

Like the proposed standard, a note to paragraph 18 would state that transactions with related parties might not be conducted on terms equivalent to those prevailing in arm's-length transactions. Except for routine transactions, it may not be possible for management to determine whether a particular transaction would have taken place, or what the terms and manner of settlement would have been, if the parties had not been related. Accordingly, it may be difficult for the auditor to obtain sufficient appropriate audit evidence to substantiate management's assertion that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. The note retains the discussion contained in AU secs. 9334.22-.23 that a preface to an assertion such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comments:

Assessing the Implications of Management's Inability to Provide Support for Its Arm's-Length Assertion: One commenter recommended that footnote 35 in the proposing release should be included in the repropoed standard. That footnote provided that a decision by management to remove, at the auditor's request, an arm's-length assertion regarding a related party transaction from the financial statements due to management's inability to provide the auditor with sufficient appropriate audit evidence, might impact the auditor's assessment of internal control over financial reporting. The Board considered this recommendation and agrees that such circumstances might impact the auditor's assessment of internal control over financial reporting or understanding of the control environment. However, such a determination would be based on the facts and circumstances of the situation. In the Board's view, including the discussion in footnote 35 of the proposing release in the repropoed standard might inappropriately create an impression that further procedures regarding

^{46/} A decision by management to remove, at the auditor's request, such an assertion from the financial statements due to management's inability to provide the auditor with sufficient appropriate audit evidence might affect the auditor's assessment of internal control over financial reporting.



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the control environment are always necessary. As a result, the Board is not proposing to make revisions for this comment.

Describing the Effect of the Auditor's Report on SEC Filings: Some commenters recommended that the standard should note that a qualified or adverse opinion will result in an inability to make appropriate SEC filings. The Board considered this comment, noting that the auditor's responsibility is to obtain sufficient appropriate audit evidence to support the auditor's opinion and issue the appropriate audit report. It is the responsibility of management to determine the impact of any modification to the auditor's standard report on the company's ability to make appropriate filings with the SEC. As such, the Board is not proposing to make revisions for this comment.

Allowing More Room for the Use of Auditor Judgment: Some commenters stated that the requirements in the proposed standard do not permit the auditor to exercise auditor judgment when responding to the significance of management's refusal to modify a disclosure that asserts that a related party transaction was conducted at arm's-length. Those commenters noted that the existing standard states that the evaluation is "based on the materiality" of the transaction and that this phrase has not been included in the repropoed standard. The Board considered these comments and noted that financial reporting frameworks permit management to assert that a related party transaction occurred on an arm's-length basis only when support for such an assertion exists. A statement by management in the financial statements that a related party transaction occurred on an arm's-length basis when support for that statement does not exist represents a departure from U.S. GAAP and IFRS. Such a misstatement would require the auditor to express either a qualified or adverse opinion on the financial statements. As such, the Board is not proposing to make revisions for this comment.

H. Communications with the Audit Committee (Paragraph 19 of the Proposed Standard in Appendix 1)

Both the auditor and the audit committee benefit from a meaningful exchange of information regarding significant risks of material misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports, including matters arising from a company's relationships and transactions with related parties.^{47/}

^{47/} Higher quality financial reporting (as a result of better informed auditors, better informed audit committees, or both) improves the quality of information available



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The Proposed Standard and Existing Requirements

Paragraph 20 of the proposed standard would have required the auditor to communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, as well as other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

In contrast, the existing standard, AU sec. 334, does not include requirements regarding the auditor's communication with the audit committee. Other, existing auditing standards, however, require that the auditor communicate significant matters to the audit committee, including those encountered during a review of interim financial information.^{48/}

As more fully discussed below, the Board is reproposing the auditor's communication requirements substantially as proposed, with revisions to further align and work in concert with, the requirements in Auditing Standard No. 16, *Communications with Audit Committees*.^{49/}

The Reproposed Standard

Paragraph 19 of the reproposed standard would require the auditor to communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with its related parties. The reproposed standard also would require that the auditor communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;

to the markets and reduces the information asymmetry that exists about the company among investors as well as between investors and the company's management.

^{48/} See Auditing Standard No. 16 and AU sec. 722.34.

^{49/} See PCAOB Release No. 2012-004 (Aug. 15, 2012).



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- b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and
- e. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

Paragraph 19 of the repropoed standard is intended to work in tandem with paragraph 7 of the repropoed standard, which would require the auditor to make inquiries of the audit committee, or its chair, at an earlier point in the audit. The communication required by paragraph 19 of the repropoed standard would provide an opportunity for the auditor to communicate information obtained during the audit relevant to those earlier inquiries.

Subsequent to the close of the comment period for the Board's proposal, the Board adopted Auditing Standard No. 16, *Communications with Audit Committees*.^{50/} The Board made changes to align the requirements in the repropoed standard with Auditing Standard No. 16. For example, a new footnote has been added to paragraph 19 of the repropoed standard that would refer the auditor to Auditing Standard No. 16 regarding the timing of communications to the audit committee. This footnote in the repropoed standard replaces a note that was included in the proposed standard that indicated the auditor should communicate with the audit committee "in a timely manner" and "prior to the issuance of the auditor's report." That note is no longer necessary because Auditing Standard No. 16 includes specific requirements on the nature and timing of auditor communications with the audit committee. In addition, the phrase, "in a timely manner and prior to the issuance of the auditor's report" in paragraph 20 of the proposed standard has not been included in the repropoed standard to avoid confusion because Auditing Standard No. 16 includes specific guidance on the timing of communications.

^{50/} See PCAOB Release No. 2012-004 (Aug. 15, 2012).



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The repropoed amendments include conforming amendments to Auditing Standard No. 16 that would:

- Replace the reference in footnote 25 to AU sec. 334 with a reference to the repropoed standard; and
- Add a reference in Appendix B, *Communications with Audit Committees Required by Other PCAOB Rules and Standards* of Auditing Standard No. 16 to the audit committee inquiries and communications required by paragraphs 7 and 19 of the repropoed standard.

Significant Comments and Board Responses

Commenters generally requested clarification regarding the alignment of the proposed standard with the requirements in the proposed auditing standard regarding auditor communications with audit committees. As described above, the Board has made revisions to the communication requirements to align with, and be incremental to, communications with the audit committee under Auditing Standard No. 16.

In developing the repropoed standard, the Board also considered all other comments received, including the following significant comments:

Reporting Matters on an Exception Basis: At the SAG discussion, the point was raised that the auditor's communications to audit committees should emphasize exceptions identified by the auditor. Another commenter recommended that the paragraph in the proposed standard requiring communication to the audit committee that the financial statements include a statement that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction be removed from the standard because, in the commenter's opinion, it would be more appropriate for the auditor to respond to questions in this area only if asked by the audit committee. Another commenter recommended waiving the communication to the audit committee when related party transactions are already well known, not unusual, or not material. This commenter questioned the benefit of communication in those instances. The Board considered these comments and is not proposing revisions to provide for communication of these matters on an exception basis. Doing so would not provide for the proactive communication that the Board believes should occur with the audit committee regarding a company's relationships and transactions with its related parties.

Making the Auditor's Communications Incremental to Management's: One commenter stated that the auditor's communication with the audit committee should be



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focused on matters not previously communicated by management and any other areas requiring significant auditor judgment. The Board considered this comment and noted that the proposed communication requirements would involve communication of the auditor's evaluation of certain matters and that management is not in a position to communicate the auditor's views. As such, the Board is not proposing to make revisions for this comment.

Timing of the Auditor's Communications: One commenter stated that the language in the proposed standard is "too soft" and is an argument for letting the information linger until "all the facts are in," up to the point when the audit report is released. That commenter recommended requiring early audit committee communication requirements regarding related party transactions. The Board considered this comment and noted that paragraph 7 of the repropoed standard would require the auditor to inquire of the audit committee as part of the auditor's risk assessment procedures. In addition, Auditing Standard No.16 anticipates timely and robust communications between the auditor and the audit committee throughout the audit. The Board, therefore, is not proposing to make revisions for this comment.

Clarifying Significant Matters: One commenter stated that it is unclear what the Board expects the auditor to communicate beyond the significant matters that are specifically identified in the proposed standard. That commenter recommended combining the requirements in the proposed standard into a single paragraph and including a requirement that the auditor communicate "other significant matters, if any, related to the auditor's evaluation of the company's identification of, accounting for, and disclosures of its relationships and transactions with related parties." Because the Board does not intend to limit audit committee communications to only those significant matters included in the repropoed standard, no revisions have been made in response to this comment. For example, in evaluating the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, the auditor might identify other significant matters that might be of interest to the audit committee, such as concerns over the company's process for identifying related parties and relationships and transactions with related parties.

I. Other Considerations

The Board did not propose any changes to the auditor's report in connection with the proposed standard and amendments, but sought input on whether the proposed standard should change the auditor's responsibilities for the auditor's report regarding related party transactions. The Board notes that any changes to the auditor's report in this area would be considered in conjunction with the Board's project on improvements



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to the Auditor's Reporting Model. The Board encourages commenters to send comments on such issues in response to future Board proposals on the Auditor's Reporting Model.^{51/}

Questions:

1. Are the requirements of the repropoed standard appropriate? Why or why not?
2. Do the changes in the repropoal clarify the relationship of the repropoed standard with the risk assessment standards? Why or why not?
3. Does the alignment of the repropoed standard with the risk assessment standards enable the auditor to introduce efficiencies in the audit approach? Why or why not?
4. Would the procedures required by the repropoed standard improve the auditor's understanding of a company's relationships and transactions with its related parties? Why or why not?
5. Is the requirement in the repropoed standard to evaluate whether the company has properly identified the company's related parties and relationships and transactions with its related parties appropriate? Why or why not?
6. Does the repropoed standard appropriately allow for the use of auditor judgment? Why or why not?
7. Are the auditor's responsibilities for the examples of information and sources of information contained in Appendix A to the repropoed standard clear? Are there other examples that should be included in the repropoed standard?
8. Is the objective of the repropoed standard appropriate? Why or why not? Does the repropoing release clearly articulate that the objective of the repropoed standard works similarly to objectives contained in other PCAOB auditing standards?

^{51/} See <http://pcaobus.org/Rules/Rulemaking/Pages/Docket034.aspx>.



9. Does the requirement in the reposed standard to perform specific procedures for each related party transaction required to be disclosed in the financial statements or determined to be a significant risk provide for a scaled approach? Why or why not?
10. Does the approach in the reposed standard for the auditor to perform specific procedures for related party transactions that are required to be disclosed in the financial statements or that are determined to be a significant risk represent a cost-sensitive, yet effective, approach? Why or why not?
11. What additional guidance, if any, regarding the auditor's responsibility for performing procedures on intercompany account balances pursuant to paragraph 13 of the reposed standard is necessary?

II. Reposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

Overall, commenters were generally supportive of the need to improve the existing requirements regarding significant unusual transactions. However, some commenters suggested changes to the proposed requirements. In response, the Board has made certain revisions to clarify and refine the proposed amendments regarding significant unusual transactions. These comments and the proposed revisions are organized by the following topical areas:

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A. Identifying Significant Unusual Transactions	A4-59
B. Evaluating Significant Unusual Transactions	A4-66

Relevant information is provided for each topical area, including a description of the proposed amendments regarding significant unusual transactions and existing requirements, a description of the reposed amendments regarding significant unusual transactions, and a discussion of significant comments received and Board responses. Specific questions for commenters follow the discussion of Evaluating Significant Unusual Transactions, however, commenters are encouraged to comment on all aspects of the reposed amendments.



A. Identifying Significant Unusual Transactions (Section A. of the Reproposed Amendments in Appendix 2)

Financial reporting frauds have demonstrated that companies may use significant unusual transactions, such as transactions in which management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction, to materially misstate their financial statements. Significant unusual transactions can also result in material misstatement of financial statements due to error. Improving the auditor's identification of significant unusual transactions can promote audit quality.

Improving the auditor's identification of significant unusual transactions also can inform the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties, as a related party transaction previously undisclosed to the auditor might also be a significant unusual transaction.

The Proposed Amendments and Existing Requirements

The proposed amendments regarding identifying significant unusual transactions aligned the description of significant unusual transactions in the Board's auditing standards, enhanced the requirements for identifying a company's significant unusual transactions, and revised and added to the examples of fraud risk factors described in AU sec. 316.

The existing standard relating to the auditor's consideration of fraud in a financial statement audit, AU sec. 316, recognizes that during an audit the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment.^{52/} The risk assessment standards also anticipate that the auditor might come across significant transactions that are outside the normal course of business for the company or that are otherwise appear to be unusual due to their timing, size, or nature.^{53/}

^{52/} See AU sec. 316.66.

^{53/} For example, paragraph 71.g. of Auditing Standard No. 12 states that one factor that should be evaluated for the auditor's determination of which risks are



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As more fully described below, after consideration of the comments received, the Board is reproposing the amendments regarding identifying significant unusual transactions substantially as proposed, except for certain changes that are intended to enhance the linkage between the reproposed amendments regarding significant unusual transactions and the reproposed standard.

The Reproposed Amendments

Description of Significant Unusual Transactions

Like the proposed amendments, the reproposed amendments regarding significant unusual transactions would amend AU sec. 316.66 to describe significant unusual transactions as 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. This description is consistent with the existing description in paragraph 71.g. of Auditing Standard No. 12. The reproposed amendments to AU sec. 316.66 also would state that significant unusual transactions may be used to engage in fraudulent financial reporting or conceal misappropriation of assets.

The reproposed amendments regarding significant unusual transactions also would make conforming changes to introduce a uniform description of "significant unusual transaction" throughout the Board's standards. Specifically, the reproposed amendments would align the terminology in paragraph 14 of Auditing Standard No. 5, *An Audit of Internal Control over Financial Reporting That Is Integrated with An Audit of Financial Statements*, paragraph 12 of Auditing Standard No. 9, paragraph 13 of Auditing Standard No. 12, paragraph 15.c. of Auditing Standard No. 13, paragraph .85.A.2 of AU sec. 316, and paragraph .55.B1. of AU sec. 722, *Interim Financial Information*. As compared to the proposed amendments, these conforming changes would reflect a number of minor revisions that are intended to further clarify the description of a significant unusual transaction throughout the Board's standards.

significant risks is whether the risk involves significant transactions outside the normal course of business or that otherwise appear to be unusual due to their timing, size, or nature.



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Enhancing Requirements for Identifying Significant Unusual Transactions

The repropoed amendments would include amendments to the Board's existing standards that would require the performance of procedures as part of the auditor's risk assessment process to identify significant unusual transactions. As discussed below, these procedures would include: (1) inquiring of management and others, (2) understanding controls relating to significant unusual transactions, and (3) taking into account other information obtained during the audit. The repropoed amendments in this area remain substantively the same, except for certain changes that serve to enhance the linkage between the repropoed amendments regarding significant unusual transactions and the repropoed standard.

Inquiring of Management and Others (Paragraphs 56-57 of Auditing Standard No. 12)

The repropoed amendments would build on existing requirements in Auditing Standard No. 12 that require the auditor to make inquiries of management and others within the company about the risks of material misstatement.^{54/} Specifically, the repropoed amendments regarding significant unusual transactions would revise paragraph 56.a. of Auditing Standard No. 12 to require the auditor to inquire of company management regarding whether the company has entered into any significant unusual transactions, and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties. The proposed amendments regarding significant unusual transactions would also revise paragraphs 56.b. and 56.c. of Auditing Standard No. 12 to require the auditor to inquire of the audit committee and internal audit personnel (if applicable), respectively, regarding whether the company has entered into any significant unusual transactions.

Paragraph 57 of Auditing Standard No. 12 requires that the auditor inquire of others within the company about their views regarding fraud risks and includes the example of employees involved in initiating, recording, or processing complex or unusual transactions. The repropoed amendments would add significant unusual transactions as an example of a complex or unusual transaction to paragraph 57 of Auditing Standard No. 12.

^{54/} See paragraphs 56-57 of Auditing Standard No. 12.



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Understanding Controls Relating to Significant Unusual Transactions (Paragraph 73A of Auditing Standard No. 12)

Auditing Standard No. 12 requires that the auditor obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.^{55/}

The repropoed amendments regarding significant unusual transactions would build on the risk assessment standards by adding paragraph 73A to Auditing Standard No. 12. That paragraph would require the auditor to obtain an understanding of the controls management has established to identify, authorize and approve, and account for and disclose significant unusual transactions in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18-40 and 72-73 of Auditing Standard No. 12.

Taking into Account Other Information Obtained During the Audit (AU sec. 316.66)

The repropoed amendments regarding significant unusual transactions would add a note to AU sec. 316.66 stating that the auditor's identification of significant unusual transactions should take into account information obtained from: (a) the risk assessment procedures required by Auditing Standard No. 12 (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial reporting), and (b) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

As discussed above, revisions have been made in the repropoal to clarify the linkage between the repropoed standard and the repropoed amendments regarding significant unusual transactions. Specifically, unlike the propoal, the repropoed amendments would add a second note to AU sec. 316.66 that would state that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. In addition, a new note would also be included after paragraph 11 in the repropoed standard that would state

^{55/} See paragraph 18 of Auditing Standard No. 12.



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that, for a related party transaction that is also a significant unusual transaction pursuant to AU secs. 316.66-.67A, the auditor is required to evaluate whether the business purpose (or the lack thereof) of the transaction indicates that the transaction was entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. Further, a new footnote to the repropoed standard would state that information obtained from identifying and evaluating a company's significant unusual transactions (as well as from obtaining an understanding of a company's financial relationships and transactions with its executive officers) could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Fraud Risk Factors

Like the proposed amendments, the repropoed amendments regarding significant unusual transactions also would revise certain examples of fraud risk factors contained in AU sec. 316. For example, AU sec. 316.85A.2 notes that significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm can provide opportunities to engage in fraudulent financial reporting. The repropoed amendments regarding significant unusual transactions would bifurcate that discussion into two separate examples, namely: (1) related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business) and (2) significant transactions with related parties whose financial statements are not audited or are audited by another firm. The repropoed amendments also would add contractual arrangements lacking a business purpose as an example of a fraud risk factor.

Significant Comments and Board Responses

The Board considered all comments received, including significant comments in the following areas:

Defining Significant Unusual Transactions and Including Examples: Some commenters recommended defining the term "significant unusual transaction." Another commenter recommended including examples of significant unusual transactions. After considering these comments, the Board has not revised the proposed amendments. In the Board's view, the description of a significant unusual transaction included in the proposed amendments permits auditor flexibility in applying the description to different companies of different sizes and in different industries. Likewise, the Board has not included examples of significant unusual transactions in its repropoal. In the Board's



view, whether a specific transaction constitutes a significant unusual transaction should be based upon the specific facts and circumstances.

Clarifying the Complementary Nature of Significant Unusual Transactions and Identifying Related Parties Previously Undisclosed to the Auditor. Some comments received by the Board appeared to indicate that commenters might not have fully appreciated the Board's intended emphasis on the complementary nature of the auditor's efforts regarding significant unusual transactions and identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor. The Board believes that emphasizing the complementary nature of the auditor's efforts in identifying significant unusual transactions can also inform the auditors evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties. To further emphasize the complementary nature of the auditor's efforts regarding a company's relationships and transactions with its related parties and significant unusual transactions, as discussed above, the Board is proposing revisions to further emphasize the linkage between these topics. These revisions include adding a new note to AU sec. 316.66, a new note to paragraph 11 of the repropoed standard, and a new footnote to paragraph 14 of the repropoed standard.

Determining Whether a Transaction is a Significant Unusual Transaction: One commenter noted that eliminating from AU sec. 316.66 the phrase "or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment," while also stating in the proposing release that significant unusual transactions need not be infrequent but could occur quarterly or more frequently, appears counterintuitive. That commenter was concerned that this could create ambiguity. Another commenter suggested providing examples of transactions that would not occur infrequently and nonetheless be considered significant unusual transactions. The Board considered these comments, noting that the description of a significant unusual transaction is designed so that the auditor determines whether a transaction is a significant unusual transaction based on the specific facts and circumstances. In the Board's view, removing the phrase contained in AU sec. 316 does not change the need for the auditor to make this determination based on the facts and circumstances, which would include the auditor's understanding of the company and its environment. Specifically, a new note to AU sec. 316.66 would state that the auditor's identification of significant unusual transactions should take into account information obtained from the risk assessment procedures required by Auditing Standard No. 12. Auditing Standard No. 12 requires the auditor to obtain an understanding of the



company and its environment.^{56/} The proposing release stated that a significant unusual transaction need not occur infrequently to clarify that the timing or frequency of transactions is only one element to be considered in determining whether a transaction is a significant unusual transaction. The Board, therefore, is not proposing to change the amendments regarding significant unusual transactions in response to these comments.

Using Management's Terminology: One commenter noted that management does not have an equivalent term for "significant unusual transaction" in its literature (that is, the applicable accounting framework, Committee of Sponsoring Organizations of the Treadway Commission ("COSO") or SEC management guidance). In that commenter's view, the transactions that the auditor determines are "significant unusual transactions" will likely be transactions that management views as the result of its non-routine or estimation processes. That commenter noted that management's processes and related controls may not be different for "significant unusual transactions" than for other similar transactions. The Board considered this comment, noting that inquiring of management and others within the company regarding the existence of significant unusual transactions as part of its risk assessment procedures is an important step – but not the only step - in the auditor's identification of significant unusual transactions. The auditor might determine that there are significant unusual transactions despite management's assertions (for example, through other procedures performed during the audit, such as reading minutes of the board of directors meetings and performing journal entry testing). Consequently, the Board is not proposing to revise the amendments regarding significant unusual transactions in response to this comment.

Incorporating Examples of Procedures That May Identify Significant Unusual Transactions from the Proposing Release: One commenter recommended including examples of procedures from the proposing release that may help identify significant unusual transactions in the proposed amendments. The Board considered this comment but is proposing to include the performance requirements in the proposed amendments, while providing the additional discussion of the amendments and related examples in an appendix to the release, as it has done in the past. This approach promotes a clear separation between the required procedures in the standard and the Board's discussion regarding the potential application of the repropoed amendments. As such, the examples of procedures and other discussion in the proposing release have not been incorporated into the repropoed amendments. However, as described above, the Board is proposing to add a second note to AU sec. 316.66 that would state

^{56/} See paragraph 7 of Auditing Standard No. 12.



that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. This note also refers the auditor to Appendix A of proposed auditing standard, *Related Parties*, which includes examples of information and examples of sources of such information.

B. Evaluating Significant Unusual Transactions (Section B. of the Reproposed Amendments in Appendix 2)

Because a company might use a significant unusual transaction to engage in fraudulent financial reporting or to obscure the company's financial position or operating results, existing standards require the auditor to perform procedures to evaluate significant unusual transactions identified by the auditor and discuss the auditor's evaluation of such transactions with the audit committee.^{57/} The amendments in this area are designed to improve the auditor's evaluation of significant unusual transactions, including the auditor's evaluation of the business purpose (or the lack thereof), and whether the transactions have been appropriately accounted for and adequately disclosed in the company's financial statements. Improving the auditor's evaluation of significant unusual transactions should also result in a more meaningful exchange of information between the auditor and the audit committee.^{58/}

The Proposed Amendments and Existing Requirements

The proposed amendments regarding significant unusual transactions were intended to strengthen the auditor's evaluation of significant unusual transactions. The proposed amendments, which would have built on existing requirements in AU secs. 316.66-.67, included specific procedures intended to focus the auditor's attention on critically evaluating whether the business purpose (or the lack thereof) for significant unusual transactions indicates that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.

^{57/} See AU secs. 316.66-.67 and paragraph 13.d. of Auditing Standard No. 16.

^{58/} Higher quality financial reporting (as a result of better informed auditors, better informed audit committees, or both) improves the quality of information available to the markets and reduces the information asymmetry that exists about the company among investors as well as between investors and the company's management.



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The proposed amendments also would have included an evaluation of whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

Existing AU sec. 316.66 currently requires that once an auditor becomes aware of significant unusual transactions, the auditor should gain an understanding of the business rationale for such transactions and whether that rationale (or the lack thereof) suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. Existing AU sec. 316.67 identifies several matters that the auditor should consider in understanding the business rationale for those transactions.

As more fully described below, after consideration of the comments received, the Board made revisions to the proposed amendments regarding evaluating significant unusual transactions.

The Reproposed Amendments

Evaluating the Business Purpose of Significant Unusual Transactions

The repropoed amendments regarding evaluating significant unusual transactions would add a new paragraph to AU sec. 316, AU sec. 316.66A, to require that the auditor design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. The repropoed procedures would include:

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.



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As repropoed, item a. of the proposed amendments to AU sec. 316.66A would clarify that the auditor should read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction.

As repropoed, item c. of the proposed amendments to AU sec. 316.66A would be expanded to require the auditor's evaluation of the financial capability of the other party to include other significant matters, specifically, significant loan commitments and supply arrangements.

Item d. of the proposed amendments to AU sec. 316.66A would be revised to better clarify the auditor's responsibilities. Like the proposed amendments, item d. would provide an opportunity for the auditor to scale the audit by requiring the auditor to supplement the basic required procedures with more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. Specifically, as revised, item d. would require the auditor to perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Like the proposed amendments, a footnote to item c. of the repropoed amendments to AU sec. 316.66A also would state that examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

The repropoed amendments also would require the auditor to evaluate certain matters when evaluating whether the business purpose (or the lack thereof) of a significant unusual transaction suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. Like the proposed amendments, the repropoed amendments would largely incorporate the list of matters currently in AU sec. 316.67 and would add additional matters. Those additional matters would include:

- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end).



- 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 other, more clearly independent, parties on an arm's-length basis.
- The transaction enables the company to achieve certain financial targets.

These additional matters are intended to strengthen the auditor's evaluation of the business purpose (or the lack thereof) for significant unusual transactions, including whether they may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.

In addition, the reproposal would align the proposed footnote to AU sec. 316.67 with the description of "related parties or relationships or transactions with related parties previously undisclosed to the auditor." The revised footnote also would reference the requirement in the repropoed standard that the auditor perform certain procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

Evaluating the Accounting and Disclosure of Significant Unusual Transactions

The repropoed amendments would emphasize the auditor's responsibility to evaluate the accounting and disclosure of significant unusual transactions by adding a new paragraph to AU sec. 316, paragraph .67A. That new paragraph would require the auditor to evaluate whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements. AU sec. 316.67A would further state that this includes evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework. A new footnote would direct the auditor to paragraph 31 of Auditing Standard No. 14.

Like the proposed amendments, the repropoed amendments would add a new note to AU sec. 316.67A that would state that, in evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in accordance with the financial reporting framework, the auditor considers management's disclosure regarding significant unusual transactions in other parts of the company's SEC filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.



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Other Matters Regarding Significant Unusual Transactions

Like the proposed amendments, the repropoed amendments regarding significant unusual transactions also would include new paragraph 11A to Auditing Standard No. 13. That paragraph would remind auditors that significant unusual transactions can affect the risks of material misstatement due to error or fraud, and that the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to the repropoed amendments to AU secs. 316.66-.67A regarding significant unusual transactions.

The repropoed amendments regarding significant unusual transactions would complement the auditor communication requirements in Auditing Standard No. 16. Specifically, improving the auditor's identification and evaluation of significant unusual transactions could improve the quality of auditor communications with audit committees. The repropoed amendments also would revise paragraph 13.d. of Auditing Standard No. 16 to refer to the "business purpose (or the lack thereof)" instead of the "business rationale" of a significant unusual transaction.

Significant Comments and Board Responses

In developing the repropoed amendments regarding evaluating significant unusual transactions the Board considered all comments received, including the following significant comments:

Providing Additional Guidance for Identifying and Assessing Risks of Material Misstatement: One commenter recommended providing guidance as to how to relate risk, materiality, and other considerations to the selection of procedures for significant unusual transactions rather than a "one-size-fits-all" approach, which that commenter asserted was inherent in the proposed amendments regarding significant unusual transactions. The Board notes that the proposed amendments regarding significant unusual transactions were designed to establish basic procedures for the auditor to identify and evaluate significant unusual transactions, and allow the auditor to assess risks and respond to risks based on the facts and circumstances, including the size and complexity of the company and the assessed significance of the identified risks of material misstatement in the financial statements. The Board, therefore, did not change the amendments in response to this comment.

Evaluating the Financial Capability of the Other Party: Some commenters expressed concern that information pertinent to an unrelated third party may not be



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available to the auditor, hindering the auditor's ability to evaluate the financial capability of the other party. After considering these comments, the Board is not proposing to make revisions for this comment. See the discussion "Evaluating the Financial Capability of the Related Party" under the heading "Transactions with Related Parties Required to Be Disclosed in the Financial Statements or That are a Significant Risk" in Section I.E. of this Appendix.

Incorporating Examples of "Other Procedures" from the Proposing Release: Some commenters suggested incorporating the examples of procedures that might be appropriate for the auditor to perform that were contained in the proposing release into the proposed amendments regarding significant unusual transactions. The Board considered these comments and determined, as it has done in other projects, to include the performance requirements in the Board's standards and to provide the additional discussion of the amendments and related examples in an appendix to the release. This approach promotes a clear separation between the required procedures in the standard and the Board's discussion regarding the potential application of the standard. As such, the examples of procedures and other discussion in the proposing release have not been incorporated into the repropoed amendments regarding significant unusual transactions.

Evaluating the Implications of the Lack of a Business Purpose: One commenter stated that older versions of the auditing standards suggested that if the auditor is unable to understand the business purpose of a transaction, the auditor may not be able to express an unqualified opinion. That commenter suggested that this provision be included, along with reporting guidance. Further, at the SAG discussion, the point was raised that the standard should include a statement similar to footnote 6 of AU sec. 334.09, which states that "[u]ntil the auditor understands the business sense of material transactions, he cannot complete his audit. If he lacks sufficient specialized knowledge to understand a particular transaction, he should consult with persons who do have the requisite knowledge."

The Board considered these comments and noted that significant unusual transactions, like all transactions, are subject to the requirements contained in AU sec. 411.06, which requires that the auditor consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. That evaluation would encompass an understanding of the "business sense" of material transactions. As a result, these comments are not reflected in the reproposal.



Evaluating Whether a Significant Unusual Transaction Enables the Company to Achieve Financial Targets: One commenter noted that the expanded list of factors (in AU sec. 316.67) was problematic. Specifically, that commenter noted that requiring the auditor to consider whether the accounting for a transaction enables the company to achieve certain financial targets could be a "catch-all" that covers a variety of unintended transactions. Another commenter suggested that this factor should be deleted, noting that the factor could result in an auditor unnecessarily evaluating transactions for fraud that clearly have not been entered into to engage in fraudulent financial reporting or the misappropriation of assets. That commenter stated that this factor is redundant as other factors, for example, whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transactions (e.g., accounting-motivated structured transaction) are sufficient.

The Board considered these comments, noting that considering whether a transaction enables the company to achieve certain financial targets is an important consideration when evaluating whether that transaction has been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. The Board is proposing to revise this factor to focus the auditor on whether the transaction enables the company to achieve financial targets.

Questions:

12. Are the repropoed amendments regarding the auditor's identification of significant unusual transactions appropriate? Why or why not?
13. Are the repropoed amendments regarding the auditor's evaluation of significant unusual transactions appropriate? Why or why not?
14. Would the procedures required by the repropoed amendments regarding significant unusual transactions improve the auditor's identification and evaluation of a company's significant unusual transactions? Why or why not?
15. Are the repropoed amendments regarding significant unusual transactions appropriately aligned with the risk assessment standards? Why or why not?
16. Do the repropoed amendments regarding significant unusual transactions appropriately allow for the use of auditor judgment? Why or



why not? Does the requirement that the auditor perform specific procedures for each significant unusual transaction identified by the auditor provide for a scaled approach? Why or why not?

17. Is the complementary relationship between the amendments regarding significant unusual transactions and the repropoed standard clear? Why or why not?

III. Other Repropoed Amendments to PCAOB Auditing Standards

The Board also proposed amendments regarding a company's financial relationships and transactions with executive officers, other new requirements that complement the proposed standard and amendments, and amendments that would have conformed other auditing standards to the proposed standard and amendments. Overall, while the proposed changes regarding a company's financial relationships and transactions with executive officers drew support from a range of commenters, some commenters raised concerns that performing such procedures could have unintended consequences, including impacting the design of compensation arrangements. In response to the comments received the Board made revisions to clarify and refine various aspects of the other proposed amendments. The discussion of the comments and proposed revisions pertains to the following PCAOB auditing standards:

	<u>Page</u>
A. Auditing Standard No. 12, <i>Identifying and Assessing Risks of Material Misstatement</i>	A4-74
B. AU sec. 315, <i>Communications Between Predecessor and Successor Auditors</i>	A4-87
C. AU sec. 316, <i>Consideration of Fraud in a Financial Statement Audit</i>	A4-89
D. AU sec. 333, <i>Management Representations</i>	A4-90
E. AU sec. 560, <i>Subsequent Events</i>	A4-91
F. AU sec. 722, <i>Interim Financial Information</i>	A4-93
G. AU sec. 9543, <i>Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543</i>	A4-94



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Relevant information is provided regarding the repropoed amendments to each standard, including a description of the proposed amendments and existing requirements, a description of the repropoed amendments, and a discussion of significant comments received and Board responses. Following the discussion of the repropoed amendments to AU sec. 722 are specific questions for commenters, although the Board encourages comments on all aspects of the repropoed amendments. In particular, the Board seeks comment regarding the repropoed amendments to Auditing Standard No. 12 that would require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment.

A. Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Appendix 3)

A company's financial relationships and transactions with its executive officers might create incentives and pressures that could create risks of material misstatement of the financial statements. Performing procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers can benefit the auditor's identification of fraud risks and other significant risks. Further, performing procedures to obtain such an understanding can result in the identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor, which in turn can contribute to the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties.

The Proposed Amendments and Existing Requirements

The Board's proposal included amendments to Auditing Standard No. 12 that would have required the auditor to perform specific procedures to obtain an understanding of relationships and transactions with the company's executive officers as part of the auditor's risk assessment. The proposed amendments also would have included procedures that the auditor *should consider* performing, namely: (i) obtaining an understanding of the company's policies and procedures regarding executive officer expense reimbursements and (ii) inquiring of the chair of the company's compensation committee (or its equivalent) and any company compensation consultants regarding the structuring of the company's compensation for its executive officers. The proposed amendments were intended to assist the auditor in identifying and assessing risks associated with a company's financial relationships and transactions with its executive officers.



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The other proposed amendments were designed to build on the existing risk assessment standards. Specifically, paragraph 11 of Auditing Standard No. 12 already requires that, as part of obtaining an understanding of the company, the auditor should consider obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses. The proposal anticipated that the additional procedures to be performed would contribute to the auditor's consideration of fraud in a financial statement audit pursuant to AU sec. 316, which recognizes certain incentives and pressures on management to commit fraud as examples of fraud risk factors.

As more fully described below, after consideration of the comments received, the Board is proposing revisions to the other proposed amendments to Auditing Standard No. 12 to clarify that the auditor's procedures in this area would be performed as part of the auditor's risk assessment process and would not require the auditor to make any determination regarding the reasonableness of the company's compensation arrangement with its executive officers or recommendations regarding such compensation arrangements.

The Reproposed Amendments

As repropoed, the Board's amendments relating to financial relationships and transactions with a company's executive officers would add paragraph 10A to Auditing Standard No. 12. The proposed change would require the auditor, as part of the auditor's risk assessment process, to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers (for example, executive compensation, including perquisites, and any other arrangements). As stated in the proposing release, the Board intends that the procedures should be sufficient to identify whether these financial relationships and transactions could create conditions (for example, incentives and pressures) that could result in risks of material misstatement, including fraud risks.^{59/}

The repropoed amendments, like the proposed amendments, would require the auditor to perform procedures that include, but are not limited to:

^{59/} See page A4-41 of the proposing release.



- Reading the employment and compensation contracts between the company and its executive officers; and
- Reading proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.^{60/}

The focus of the repropoed procedures is the company's "executive officers." As noted above, the Board's repropoed amendments would build on the existing focus in paragraph 11 of Auditing Standard No. 12 on the company's compensation arrangements with "senior management." Like the proposed amendments, the repropoed amendments would include a definition of the term "executive officer" that links to the SEC's definition of an executive officer in Rule 3b-7 under the Exchange Act, for issuers, and a list contained in Schedule A of Form BD, for broker-dealers.^{61/}

The repropoed amendments would not change the existing requirement to consider obtaining an understanding of compensation arrangements with senior management. The population for the procedures required by paragraph 10A of the other repropoed amendments is the list of "executive officers," as defined in the SEC rules or

^{60/} The auditor also might read the company's proxy statements and other relevant SEC company filings in meeting the requirements of paragraph 11 of Auditing Standard No. 12, which states that the auditor should consider reading public information regarding the company as part of the process for obtaining an understanding of the company.

^{61/} Specifically, the repropoed amendments to Auditing Standard No. 12 would include the following definition of an "executive officer": For issuers, the president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policy-making functions for the company. (See Rule 3b-7 under the Exchange Act.) For brokers and dealers, the term "executive officer" includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions. (See Schedule A of Form BD.)



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included on Schedule A of Form BD,^{62/} while the existing requirement in paragraph 11 of Auditing Standard No. 12 continues to apply to what may be a larger population of a company's management.

Like the Board's proposed amendments, the repropoed amendments also would include a number of other changes designed to strengthen the auditor's consideration of the risk of material misstatement associated with financial relationships and transactions with its executive officers. As repropoed, the revisions to paragraph 11 of Auditing Standard No. 12 would require the auditor to consider performing procedures to:

- Inquire of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers, and
- Obtain an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

In the Board's view, understanding a company's financial relationships and transactions with its executive officers can assist the auditor in understanding whether those relationships and transactions affect the risks of material misstatement.^{63/} For example, the auditor could consider whether the company's internal control over

^{62/} See Exchange Act Rule 3b-7, 17 C.F.R. §240.3b-7, and Schedule A of Form BD. See *generally* Item 401(b) of Regulation S-K, 17 C.F.R. §229.4-01(b).

^{63/} For example, according to a May 2010 academic study that examined in detail SEC accounting and auditing enforcement releases from 1998 to 2007, the chief executive officer or chief financial officer was named in 89 percent of the enforcement actions involving fraudulent financial reporting. That study also noted that the SEC's most commonly cited motivations for fraud included the need to meet internal or external earnings expectations, an attempt to conceal the company's deteriorating financial condition, the need to increase the stock price, the need to bolster financial performance for pending equity or debt financing, or the desire to increase management compensation based on financial results. See, M. Beasley, J. Carcello, D. Hermanson, and T. Neal, "*Fraudulent Financial Reporting 1998-2007 An Analysis of U.S. Public Companies*," at 3, available at http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.



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financial reporting is designed and operating to address risks that management might seek accounting results solely to boost certain executive officers' compensation. This understanding could also assist the auditor in determining areas where management bias might occur (for example, certain accounting estimates, including fair value measurements).

Similarly, obtaining an understanding of how the company has structured its compensation for its executive officers can assist the auditor in identifying fraud risks. Existing standards identify a company's financial relationships and transactions with its executive officers as examples of fraud risk factors.^{64/} The information obtained from this risk assessment procedure, therefore, could complement the requirement in paragraph 52 of Auditing Standard No. 12 that key engagement team members discuss the potential for material misstatement due to fraud, including consideration of the known external and internal factors affecting the company that might create incentives or pressures for management and others to commit fraud.

As described above, the repropoed amendments are not intended to call into question the compensation policies and procedures of the company, but rather, to assist the auditor in identifying and assessing risks of material misstatement in the financial statements that may be a consequence of a company's financial relationships and transactions with its executive officers.^{65/}

Significant Comments and Board Responses

Many commenters generally supported the proposed amendments to Auditing Standard No. 12 relating to executive compensation. One commenter stated that requiring the auditor to perform additional procedures to obtain an understanding of this aspect of company governance should result in higher quality audits that better assist investors in making informed investment decisions and improve public confidence in the financial markets. Other commenters however, did not support the proposed amendments and expressed concerns, including concerns that the proposed amendments might influence the design and appropriateness of company compensation arrangements with its executive officers and that the proposed amendments might impair auditor independence. Other commenters provided

^{64/} See AU sec. 316.85.

^{65/} See page A4-44 of the proposing release.



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recommendations to further strengthen the proposed amendments. In developing its reproposal, the Board considered all comments received, including the following significant comments:

Clarifying That the Proposed Procedures are Performed As Part of the Auditor's Risk Assessment: Some commenters expressed a concern that the proposal might result in auditors influencing the design and appropriateness of compensation arrangements with executive officers. One commenter suggested that the proposed amendments could potentially transform the traditional auditor's role from providing assurance on the reliability of financial statements to evaluating the design or appropriateness of executive compensation, including the business purpose and impact of executive compensation arrangements on the company.

Another commenter stated that the amendments would require the auditor to substantively judge executive compensation and that this could fundamentally change the relationship between the board and the auditor. That commenter also noted that the proposed amendments would appear to place the auditor in the role of advising the board on substantive business decisions. That commenter stated that this seems inconsistent with the non-audit service prohibitions in Section 201 of the Sarbanes-Oxley Act and, in fact, not suited to the auditor's areas of expertise. That commenter stated that this expanded role would entail analyzing executive compensation risk, without the need to connect the risk with the rewards and that the auditor's advice may be skewed in favor of limiting compensation in a manner that may not be in the best interest of the shareholders. That commenter further stated that the proposed amendments could result in certain companies having uncompetitive compensation arrangements, thereby, putting those companies at risk of losing talented executives.

Other commenters supported the proposed amendments but noted that there was confusion surrounding the proposal and suggested that the Board clarify the purpose of the proposed amendments. In addition, during the SAG discussion it was suggested that the Board clarify that there is no expectation that auditors will be engaged in the compensation committee process or in an audit of that process.

The Board considered all comments received and made revisions to emphasize that the purpose of the procedures is to further the auditor's risk assessment rather than to require the auditor to determine the appropriateness of a company's compensation agreements with its executive officers. The Board notes that the repropoed amendments would not require the auditor to assess the appropriateness of the compensation of executive officers. As repropoed, the first sentence of paragraph 10A of Auditing Standard No. 12 would read as follows:



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To assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers.

The revisions are intended to clarify that the procedures performed are intended to occur in the context of the auditor's process for assessing the risks of material misstatement of the company's financial statements.

Performing the Proposed Procedures Could Impair Auditor Independence: Some commenters expressed concern that the proposed amendments might affect an auditor's independence. Those commenters noted that, while the PCAOB recognized in the proposing release that it is not suggesting that auditors become involved in or influence executive compensation decisions, they are concerned that auditor independence could in fact be compromised in this manner. As support, those commenters noted their belief that it would be unreasonable to assume that auditors would not express opinions or have discussions with board members or management that could influence, wittingly or not, decisions regarding performance-based compensation plans.

The Board considered these comments and noted that auditors already have an existing responsibility to assess the risk of material misstatement of the financial statements. The Board further noted that obtaining an understanding of compensation arrangements with a company's senior management is already part of procedures that are considered in the context of the auditor's risk assessment activities. As proposed, the amendments relating to a company's financial relationships and transactions with its executive officers extend the auditor's existing work in this area, with a focused set of required procedures to address a critical area that could pose substantial risk to the integrity of companies' financial statements and reporting processes. Thus, the Board did not make changes in response to these comments. In the Board's view, performing procedures to understand a company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment represents an extension of the auditor's existing responsibilities. The performance of such audit procedures should not impair auditor independence.

Performing the Proposed Procedures Might Require Specialists: Several commenters suggested that auditors might need to engage specialists to understand



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company employment contracts, noting that the time to obtain and understand these contracts might be significant.

The Board considered these comments and noted that Auditing Standard No. 12 already requires the auditor to consider performing procedures with respect to employment arrangements with a company's senior management. The Board did not receive comments from auditing firms that suggested that they would have difficulty performing the procedures that would have been required by the proposed amendments. Accordingly, the Board is not proposing revisions to the proposed amendments, but is soliciting comment regarding potential costs of its reproposal.

Generating Documentation That Complicates Litigation: One commenter stated that the proposed amendments would generate documentation and other records that could complicate any litigation or claims relating to executive compensation discussions. That commenter further stated that these records would not be subject to attorney-client privilege or similar protections and could result in increased liability on the part of companies and their shareholders.

In the Board's view, the auditor's responsibilities to conduct the audit and prepare related documentation generally should not be limited by the threat of potential litigation against the company. Obtaining an understanding of the company, including by performing procedures relating to a company's financial arrangements with its executive officers, is an important part of the auditor's risk assessment activities. This understanding may lead to the discovery of incentives and pressures that could foster fraudulent financial reporting or conceal the misappropriation of assets. After consideration, the Board is not proposing to make revisions in response to this comment.

Determining the Company's Executive Officers: Some commenters recommended that the amendments clarify the auditor's role in determining who is considered an "executive officer." In particular, commenters questioned whether the auditor is expected to determine whether the list of executive officers, as set out in Rule 3b-7 under the Exchange Act or Schedule A of Form BD for brokers and dealers, is complete. Other commenters suggested that the Board incorporate portions of the discussion in the proposing release into the text of the amendments to clarify that it is management's responsibility to designate the company's executive officers.

The Board considered these comments, noting that the proposed amendments would not have required the auditor to evaluate management's identification of its "executive officers," for other regulatory and SEC filing purposes. In the Board's view,



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the SEC rules cited in the amendments provide an objective definition of the term "executive officers."^{66/} The Board did not make revisions in response to these comments.

Defining the Term "Senior Management": Some commenters stated that the amendments should clarify the interaction between the terms "executive officer" and "senior management." Several commenters recommended that the Board define senior management. One commenter recommended that the amendments recognize that, for certain entities, it may be possible for executive officers and senior management to be the same individuals (for example, at non-issuer brokers and dealers). That commenter further suggested discussing how the definition of executive officer would be applied to other types of non-issuer entities, for example, subsidiaries of issuers.

The Board notes that the term "senior management" is not a defined term in Auditing Standard No. 12 or SEC rules. The Board also recognizes that, for certain companies or brokers or dealers, senior management might be the same population as its executive officers. Further, the individuals the company considers to be its "senior management" may differ among issuers and among broker-dealers. The existing standard anticipates that a company's or broker's or dealer's facts and circumstances may affect the composition of its "senior management." The Board does not wish to foreclose the possibility that an auditor would (1) gain an understanding of the compensation arrangements with a larger group of "senior management" under Auditing Standard No. 12 in order to obtain an understanding of the company and then (2) perform the procedures under the other repropoed amendments regarding the financial arrangements with a smaller group of "executive officers." As such, the Board is not proposing revisions for these comments.

Using the "Named Executive Officers" ("NEOs") Contained in the Company's Proxy Statement: One commenter stated that the proposed amendments cast a wide net that places unnecessary requirements on auditors and unnecessary costs and burdens on issuers, management, and board members of companies. That commenter suggested narrowing the scope of the auditor's inquiries to NEOs, which consist of five executive officers that are specified in the SEC's rules, and that requiring auditors to perform procedures relating to the more broadly defined universe of "executive officers"

^{66/} See Item 401(b) of Regulation S-K, 17 C.F.R. §229.4-01(b).



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is unnecessary.^{67/} That commenter noted that, in their case, using the executive officers listed in their Form 10-K (pursuant to Rule 3b-7) would triple the amount of work as compared to using the NEOs contained in the company's proxy statement.

The Board considered this comment and observed that the term "senior management" is used in the risk assessment standards and that a review of the compensation arrangements for those "executive officers," as defined in the repropoed amendments, would represent a targeted expansion of work the auditor already considers performing under the existing standards.

The Board considered the commenter's suggestion that the auditor's work be limited to performing procedures for NEOs. However, using the universe of "NEOs," which includes the CEO, CFO, and the three other most highly compensated individuals at an issuer, might not include individuals with direct oversight of the financial reporting process, for example, the chief accounting officer. Additionally, the Board notes that, according to a recent study, the median number of "executive officers" for the S&P 500 is 8 (the mean is 8.71), and the median number of executive officers for the Russell 2000 is 5 (the mean is 6.12).^{68/} Accordingly, the Board is not proposing to incorporate this suggestion into the repropoed amendments. The Board, however, welcomes additional empirical data and other input on this matter.

Performing Procedures after Identifying a Significant Risk: Some commenters were concerned that the proposed amendments could be interpreted by auditors to require that performance-based compensation arrangements with executive officers would need to be substantively audited, rather than assessed for risk of material misstatement. Those commenters noted that the auditor should first determine that a significant risk to the financial statements exists prior to performing extended substantive procedures related to executive compensation arrangements.

The Board considered these comments and noted that the repropoed amendments would better position the auditor to identify and assess risks of material

^{67/} See Item 402(a)(3) of SEC Regulation S-K; 17 C.F.R. §229.4-02(a)(3) and SEC Securities Release Act No. 8732A, *Executive Compensation and Related Person Disclosure* (Aug. 29, 2006).

^{68/} See Study: Benchmarking the Number of "Executive Officers" The Corporate Counsel.net and LogixData (March 2, 2011).



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misstatement, including significant risks, that may be a consequence of the company's financial relationships and transactions with its executive officers. The repropoed amendments would not alter the auditor's responsibility under existing standards for performing substantive auditing procedures.^{69/} The Board is not proposing to make revisions in response to these comments.

Reading Proxy Statements and Other Company Documents: One commenter objected to the proposed requirement that the auditor read the proxy statement as part of the auditor's risk assessment procedures. That commenter questioned the availability of, and relevancy of the information in, the company's proxy statement. The Board considered this comment and, in the Board's view, reading proxy statements that are available to the auditor can provide the auditor with relevant information regarding a company's financial relationships and transactions with its executive officers that may be helpful to informing the auditor's understanding of the company. In addition, the risk assessment standards require that the auditor should consider reading public information about the company, for example, SEC filings.^{70/} Accordingly, the Board is not proposing any revisions in response to these comments.

Addressing Transactions Outside of Executive Compensation: One commenter noted that there are greater areas of exposure related to relationships with executive officers, such as supplier or customer relationships, that outweigh the risk of executive compensation. The Board considered this comment and notes that the repropoed amendments, like the proposed amendments, address all of a company's financial relationships and transactions with its executive officers, which would include supplier and customer relationships.

Inquiring of the Compensation Committee and Consultants: The proposed amendments would require that the auditor should consider inquiring of the compensation committee and its chair and any compensation consultants. One commenter noted that the Board should not require such inquiries, because any required inquiry by the auditors of the compensation committee chairperson would be unnecessarily intrusive and burdensome on the chairperson's time. That commenter further noted that any discussion with consultants seems to be a duplication of efforts. In contrast, other commenters recommended that the standard include a requirement

^{69/} See paragraphs 36-47 of Auditing Standard No. 13.

^{70/} See paragraph 11 of Auditing Standard No. 12.



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for the auditor to 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. Further, other commenters stated that the proposed standard may be too imprecise and recommended that the Board clarify the information auditors should seek from compensation committees and compensation consultants regarding executive compensation arrangements.

The Board considered these comments, noting that the proposed standard was designed to permit the auditor to decide whether to inquire of the compensation committee or any compensation consultants and, if so, the nature and extent of inquiries to make based on the company's facts and circumstances. This flexibility would allow the auditor to avoid potentially unnecessary efforts, while focusing on matters that are important to the audit. Accordingly, the reproposal maintains the same approach taken in the proposal.

Obtaining an Understanding of Policies and Procedures Regarding Executive Officer Expense Reimbursements: Commenters expressed differing opinions regarding the proposed requirement that the auditor consider obtaining an understanding of established policies and procedures regarding executive officer expense reimbursements in paragraph 11 of Auditing Standard No. 12. One commenter recommended that the amendments establish a requirement for the auditor to review the expense reports of executive officers, whether or not it demonstrated a possible risk. Another commenter noted that, while there have been many recent headlines regarding executive officer expense reimbursements, those instances were generally immaterial to the financial statements. That commenter stated that, for this reason, because examining expense reimbursements for executive officers is likely to be time consuming, any expense reimbursement reviews should focus on detecting material misstatement.

The Board considered these comments and determined that the proposed amendments, which would have required that the auditor consider obtaining an understanding of the company's established policies and procedures for executive officer expense reimbursements, would have permitted the auditor to determine whether to perform this risk assessment procedure. Further, obtaining an understanding of the company's policies and procedures would not require the auditor to examine all of a company's executive officer reimbursements. Accordingly, the Board is not proposing to make revisions in this area, but is soliciting comments regarding potential costs relating to its reproposal.



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Coordinating with Other Regulators: One commenter stated, that while the proposed amendments were based upon existing audit standards, it had concerns regarding the possible encroachment of the PCAOB into areas of corporate governance that are within the purview of state corporate law, or under federal legislation, such as the Sarbanes-Oxley Act, or within the jurisdiction of the SEC. That commenter noted that under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the SEC is involved in or expected to propose a series of regulations on executive compensation, including incentive-based compensation in the financial services industry, pay-for-performance disclosures, pay ratio disclosures, and independent compensation committees. That commenter further noted that the proposed incentive-based compensation regulation is a joint rulemaking of several financial regulators and recommended that the PCAOB act within the bounds of its jurisdiction and also coordinate with these regulators to understand how the proposal interacts with expected regulatory changes.

The Board considered this comment and notes that the Board's existing standards already require that the auditor consider performing procedures to obtain an understanding of compensation arrangements with a company's senior management. The repropoed amendments would be an incremental expansion of the auditor's existing requirements and, thus, in the Board's view, represents an appropriate matter for Board standard setting. In addition, before any standard adopted by the Board becomes effective, it is subject to approval by the SEC.

Retaining Existing Requirements: One commenter recommended that the Board reconsider the need for the requirement in paragraph 11 of the proposed amendment to Auditing Standard No. 12 to consider obtaining an understanding of compensation arrangements for senior management other than executive officers. That commenter noted that, should the Board decide to retain the proposed requirement in the final amendment, it would be helpful to understand the reasons why the additional requirement is considered necessary. That commenter also recommended that the Board provide guidance as to the procedures the auditor should perform with respect to senior management other than executive officers, similar to paragraph 10A of the proposed amendments. Further, during the SAG discussion, the point was made that financial arrangements with employees other than executive officers could also result in risks of material misstatement.

The Board considered these comments, noting that the intent of these amendments is to better inform the auditor's risk assessment about possible risks of material misstatement arising from an "executive officer" population that is generally smaller than the senior management population. The intent is not to restrict the



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performance of existing risk assessment procedures that might provide the auditor with additional information regarding possible risks of material misstatement, including fraud risks or other significant risks. As such, the Board is not proposing to revise the existing requirements in Auditing Standard No. 12 for this comment.

Existing Requirements Are Sufficient: One commenter stated that the requirement in existing paragraph 11 of Auditing Standard No. 12 is more appropriate than the proposed amendment because other auditing standards state that the auditor's identification of fraud risks should include the risk of management override of controls.^{71/} Some commenters expressed the view that high-profile audit failures, such as Enron and Worldcom, did not occur because of a failure to understand the incentive compensation arrangements of these companies and recommended that the focus of the amendments should instead be on the control environment of the company.

The Board considered these comments, noting that obtaining an understanding of the company's financial relationships and transactions with its executive officers can assist the auditor in identifying incentives and pressures that might cause management to override controls. This understanding could also inform the auditor how and where management override might be likely to occur. Thus, no revisions have been made for these comments.

B. AU sec. 315, *Communications Between Predecessor and Successor Auditors* (Appendix 3)

Inquiring of a predecessor auditor regarding the company's relationships and transactions with its related parties and its significant unusual transactions can assist the successor auditor in determining whether to accept the engagement. Such inquiries also can benefit the successor auditor in obtaining an understanding of the company's relationships and transactions with its related parties and in identifying significant unusual transactions.

The Proposed Amendments and Existing Requirements

Existing AU sec. 315, *Communications Between Predecessor and Successor Auditors*, provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place but does not

^{71/} See paragraph 69 of Auditing Standard No. 12.



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specifically address a company's relationships or transactions with its related parties or its significant unusual transactions. AU sec. 334 notes that determining the existence of relationships with related parties requires the application of audit procedures that may include inquiring of predecessor auditors concerning their knowledge of existing relationships and the extent of management involvement in material transactions.^{72/}

The proposed amendments to AU sec. 315 would have required the auditor to make inquiry of the predecessor auditor's understanding of the company's relationships and transactions with related parties and significant unusual transactions. The proposed amendments also would have included within the successor auditor's review of the predecessor auditor's working papers any documentation regarding relationships and transactions with related parties and significant unusual transactions.

As more fully described in the following section, after consideration of the comments received, the Board did not substantively revise the other proposed amendments to AU sec. 315.

The Reproposed Amendments

The reproposed amendments would revise AU sec. 315.09 to require that the successor auditor make specific and reasonable inquiries of the predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions. The reproposed amendments also would revise AU sec. 315.11 to include in the successor auditor's review of the predecessor auditor's working papers any documentation regarding related parties and significant unusual transactions.

Significant Comments and Board Responses

The Board received general comments concerning communications between predecessor and successor auditors, but not comments specific to a company's relationships and transactions with related parties or its significant unusual transactions. The Board acknowledges those comments, but believes that the issues raised fall outside the scope of this standard-setting project.

^{72/} See AU sec. 334.07.g. and AU secs. 9334.12-.13.



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C. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (Appendix 3)

Emphasizing the auditor's identification and evaluation of significant unusual transactions could lead to more instances of auditors becoming aware of indications that fraud or another illegal act has or may have occurred.

The Proposed Amendments and Existing Requirements

The proposed amendments would have amended AU sec. 316 by expanding the discussion in the standard regarding certain audit requirements contained in Section 10A of the Exchange Act. The proposed amendments would have emphasized the auditor's responsibility to investigate and disclose possible fraud to management, the audit committee and, upon the satisfaction of certain conditions, the SEC, consistent with the auditor's responsibility under Section 10A of the Exchange Act.

As more fully described in the following section, the Board did not substantively revise the other proposed amendments to AU sec. 316.

The Reproposed Amendments

The other repropoed amendments to AU sec. 316 would add paragraph AU sec. 316.81A, which would state that the auditor has a responsibility, under certain conditions, to disclose possible fraud to the SEC to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change and the fraud or related risk factors constitute a reportable event or are the source of a disagreement, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required pursuant to Section 10A(b) of the Exchange Act of 1934 relating to an illegal act that the auditor concludes, among other things, has a material effect on the financial statements.

The other repropoed amendments would amend AU sec. 316.82 to state that the auditor also may have a duty to disclose the existence of possible fraud to parties outside the entity in the following circumstances: (a) to a successor auditor when the successor makes inquiries in accordance with AU sec. 315, (b) in response to a subpoena, and (c) to a funding agency or other specified agency in accordance with requirements for the audits of companies that receive governmental financial assistance.



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Significant Comments and Board Responses

The Board did not receive comments in this area.

D. AU sec. 333, *Management Representations* (Appendix 3)

Obtaining written management representations regarding the information that management has provided to the auditor can inform the auditor's efforts regarding a company's relationships and transactions with its related parties and a company's significant unusual transactions.

The Proposed Amendments and Existing Requirements

Existing AU sec. 333 requires auditors to obtain written representations from management for the periods covered by the auditor's report. That standard addresses representations covering financial statements; completeness of information; recognition, measurement, and disclosure; and subsequent events. AU sec. 333 currently requires the auditor to obtain a representation regarding the recognition, measurement, and disclosure of related party transactions.

The proposed amendments to AU sec. 333 would have required the auditor to obtain written representations regarding the company's related parties and the absence of side agreements or other arrangements.

As more fully described below, after consideration of the comments received, the Board did not substantively revise the other proposed amendments to AU sec. 333, except to remove a proposed amendment that was considered duplicative.

The Reproposed Amendments

The reproposed amendments to AU sec. 333 would revise AU sec. 333.06 to require that the auditor obtain written representations that management has disclosed to the auditor: (i) the names of all related parties and all relationships and transactions with related parties; (ii) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor; and (iii) that management has made available support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

The reproposed amendments also would revise the illustrative management representation letter in Appendix A of AU sec. 333, consistent with the amendments described above.



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Significant Comments and Board Responses

In developing the repropoed amendments to AU sec. 333, the Board considered all comments received, including the following significant comments:

Necessity for the Proposed Amendments: One commenter stated that the proposed amendments to AU sec. 333: (1) were unnecessary, (2) imply that related party transactions are more important than other information that the auditor must obtain from management, and (3) could result in voluminous management representation letters. The Board considered this comment, noting that obtaining the names of all of the company's related parties and relationships and transactions with related parties is important to the auditor's evaluation of whether a company has properly identified its related parties and relationships and transactions with related parties. Obtaining this information also is important to evaluating whether the company's relationships and transactions with its related parties have been appropriately accounted for and disclosed. Consequently, the Board has maintained the same approach in the reproposal as it did in the proposal.

Duplicative Requirements Regarding Arm's-Length Assertions: Some commenters noted that the proposed amendments to paragraph .06.I. and the addition of paragraph .11A to AU sec. 333 regarding assertions that a related party transaction was conducted on terms equivalent to those prevailing in an arm's-length transaction appeared to be duplicative. These commenters recommended either combining these proposed requirements into a single amendment or eliminating one of the proposed amendments. The Board considered these comments and agreed that the proposed amendments to AU sec. 333.06.I. are sufficient to explain the auditor's responsibilities to obtain a written representation from management regarding an arm's-length assertion included in the financial statements. Accordingly, the representation that would have been required by paragraph .11A has not been included in the reproposal.

E. AU sec. 560, Subsequent Events (Appendix 3)

Events or transactions that occur subsequent to the balance sheet date, but prior to the issuance of the financial statements, may have a material effect on the financial statements. Making specific inquiries during the "subsequent period" regarding a company's relationships and transactions with its related parties and its significant unusual transactions can benefit the auditor's identification of matters that might require disclosure in the financial statements.



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The Proposed Amendments and Existing Requirements

The proposal did not include amendments to AU sec. 560, *Subsequent Events*. That standard requires the auditor to perform auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles.^{73/} Existing AU sec. 560 does not require the auditor to inquire regarding the company's relationships and transactions with its related parties and its significant unusual transactions.

As more fully described below, after consideration of the comment received in this area, the Board is proposing amendments to require inquiries regarding related parties and significant unusual transactions during the "subsequent period."

The Reproposed Amendments

The reproposed amendments would amend AU sec. 560.12 to require that during the "subsequent period" the auditor inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to whether: (1) there have been any changes in the company's related parties or significant new related party transactions and (2) the company has entered into any significant unusual transactions.

Significant Comments and Board Responses

One commenter recommended including a requirement that the auditor inquire of management during the period after the balance-sheet date to assess whether any related party transactions have occurred that may require adjustment or disclosure essential to the fair presentation of the financial statements. The commenter recommended amending AU sec. 560.12.b. to specifically address related party transactions. The Board agrees with this recommendation and, as discussed above, is proposing an amendment because performing this inquiry might benefit investors by improving the auditor's identification of matters that might require disclosure in the financial statements.

^{73/} See AU sec. 560.12.



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F. AU sec. 722, *Interim Financial Information* (Appendix 3)

Obtaining written management representations during a review of interim financial information regarding the information that management has provided to the auditor can inform the auditor's efforts regarding a company's relationships and transactions with its related parties and a company's significant unusual transactions.

The Proposed Amendments and Existing Requirements

Existing AU sec. 722 requires the auditor to inquire of management that has responsibility for financial and accounting matters concerning unusual or complex matters that might have an effect on the interim financial information. The other proposed amendments would have revised AU sec. 722 to be consistent with the proposed amendments to AU sec. 333 and would have required the auditor to obtain written representations each interim period regarding the company's related parties and the absence of side agreements or other arrangements.

As more fully described below, after consideration of the comments received, the Board is reproposing the amendments to AU sec. 722 substantively as proposed.

The Reproposed Amendments

The reproposed amendments to AU sec. 722 would require that the auditor obtain written representations each interim period that management has disclosed to the auditor: (i) the names of all related parties and all relationships and transactions with related parties; (ii) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor; and (iii) that management has made available support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

The Board also is reproposing amendments to the illustrative management representation letter contained in Appendix C of AU sec. 722, consistent with the amendments described above.

Significant Comments and Board Responses

In developing the reproposed amendments to AU sec. 722, the Board considered all comments received, including the following significant comment:

Obtaining the Names of The Company's Related Parties During an Interim Review: One commenter stated that the proposed amendment to AU sec. 722.24.g.



indirectly may imply that the auditor should obtain the names of all related parties and all relationships and transactions with related parties on a quarterly basis. However, that commenter stated that AU sec. 722 contains no corresponding required auditor inquiry of management to obtain such information. That commenter suggested amending AU sec. 722.18.c. to require inquiries of management regarding changes in related parties or significant new related party transactions, noting that the representation in AU sec. 722.24.g. then may focus on management's communication of such changes to the auditor.

The Board considered this comment and noted that the second bullet of AU sec. 722.18.c. states that the auditor ordinarily inquires of members of management who have responsibility for financial and accounting matters concerning unusual or complex situations that may have an effect on interim financial information. Appendix B to AU sec. 722 states that changes in related parties or significant new related party transactions is an example of a situation about which the auditor ordinarily would inquire of management pursuant to AU sec. 722.18.c. Consequently, the Board is not proposing to make revisions for this comment.

G. *AU sec. 9543, Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543*

Existing standards note that determining the existence of relationships with related parties requires the application of audit procedures, which may include inquiring of principal or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions.^{74/}

The Proposed Amendments and Existing Requirements

The proposed amendments to AU sec. 9543 would have revised AU sec. 9543.05 to remove the reference to AU sec. 334 and state that, before issuing his or her report, the other auditor should inquire of the principal auditor as to matters significant to the audit. Those matters would have included relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties. Accordingly, the proposed amendment aligned AU sec. 9543 with the requirements for a principal auditor included in paragraph 10 of the proposed standard.

^{74/} See AU sec. 334.07.g. and AU secs. 9334.12-.13.



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The Reproposed Amendments

The Board is not proposing revisions to AU sec. 9543. After consideration of the comments received, the Board has decided that any substantial revision to AU sec. 9543 should be considered as part of the Board's standard-setting project on AU sec. 543.

Significant Comments and Board Responses

In developing the revisions to the proposed amendment, the Board considered all comments received, including the following significant comments:

Clarifying the Other Auditor's Inquiries: One commenter noted that the Board did not propose amendments to AU secs. 9543.06-.07 and that those paragraphs infer that the inquiry of the principal auditor is based on the other auditor's judgment. Another commenter stated that the Board should clarify that other communications anticipated by AU sec. 9543 with respect to "matters significant to the audit" are those transactions, adjustments, or other matters that have come to the auditor's attention that may require adjustment to or disclosure in the financial statements. As discussed above, any substantive revision to AU sec. 9543 will be done as part of the Board's standard-setting project on AU sec. 543.

Questions:

18. Are the other reproposed amendments appropriate to address risks of material misstatement of the financial statements? Why or why not?
19. Is it sufficiently clear that the auditor (a) should obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment and (b) should not assess the appropriateness of executive officer compensation? Why or why not?
20. Are "executive officers" the appropriate population for the audit procedures designed to provide the auditor with an understanding of the company's financial relationships and transactions as part of its risk assessment process? Why or why not?



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IV. Economic Considerations, Including Audits of Emerging Growth Companies

The Board is considering the repropoed standard and amendments pursuant to its mandate to protect the interest of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The Board designed the repropoed standard and amendments to reduce the risk of material misstatements of financial statements not being detected by the auditor in three critical areas that have been contributing factors in prominent financial reporting frauds over the last few decades, which have resulted in investor losses and lost jobs. The auditor, serving in the role as a gatekeeper in the financial reporting system, should be alert to the possibility that transactions in these areas require heightened scrutiny during the audit process.^{75/} As such, the repropoed standard and amendments are intended to enhance audit quality.

As more fully described in the release and in Sections I. through III. of this Appendix, the Board believes that the repropoed standard and amendments regarding relationships and transactions with related parties, significant unusual transactions, and relationships and transactions with executive officers can improve the auditor's identification of, assessment of and response to the risks of material misstatement of financial statements, which may lead to higher quality accounting and disclosures for investors. Further, the Board's approach anticipates a more meaningful exchange of information between the auditor and a company's audit committee. These improvements have the potential to reduce information asymmetry in these critical areas.^{76/}

Throughout the development of its proposals, the Board has been sensitive to economic considerations, with the goal of adopting new requirements that make its

^{75/} See, e.g., *In the Matter of the Application of Wendy McNeeley, CPA*, SEC AAER No. 3427 at 10-12 (Dec. 13, 2012).

^{76/} Information asymmetry refers to situations involving separate parties in which one party has more, or better, information than the other party. For example, the separation of ownership and control in companies results in information asymmetry between managers and stakeholders. See Jensen, M.C. and Meckling, W.H. 1976. Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics* 3 (4): 305-360.



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auditing standards in these critical areas more effective, while avoiding unnecessary costs. The Board's approach to promoting audit quality features a scaled approach, requiring the auditor to perform basic procedures and then to determine, based on the risks posed by the company's facts and circumstances, whether additional procedures would be necessary.

Underlying the scaled approach is the concept that the procedures performed, and therefore the associated costs, are commensurate with the risks of material misstatement of the financial statements. Under such a scaled approach, the Board would not expect there to be a significant change in costs for the audit of a company that does not have: (1) extensive relationships or transactions with related parties; (2) significant unusual transactions or (3) financial relationships and transactions with the company's executive officers that give rise to risks of material misstatement.

In contrast, a company that has extensive relationships and transactions with related parties or significant unusual transactions, or that has financial relationships and transactions with executive officers that give rise to risks of material misstatement, could anticipate an increase in audit costs. Further, if the auditor identifies related parties or relationships or transactions with related parties that were previously undisclosed to the auditor, there would be incremental costs associated with the auditor's response to the increased risks of material misstatement.

The release and Sections I.-III. of this Appendix discuss how the repropose standard and amendments will result in improved audit quality. This section provides a further discussion of economic considerations, including the need for improvements to existing standards, the Board's approach for promoting audit quality, and how the Board's approach reflects economic considerations. This section also discusses considerations for audits of emerging growth companies ("EGCs"). Following each discussion are lists of specific questions for commenters. Commenters are encouraged not only to respond to those questions but also to provide input on all aspects of the repropose standard and amendments.

A. The Need for Improvements to Existing Standards

As described more fully in the proposing release, several factors collectively indicate a need for improvement to the existing standards.¹⁷⁷ Specifically, the Board

¹⁷⁷ The Board also recognizes that the interim auditing standard for auditing related party relationships and transactions adopted by the Board in 2003 had not been



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developed the proposed standard and amendments in light of the magnitude and number of financial reporting frauds involving companies' relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers.^{78/} The Board's proposal also was informed by observations from the PCAOB's oversight activities, discussions with the SAG, and international developments.

The Board's inspection program has identified deficiencies relating to the auditing of related party transactions, many of which relate to audits of financial statements of smaller public companies that were conducted by smaller audit firms.^{79/} In addition, the

revised since its issuance. The Board's interim standard, AU sec. 334, replaced AU sec. 335, *Related Party Transactions*, which was issued in July 1975. In 1983, AU sec. 334 was amended to remove guidance relating to accounting considerations and disclosure standards for related parties provided in Financial Accounting Standard Board ("FASB") Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, and by making other related technical changes. However, the nature and extent of the auditor's responsibilities and procedures pertaining to related parties in AU sec. 335 was carried over into AU sec. 334. Thus, audit procedures relating to related parties have remained largely unchanged since the issuance of AU sec. 335 in July 1975.

^{78/} The proposing release contains a discussion of prominent cases involving fraudulent financial reporting. In addition, a recent SEC case has supported the need for heightened scrutiny of related party transactions. In a case involving company transactions with its executive officers, the SEC, quoting the D.C. Circuit, stated: "although in an ordinary arms-length transaction, one may assume that parties will act in their own economic interest, this assumption breaks down when the parties are related. A company that would perform a thorough credit-risk assessment before extending a loan might not do so if the loan were to one of its officers or directors." See, *In the Matter of the Application of Wendy McNeeley, CPA*, AAER No. 3427 (Dec. 13, 2012).

^{79/} See *Report On 2007-2010 Inspections Of Domestic Firms That Audit 100 Or Fewer Public Companies*, PCAOB Release No. 2013-001 (Feb. 25, 2013) at 29, available at: http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf, which states, in part:

Inspections staff have observed deficiencies related to firms' failures to test for undisclosed related parties or transactions with undisclosed



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Board took note of the fact that a significant number of the Board's settled disciplinary actions to date have involved auditors' failures to perform sufficient procedures regarding related party transactions, many of which also involved audits of smaller public companies.

As part of its standard-setting process, the Board initially considered whether sufficient improvements could be made through its inspection and enforcement programs, without amending its standards and requirements but concluded that new requirements were appropriate as these critical areas could pose significant risks of material misstatement.^{80/} The Board also concluded that it was appropriate to propose a new standard regarding related parties, rather than amend the existing standard, because of, among other things, the nature and extent of changes necessary to align the existing standard with the risk assessment standards. In contrast, the Board concluded that appropriate improvements in audit quality with respect to a company's significant unusual transactions and financial relationships and transactions with its executive officers could be achieved by amendments to existing standards in those areas.

The Board further noted that in July 2008, the IAASB revised its auditing standard on related parties with the issuance of International Standard on Auditing No.

related parties. Some of those firms failed to identify and address the lack of disclosure of related party transactions in the financial statements. Inspections staff have also identified deficiencies relating to the firms' failure to obtain an understanding of the nature and business purpose of transactions with related parties and to evaluate whether the accounting for those transactions reflects their economic substance.

See also, *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms*, PCAOB Release No. 2007-010 (Oct. 22, 2007) at 7, available at: http://pcaobus.org/Inspections/Documents/2007_10-22_4010_Report.pdf.

^{80/} For example, before deciding to issue its initial proposal, the Board issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010), which discusses a range of auditor practice issues identified by PCAOB staff pertaining to significant unusual transactions.



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550, *Related Parties*.^{81/} The ASB also has revised its auditing standard on related parties with the issuance of AU-C Section 550, *Related Parties*, contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification*, in October 2011.

As described previously, commenters were generally supportive of the Board's efforts to enhance the auditor's identification and evaluation of related party and significant unusual transactions and agreed that improvements to the auditing standards were appropriate. While the proposed changes regarding a company's financial relationships and transactions with its executive officers drew support from a range of commenters, some commenters raised concerns that performing such procedures could have unintended consequences, including impacting the design of compensation arrangements.

As discussed in Section III.A, the Board is proposing revisions to the proposed amendments to Auditing Standard No. 12 to clarify that the auditor's procedures in this area would be performed as part of the auditor's risk assessment process and would not require the auditor to make any determination regarding the reasonableness of the company's compensation arrangements with its executive officers or recommendations regarding such compensation arrangements.

B. The Board's Approach for Promoting Audit Quality

The following discussion contains a general overview of how the improvements in the repropoed standard and amendments are designed to improve the auditor's assessment of and response to the risks of material misstatement, and promote the exercise of professional skepticism and audit quality. These improvements are more fully discussed in the release and Sections I.-III. of this Appendix.

Related Parties

The repropoed standard is designed to address specific risks associated with a company's relationships and transactions with its related parties, including whether the

^{81/} The IAASB emphasized that a new standard was warranted given the public focus on the accounting and auditing of related party relationships and transactions after recent major corporate scandals. See IAASB Exposure Draft, *Related Parties* (Dec. 2005).



company has (1) properly identified its related parties and relationships and transactions with its related parties and (2) properly accounted for and disclosed its relationships and transactions with its related parties in the financial statements. The repropoed standard also includes new requirements regarding the auditor's communications with the audit committee.

The repropoed standard includes specific procedures that would require the auditor, in order to identify and assess the risks of material misstatement, to obtain an understanding of the company's relationships and transactions with its related parties and then evaluate whether the company has properly identified its related parties and relationships and transactions with its related parties.

The repropoed standard has been developed to permit the auditor flexibility in determining the nature, timing, and extent of audit procedures to perform when evaluating whether the company has properly identified its related parties and relationships and transactions with related parties. In addition, this approach contemplates that the auditor's efforts regarding significant unusual transactions can assist in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor.

The repropoed standard also includes basic procedures that would require the auditor to evaluate whether the company has properly accounted for and disclosed its relationships and transactions with its related parties in the financial statements. Those procedures are designed to assist the auditor in identifying potential "red flags" that might indicate a risk of material misstatement.

Notably, research indicates that where fraud does exist, the presence of related parties is one of the top reasons cited for audit failures.^{82/} Research also indicates that 67% of alleged audit deficiencies with respect to related party transactions involved inadequate examination of the transaction.^{83/} Additional research indicates if auditors

^{82/} See Gordon, E.A., Henry, E., Louwers, T.J., and Reed, B.J. 2007. Auditing Related Party Transactions: A Literature Overview and Research Synthesis. *Accounting Horizons* 21 (1): 81-102.

^{83/} See Louwers, T.J., Henry, E., Reed, B.J., and Gordon, E.A. 2008. Deficiencies in Auditing Related-Party Transactions: Insights from AAERs. *Current Issues in Auditing* 2 (2): A10-A16.



increase their sensitivity to fraud risk, they will likely exert more effort.^{84/} Consistent with this research, the repropoed standard is designed to assist auditors in evaluating whether the company's relationships and transactions have been properly accounted for and disclosed in the financial statements.

The repropoed standard also would require the auditor to communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties and other significant matters arising from the audit regarding the company's relationships and transactions with related parties. Improving the auditor's evaluation of a company's accounting and disclosure of its related parties should result in a more meaningful exchange of information between the auditor and the audit committee.

Significant Unusual Transactions

The repropoed amendments would require the auditor to perform specific procedures to identify a company's significant unusual transactions. In contrast, the existing standards only anticipate that the auditor may become aware of such transactions while performing other audit procedures. Once a significant unusual transaction is identified, the repropoed amendments should improve the effectiveness of the auditor's evaluation of that transaction, including whether the business purpose (or the lack thereof) indicates that the transaction was entered into to engage in financial statement fraud or conceal misappropriation of assets.

In addition to assisting in the auditor's evaluation of possible misstatements in a company's financial statements, improving the auditor's evaluation of significant unusual transactions should result in a more meaningful exchange of information between the auditor and the audit committee.

The identification and evaluation of a company's significant unusual transactions also may inform the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with its related parties.

^{84/} See, e.g., Zimbelman, M.F. 1997. The Effects of SAS No. 82 on Auditors' Attention to Fraud Risk Factors and Audit Planning Decisions. *Journal of Accounting Research* 35 (Supplement): 75-97.



Financial Relationships and Transactions with a Company's Executive Officers

The other repropoed amendments would require the auditor to perform procedures to obtain an understanding of the company's relationships and transactions with its executive officers. This understanding could assist the auditor in determining whether there are incentives or pressures for the company's executive officers that might give rise to a fraud risk or other significant risk. The auditor's efforts in obtaining an understanding of the company's financial relationships and transactions with its executive officers also has the potential to identify related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Other Repropoed Amendments to PCAOB Auditing Standards

The requirements in the other repropoed amendments are designed to complement the efforts in the repropoed standard and amendments to improve the auditor's: (1) efforts to address the risks associated with a company's relationships and transactions with its related parties and (2) identification and evaluation of significant unusual transactions. For example, the other repropoed amendments are designed to improve the auditor's identification of significant unusual transactions through improvements to the auditor's: (1) communications with a predecessor auditor, (2) procedures during the "subsequent period," and (3) procedures during interim reviews.

The Board's repropoal provides complementary audit procedures that consider the links and relationships between a company's relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with its executive officers. Clarifying the linkages between these areas can increase the probability of the auditor's uncovering the potential for fraud or error in a company's financial statements – as the auditor is more likely to "connect the dots."

C. How the Board's Approach Reflects Economic Considerations

As discussed above, the Board believes that the repropoed standard and amendments should enhance audit quality in ways that could also enhance the quality of a company's financial reporting. Enhancing the quality of a company's financial reporting could serve to reduce information asymmetry, foster increased public confidence in the financial markets, and potentially enhance capital formation and the efficiency of capital allocation decisions.

The repropoed standard and amendments are intended to raise the minimum threshold across audit firms for audit procedures. Improving consistency across audit



firms could level the playing field in terms of the probability of uncovering events that could impact investors, such as misstatements due to fraud or errors arising from non-arm's length transactions or significant unusual transactions. Similarly, raising the minimum threshold for audit procedures could lead to an increase in the perceived value of the auditor's assurances regarding a company's disclosures and accounting, which could have a positive impact on the efficient allocation of capital.

The auditor's increased focus on these critical areas could lead companies to improve their disclosures of such transactions. Incrementally increasing the transparency of relevant disclosures could reduce information asymmetry.^{85/} To the extent that the repropose standard and amendments are viewed by the market as a step towards increasing the transparency of these areas and/or lowering the probability of fraudulent financial reporting, this could reduce the cost of capital for issuers.^{86/}

Enhancements to audit committee communications anticipated by the repropose standard and amendments also may reduce information asymmetry and potentially enhance corporate governance mechanisms to improve company financial reporting and the quality of information available to the markets. Research has indicated that improving the quality of financial reporting can reduce investors' uncertainty about the information being provided in companies' financial reports, and thus increase efficiency in capital allocation and foster capital formation.^{87/}

^{85/} See Lambert, R.A., Leuz, C., and Verrecchia, R.E. 2012. Information asymmetry, information precision, and the cost of capital. *Review of Finance* 16 (1): 1-29.

^{86/} If the repropose standard and amendments are successful at "shedding light" on these disclosures, it could reduce the level of information asymmetry. Information asymmetry has been linked to increased costs of capital (See e.g., Easley, D., and O'hara, M. 2004. Information and the Cost of Capital. *The Journal of Finance* 59 (4): 1553-1583.

^{87/} An increased level and/or quality of financial disclosures has been found to decrease the cost of equity (See Botosan, C., and M. Plumlee. 2002. A Re-examination of Disclosure Level and the Expected Cost of Equity Capital. *Journal of Accounting Research* 40 (1): 21-40.), decrease the cost of debt (See Sengupta, P. 1998. Corporate Disclosure Quality and the Cost of Debt. *The Accounting Review* 73 (4): 459-474.) and decrease bid-ask spreads (See Welker, M. 1995. Disclosure Policy,



While the repropoed standard and amendments are designed to improve audit quality in critical areas that could pose significant risks of material misstatement, the Board recognizes that transactions with related parties are also used for legitimate purposes, including the efficient procurement of necessary resources.^{88/} To the extent that potential costs stemming from the repropoed standard and amendments increase audit costs related to transactions with related parties, this could conceivably serve as a deterrent against their use. This unintended consequence could adversely affect the competitiveness of companies that rely on transactions with related parties during their normal course of operations.

The Board recognizes that its proposals to enhance and update its existing auditing procedures involve new requirements that will impose costs. Being sensitive to the potential burden imposed by such costs, the Board developed an approach for improving audit quality in these three critical areas that encourages the efficient and effective implementation of its standards.

To the extent that the Board received comments on issues relating to costs in the context of its proposal, such comments were not uniform. For example, while one commenter criticized the Board for the lack of a specific economic analysis that could help commenters ascertain what additional burdens would be placed upon businesses and auditors as a result of the proposed standard and amendments, another commenter stated that they did not expect that the more specific requirements of the Board's proposed amendments regarding a company's financial relationships and transactions with its executive officers would result in a meaningful increase in audit costs.

As described above, the Board has attempted to be responsive in its repropoal to comments regarding audit effort (and resulting costs) by seeking to further align its repropoal with its existing risk assessment framework, by describing the differences between existing requirements and its proposals, and by considering revisions that would provide the auditor with more flexibility in appropriate situations.

Information Asymmetry and Liquidity in Equity Markets. *Contemporary Accounting Research* 11 (2): 801 – 827.).

^{88/} See Gordon, E.A., Henry, E., and Palia, D. 2004. Related party transactions and corporate governance. *Advances in Financial Economics* 9: 1-27.



The Board received a number of comments regarding the potential costs that could arise from the proposed amendments regarding a company's financial relationships and transactions with its executive officers. As discussed in Section III.A. of this Appendix, in response to comments, the Board has revised its proposal to clarify its expectations that these new audit procedures are performed as part of the auditor's risk assessment process.

The following paragraphs describe the Board's considerations to date, including how the application of the Board's approach was revised, based on the comments received:

Alignment with the Risk Assessment Standards: The foundational requirements in the risk assessment standards cover the entire audit process, and focus the auditor's attention on considering the risks of material misstatement, whether due to error or fraud. Aligning the proposal with these requirements could promote audit quality by maintaining the auditor's focus, in connection with the audit procedures required by the repropoed standard, on risks of material misstatement. In the Board's view, this approach also should provide for the integration of audit effort, where appropriate, to achieve a more effective and cohesive audit. In response to comments received, the Board made revisions to clarify the relationship of the repropoed standard to the risk assessment standards.

Linkages with Other Standards: The auditor's efforts regarding a company's relationships and transactions with its related parties, its significant unusual transactions, and its financial relationships and transactions with its executive officers are complementary to one another and offer opportunities for the proposed standard and amendments to be implemented in an efficient manner. For example, the auditor's work on identifying and evaluating significant unusual transactions might assist the auditor in identifying related party transactions that management had not previously disclosed to the auditor.

Use of Existing Concepts and Procedures: Retaining existing auditing concepts and procedures in the proposed standard and amendments, to the extent appropriate, permits audit firms to build on their existing methodologies. This could minimize the incremental costs of implementing the repropoed standard and amendments. For example, Appendix A of the repropoed standard includes examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Many of the examples contained in Appendix A are in the existing standard, AU sec. 334.



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Opportunity for Scalability: The proposals employ a scaled approach, requiring basic procedures that are supplemented, as needed, by more in-depth procedures commensurate with the risks posed by the company's facts and circumstances. Such facts and circumstances may include the size or complexity of the transaction, the nature of the company's relationships or transactions with its related parties, and the related risk of material misstatements in the financial statements. For example, the improvements in the repropoed standard are designed for the auditor to perform specific procedures regarding related party transactions that require disclosure in the financial statements, rather than requiring the auditor to presume related party transactions are fraud risks in all cases, an approach that could result in unnecessary audit effort and costs.

Further, the Board revised its proposal in response to comments requesting the additional use of auditor judgment to avoid unnecessary costs. For example, the Board removed the proposed requirement that the auditor always treat each related party transaction previously undisclosed by management to the auditor as a significant risk, which would have triggered additional audit work in all cases.

Focus on Executive Officers: As proposed, the auditor's consideration of a company's financial relationships and transactions with its executive officers does not require the auditor to perform procedures relating to all members of a company's senior management, but, rather, generally focuses the auditor's attention on a smaller group who are more likely to be in a position to influence the company's accounting and financial statements or conceal misappropriation of assets.

As repropoed, the amendments regarding the auditor's consideration of a company's financial relationships and transactions with its executive officers has been clarified to explicitly provide that the procedures regarding a company's financial relationships and transactions with its executive officers are performed as part of the auditor's risk assessment process. The repropoed amendments would not require the auditor to make any determination regarding the appropriateness or reasonableness of the company's compensation arrangements with its executive officers or recommendations regarding such compensation arrangements.

Notwithstanding the efforts the Board has made to tailor the repropoed standard and amendments to achieve audit efficiencies and provide for a more cohesive and effective audit effort, the Board recognizes that its proposals to enhance and update its existing auditing procedures involve new requirements that will impose costs.



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To further inform its considerations, the Board is seeking comment regarding economic considerations that should be taken into account when considering its reproposal, including seeking comment and empirical data regarding costs. As noted above, the Board anticipates that there will be some costs imposed by the reproposed standard and amendments, and that anticipated costs could include costs to audit firms, audit costs, and costs to companies. For example, audit firms will need to incur costs to update their audit methodologies to reflect the new requirements and conduct initial training of their personnel on the new requirements.

Audit fees also may increase due to the new auditor performance requirements in the Board's reproposal. Likewise, companies may need to incur additional expenses as, for example, audit committees may incur additional time and expense resulting from the new audit committee communication requirements for related party transactions, and management and others within the company might spend more time responding to inquiries by the auditor. Although the Board's reproposal builds on, and works in concert with, the approach taken in Auditing Standard No. 16, companies may need additional time or resources to conduct the new audit committee communications regarding related parties.

In addition to information and data involving costs, generally, the Board also is interested in receiving comments focusing on issues related to smaller companies and smaller audit firms. The benefits to audit quality that should result from the strengthening of auditor performance requirements for related party transactions, significant unusual transactions, and relationships and transactions with a company's executive officers, should accrue to companies of various types and natures, but they may have a differential impact on smaller companies and smaller audit firms.

For example, the Board notes that smaller companies may engage in more related party transactions, as was generally asserted by one commenter. In addition, as noted above, the Board's oversight activities in inspections and enforcement have revealed auditor failures to perform sufficient procedures regarding related party transactions, with most of these deficiencies involving smaller audit firms. Thus, smaller audit firms and their clients may incur costs to improve their existing audit approach regarding a company's relationships and transactions with its related parties. On the other hand, those firms and their clients may benefit from greater improvements in audit quality through the requirements contained in the reproposed standard and amendments. Smaller audit firms also may pass on additional costs to smaller companies in the form of increased audit fees.



The Board specifically requests commenters' views regarding the various economic considerations discussed above and is particularly interested in obtaining empirical data regarding both benefits and costs and other effects that may be related to the repropose standard and amendments. The Board also requests comments on the questions outlined below.

Questions:

21. Would improving the auditor's understanding of a company's relationships and transactions with its related parties assist the auditor in obtaining sufficient appropriate evidence necessary to support the audit opinion? Would improving the auditor's understanding promote the exercise of professional skepticism? Would improving the auditor's understanding increase the likelihood of the auditor identifying material misstatements? Are there additional benefits that the Board should consider?
22. Could the required communications with audit committees in the repropose standard result in improvements to audit committees' abilities to fulfill their duties?
23. Could the improved communications between the audit committee and the auditor lead to an improvement in the company's financial statement disclosures about its relationships and transactions with its related parties?
24. Would improving the auditor's identification and evaluation of significant unusual transactions increase the likelihood of the auditor identifying potential misstatements, including misstatements due to fraud? Would improving the auditor's identification and evaluation of significant unusual transactions promote the exercise of professional skepticism by the auditor? Are there additional benefits that the Board should consider?
25. Could the repropose amendments regarding significant unusual transactions lead to an improvement in the company's disclosures about its significant unusual transactions?
26. What benefits are associated with auditors obtaining an understanding of a company's financial relationships and transactions with its executive officers as part of its risk assessment? Are there additional benefits that the Board should consider?



27. What benefits are associated with the other repropoed amendments?
28. What costs will audit firms incur when implementing the repropoed standard and amendments? Please discuss both initial costs and recurring costs.
29. What costs will companies incur as a result of the implementation of the repropoed standard and amendments?
30. Could the repropoed standard and amendments lead to other changes in behavior by the auditor, the company, or the audit committee that the Board should consider?
31. Are there considerations relating to smaller companies that the Board should be aware of in considering its repropoal? Do smaller companies share the same risks of material misstatement of the financial statements regarding related party transactions and significant unusual transactions as the broader issuer population? Are related party transactions more common in smaller companies than the broader issuer population? Would the repropoed standard and amendments result in smaller companies experiencing unnecessarily greater or disproportionate costs compared to those experienced by larger companies? If so, how could such costs be controlled while improving audit quality?
32. Are there any unique considerations regarding costs for audits of brokers and dealers?
33. Are there unique considerations regarding costs for specific types of companies based on characteristics other than size of the transaction (e.g., industry)?
34. Are there additional considerations relating to competition, efficiency, and capital formation that the Board should take into account with respect to the repropoed standard and amendments? Specifically, are there benefits in lowered cost of capital from confidence in audits of issuers with related party disclosures?

D. Considerations For Audits of Emerging Growth Companies

Pursuant to Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act"), any rules adopted by the Board subsequent to April 5, 2012, do not apply to the



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audits of EGCs (as defined in Section 3(a)(80) of the Exchange Act) unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."^{89/}

The Board's proposal was issued for comment prior to the enactment of the JOBS Act. The Board is reproposing the standard and amendments, in part, to obtain commenters' views regarding the applicability of its reproposal to audits of EGCs. As a result of the JOBS Act, the Board expects to provide information to assist the SEC in its determination regarding whether to apply the reproposed standard and amendments to audits of EGCs.

The Board is thus requesting that commenters provide any views or empirical data that will assist the PCAOB in providing information to the SEC regarding whether the reproposed standard and amendments should be applicable to audits of EGCs. The Board specifically requests comments, including empirical data, regarding the impact of the reproposed standard and amendments on investor protection, and whether the application of the reproposed standard and amendments would promote efficiency, competition, and capital formation. The Board also specifically requests comments that include empirical data regarding costs that are specific to the application of the reproposed standard and amendments to audits of EGCs. Specific questions are also set forth below.

The PCAOB has begun to monitor implementation of the JOBS Act in order to understand the characteristics of EGCs^{90/} and inform the Board's considerations

^{89/} Pub. L. No. 112-106 (April 5, 2012). See Section 103(a)(3)(C) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. §7213(a)(3)), as added by Section 104 of the JOBS Act.

^{90/} Pursuant to the JOBS Act, an "emerging growth company" is defined in Section 3(a)(80) of the Exchange Act. In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than \$1 billion during its most recently completed fiscal year (and its first sale of common equity securities pursuant to an effective Securities Act registration statement did not occur on or before December 8, 2011). See JOBS Act Section 101(a), (b), and (d). Once an issuer is an EGC, the entity retains its EGC status until the earliest of: (i) the first year after it has total annual gross revenue of \$1 billion or more (as indexed for inflation every five years by the SEC); (ii) the end of the fiscal year after the fifth anniversary of its first sale of common equity



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regarding whether it should request that the SEC apply the standard and amendments to audits of EGCs. To assist commenters, the Board is providing the following information regarding EGCs that it has compiled from public sources.^{91/}

Characteristics of Self-Identified EGCs

As of November 15, 2012, based on the PCAOB's research, 579 SEC registrants have identified themselves as EGCs in SEC filings.

These entities operate in diverse industries. The five most common Standard Industrial Classification (SIC) codes applicable to these entities are: blank check companies; pharmaceutical preparations; prepackaged software services; real estate investment trusts; and computer processing/data preparations services.

A majority of the entities that have identified themselves as EGCs have begun reporting information under the securities laws, whether under the Securities Act or Exchange Act, since 2012. Of these entities, approximately:

- 36% identified themselves in registration statements and were not previously reporting under the Exchange Act.
- 47% of entities that have identified themselves as EGCs began reporting under the Exchange Act in 2012.

securities under an effective Securities Act registration statement; (iii) the date on which the company issues more than \$1 billion in non-convertible debt during the prior three year period; or (iv) the date on which it is deemed to be a "large accelerated filer" under the Exchange Act (generally, an entity that has been public for at least one year and has an equity float of at least \$700 million).

^{91/} To obtain data regarding EGCs, the PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and November 15, 2012, for disclosures by entities related to their EGC status. Only those entities that have voluntarily disclosed their EGC status have been identified. The PCAOB has not validated these entities' self-identification as EGCs. The information presented also does not include data for entities that have filed confidential registration statements and have not subsequently made a public filing. The PCAOB intends to update this information semi-annually.



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- 17% of these entities have been reporting under the Exchange Act since 2011 or earlier.

Approximately 20% of these entities have securities listed on a U.S. national securities exchange as of November 15, 2012.

Audited financial statements were available for nearly all of the entities that have identified themselves as EGCs. For those entities for which audited financial statements were available, based on information included in the most recent audited financial statements filed as of November 15, 2012:

- The reported assets for those entities ranged from zero to approximately \$13 billion. The average and median reported assets of the entities were approximately \$122.1 million and approximately \$0.2 million, respectively.^{92/}
- The reported revenue for these entities, ranged from zero to approximately \$973.7 million. The average and median reported revenue of these entities was approximately \$53.7 million and zero, respectively.
- The average and median reported assets among these entities that reported revenue greater than zero was approximately \$257.3 million and \$42.9 million. The average and median reported revenue among these entities that reported revenue greater than zero was approximately \$109.1 million and \$16.5 million.

^{92/} For purposes of comparison, the PCAOB compared the data compiled with respect to the 579 entities with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The Russell 3000 was chosen for comparative purposes because it is intended to measure the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market (as marketed on the Russell website). The average and median reported assets of issuers in the Russell 3000 was approximately \$11.4 billion and approximately \$1.4 billion, respectively. The average and median reported revenue from the most recent audited financial statements filed as of November 15, 2012 of issuers in the Russell 3000 was approximately \$4.6 billion and \$705.5 million, respectively.



- Approximately 52% of the entities that filed audited financial statements identified themselves as "development stage entities" in their financial statements.^{93/}
- Approximately 31% were audited by firms that are annually inspected by the PCAOB (i.e., firms that have issued audit reports for more than 100 public company audit clients in a given year). Approximately 69% were audited by triennially inspected firms (i.e., firms that have issued audit reports for 100 or fewer public company audit clients in a given year).

Special Considerations Relating to Smaller Companies that are EGCs. Based on the data outlined above, EGCs generally appear to be smaller public companies. As noted above, based on the PCAOB's oversight findings, enhanced auditor consideration of related party transactions may be of particular benefit to smaller audit firms. As previously discussed, the Board's inspection program has identified deficiencies relating to the auditing of related party transactions, particularly with respect to smaller audit firms. Further, a significant number of the Board's settled disciplinary actions to date, many of which involved audits of smaller public companies, have involved auditors' failures to perform sufficient procedures regarding identified related party transactions and transactions with related parties previously undisclosed to the auditor.

Under the scaled approach of the repropoed standard and amendments, required audit procedures would vary based on each EGC's facts and circumstances. For EGCs without extensive related party relationships or transactions, the repropoed standard and amendments should not result in a significant change in audit costs. But, EGCs with extensive related party relationships or transactions would see a cost increase. The Board is sensitive to the disproportionate effects additional audit costs may have on smaller companies.

The Board also has taken note of the potential for a differential effect of its repropoal on small companies, including EGCs. Based on the Board's ongoing, but

^{93/} According to FASB guidance, development stage entities are entities devoting substantially all of their efforts to establishing a new business and for which either of the following conditions exists: (a) planned principal operations have not commenced or (b) planned principal operations have commenced, but there has been no significant revenue from operations. See FASB Accounting Standards Codification, Subtopic 915-10, Development Stage Entities – Overall.



preliminary, analysis of EGC data, EGCs generally appear to be companies that are relatively new to the SEC reporting process. There is likely less information available to investors regarding such companies (e.g., they may have fewer audited results, fewer analysts follow them, and less press coverage).

The staff has reviewed the financial statements of certain companies that have identified themselves as EGCs and noted a significant percentage of EGCs disclose related party transactions.^{94/}

To the extent that the repropoed standard and amendments result in increased disclosure of relationships or transactions with related parties or significant unusual transactions, this information may be incrementally more valuable to both EGCs and investors in EGCs because the decrease in information asymmetry for such companies would be incrementally larger relative to other operating companies.

Further, improved disclosure of an EGC's relationships and transactions with its related parties, when entering public capital markets, could increase investor confidence in the reliability of the financial statements and, therefore, the supply of capital. Conversely, the additional audit related costs may deter certain EGCs from entering public markets, if those costs weigh heavily on their potential profitability.

To the extent that the market perceives adoption of the standard and amendments as a step towards lowering the probability of fraudulent financial reporting, exempting EGCs from the repropoed standard and amendments may put them at a competitive disadvantage as they would not derive this and the other benefits outlined above.

The Board specifically requests commenters' views regarding the various economic considerations discussed above, and is particularly interested in obtaining empirical data regarding benefits and costs and other effects that may result from the

^{94/} As previously noted, the PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012 and November 15, 2012 for disclosures by entities related to their EGC status. An analysis of 450 audited financial statements from the self-identified sample of EGCs indicates that 54 percent of the EGCs disclosed at least one related party transaction.



reproposed standard and amendments. The Board also requests comments on the questions outlined below.

Questions:

35. Should the reproposed standard and amendments be applicable for audits of EGCs? Why or why not? Please provide empirical data, examples and explanations for why the requirements should or should not be applicable for audits of EGCs.
36. Are related party transactions or significant unusual transactions more common at EGCs than the broader issuer population? Do financial relationships and transactions with executive officers at EGCs give rise to increased risks of material misstatements than the broader issuer population? Please provide any data you have to support your views.
37. Are there other characteristics of EGCs (e.g., the size of the company and the length of time it has been a reporting company) that the Board should consider?
38. Would EGCs benefit more or less from the reproposed standard and amendments than other companies? Would inherently riskier EGCs receive benefits relative to other EGCs because the market cannot observe certain undisclosed related party risks that the new standards would otherwise make available through better compliance by management with its disclosure obligations?
39. What costs would firms incur when implementing the reproposed standard and amendments for audits of EGCs? How will those costs differ from the costs for the larger issuer population? Which of the costs are initial or recurring or both?
40. Are there particular costs, benefits, or burdens applicable to EGCs that the Board should consider when determining whether to recommend to the Commission the application of the reproposed standard and amendments to audits of EGCs? For example, do EGCs share the same risk of material misstatement of the financial statements as the broader issuer population due to relationships and transactions with related parties?
41. Regardless of the applicability of the reproposed standard and amendments to audits of EGCs, would an audit firm perform the same



procedures for an audit of an EGC and an audit of a non-EGC to ensure a consistency in the training, methodology, and tools in their audit practice or to respond to risks of material misstatement with similar approaches?

42. Would the implementation and training costs that a firm would incur be dependent upon whether the standard is applicable to EGCs? Would such costs generally be fixed once required to be implemented, regardless of whether the standard is applicable to audits of EGCs?
43. For auditors of both EGCs and other SEC registrants, would it be more costly to not apply the repropoed standard and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?
44. Are there any other considerations relating to competition, efficiency, and capital formation that the Board should take into account when determining whether to recommend to the Commission the application of the repropoed standard and amendments to audits of EGCs?

V. Audits of Brokers and Dealers

As described in Section V. of the release, the Dodd-Frank Wall Street Reform and Consumer Protection Act gave the Board explicit oversight authority over audits of brokers and dealers that are required under SEC rules. In the event that the SEC directs that audits of brokers and dealers be conducted in accordance with PCAOB standards, the repropoed standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to such audits.

The Board requested comments from auditors of brokers and dealers and others on the proposed standard and amendments. Several commenters generally stated that the proposed standard and amendments are appropriate for audits of brokers and dealers.

Related Party Transactions at Brokers and Dealers: At the SAG discussion the point was raised that a robust auditing standard on related parties was important for both regulators of brokers and dealers and users of their financial statements. Several scenarios were discussed by which related party transactions might be improperly used by brokers and dealers, including to: overpay for goods or services and disguise capital withdrawals; avoid the imposition of higher capital requirements and various capital



charges; structure a broker's or dealer's business model to appear smaller; and transfer customer assets to parties that are not approved custodians.

Providing Exceptions for Audit Committee Communications: One commenter noted that many non-issuer securities broker-dealers may have no financial oversight or functional governance bodies other than the owner-managers, making audit committee communication of no practical benefit. That commenter recommended providing exceptions in these cases. The Board considered this comment and noted that the definition of "audit committee," including for audits of brokers and dealers, was established by Auditing Standard No. 16 and is not being amended by the new proposed auditing standard or the other repropoed amendments.^{95/} As discussed in the adopting release for Auditing Standard No. 16, this definition should allow the auditor to identify the appropriate persons within brokers and dealers to receive such communications. The proposed standard therefore has not been revised for this comment.

Questions:

45. Are the repropoed standard and repropoed amendments appropriate for audits of brokers and dealers? Why or why not?
46. Are there additional procedures specific to audits of brokers and dealers that should be included in the repropoed standard and repropoed amendments?
47. Should auditors of brokers and dealers be required to evaluate whether a broker's or dealer's relationships and transactions with its related parties impact that broker's or dealer's compliance with its regulatory requirements? Why or why not?
48. Should the auditor's communications to audit committees included in the repropoed 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.

^{95/} See earlier discussion of paragraph 19 of the repropoed standard in Section I.H. of this Appendix.



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VI. Effective Date

The Board anticipates that the repropoed standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2013. In developing the effective date, the Board considered the comments received regarding the anticipated effective date of the Board's proposal. The Board seeks comment regarding whether the anticipated effective date would allow sufficient time for PCAOB registered firms to incorporate the new requirements into their methodology, guidance and audit programs, and to provide training for staff.

Questions:

49. Is the Board's anticipated effective date appropriate? Why or why not?
50. Does the new proposed effective date allow sufficient time for firms to incorporate the new requirements into their methodology, guidance and audit programs, and training for staff? Why or why not?



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APPENDIX 5 – Comparison of the Objectives and Requirements of the Reproposed Standard and Amendments with the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

The Board is reproposing a new auditing standard, *Related Parties* (the "reproposed standard"); amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "reproposed amendments regarding significant unusual transactions"); and other amendments to PCAOB auditing standards (the "other reproposed amendments").^{1/} This Appendix discusses the reproposed standard in Appendix 1, the reproposed amendments regarding significant unusual transactions, in Appendix 2, and the other reproposed amendments in Appendix 3.

This appendix compares certain significant differences between the objectives and certain key requirements of the reproposed standard and amendments with the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA").

The analogous standards of the IAASB discussed in this comparison include:

- International Standard on Auditing 550, *Related Parties* ("ISA 550");
- International Standard on Auditing 210, *Agreeing the Terms of Audit Engagements* ("ISA 210");
- International Standard on Auditing 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* ("ISA 240");
- International Standard on Auditing 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* ("ISA 315");
- International Standard on Auditing 510, *Initial Audit Engagements-Opening Balances* ("ISA 510");
- International Standard on Auditing 560, *Subsequent Events* ("ISA 560");

^{1/} The reproposed amendments regarding significant unusual transactions and the other reproposed amendments are collectively referred to as the "reproposed amendments." The reproposed standard and reproposed amendments are collectively referred to as the "reproposed standard and amendments" or the "reproposal."



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- International Standard on Auditing 580, *Written Representations* ("ISA 580");
- International Standard on Auditing 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* ("ISA 600"); and
- International Standard on Review Engagements 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*, ("ISRE 2410").

The analogous standards of the ASB discussed in this comparison include:

- AU-C Section 550, *Related Parties* ("AU-C Section 550");
- AU-C Section 210, *Terms of Audit Engagements* ("AU-C Section 210");
- AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit* ("AU-C Section 240");
- AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* ("AU-C Section 315");
- AU-C Section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements* ("AU-C Section 510");
- AU-C Section 560, *Subsequent Events* ("AU-C Section 560");
- AU-C Section 580, *Written Representations* ("AU-C Section 580");
- AU-C Section 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* ("AU-C Section 600"); and
- AU-C Section 930, *Interim Financial Information* ("AU-C Section 930").^{2/}

This comparison is organized in the following sections: (I.) the repropoed auditing standard, (II.) the repropoed amendments regarding significant unusual transactions, and (III.) the other repropoed amendments to PCAOB auditing

^{2/} These AU-C Sections are contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification* ("SAS No. 122"). In October 2011, the ASB adopted SAS No. 122, which contains 39 clarified SASs with "AU-C" section numbers for each clarified SAS. The "AU-C" is a temporary identifier to avoid confusion with references to existing "AU" sections in AICPA Professional Standards. See <https://www.aicpa.org/interestareas/frc/auditattest/pages/improvingclarityasbstandards.aspx>.



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standards.^{3/} This comparison does not cover the application and explanatory material in the analogous standards of the IAASB or ASB.^{4/}

This appendix is provided for informational purposes only. It is not a summary of or substitute for the repropoed standard in Appendix 1 or the repropoed amendments in Appendices 2 and 3 of this release. This comparison may not represent the views of the IAASB or the ASB regarding the interpretations of their standards.

I. Repropoed Auditing Standard, *Related Parties* (Appendix 1)

A. Introduction (Paragraph 1 of the Repropoed Standard in Appendix 1)

PCAOB

The repropoed standard would refer auditors to the requirements of the U.S. Securities and Exchange Commission ("SEC") for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties", and the financial statement disclosure requirements with respect to related parties. The repropoed standard would not include definitions that might represent accounting guidance, including a definition for an arm's-length transaction.

IAASB

^{3/} This comparison does not cover the foundational requirements contained in the risk assessment standards. Appendix 11 of PCAOB Release No. 2010-004, *Auditing Standards Related to Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, contains a comparison of the objectives and requirements of those standards with the analogous standards of the IAASB and the ASB.

^{4/} Paragraph A59 of International Standard on Auditing 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, states that the Application and Other Explanatory Material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section."



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Paragraph 10(b) of ISA 550 defines a related party as a party that is either:

- i. A related party as defined in the applicable financial reporting framework;
or
- ii. Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - c. Another entity that is under common control with the reporting entity through having:
 - (i) Common controlling ownership;
 - (ii) Owners who are close family members; or
 - (iii) Common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

ISA 550 also defines an arm's-length transaction as a transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

ASB

AU-C Section 550 defines a related party as a related party as defined in generally accepted accounting principles. AU-C Section 550 also contains a definition of arm's-length transaction that is similar to the definition in ISA 550.

B. Objective (Paragraph 2 of the Reproposed Standard in Appendix 1)



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PCAOB

Paragraph 2 of the repropoed standard would state that the auditor's objective is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

IAASB

Paragraph 9 of ISA 550 states that the objectives of the auditor are:

- (a) Irrespective of whether the applicable financial reporting framework establishes related party requirements to obtain an understanding of related party relationships and transactions sufficient to be able:
 - i. To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
 - ii. To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:
 - a. Achieve fair presentation (for fair presentation frameworks); or
 - b. Are not misleading (for compliance frameworks); and
- (b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

ASB

AU-C Section 550 contains a similar objective to the objective in ISA 550 for fair presentation frameworks.



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C. Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 – 9 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 3 of the reproposed standard would require that the auditor 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 in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Paragraph 3 of the reproposed standard also would state that the procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company's process (paragraph 4);
- b. Performing inquiries (paragraphs 5-7); and
- c. Communicating with the audit engagement team and other auditors (paragraphs 8-9).

A note to paragraph 3 of the reproposed standard would state that 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.

Another note to paragraph 3 of the reproposed standard would state that performing the risk assessment procedures described in paragraphs 4-9 of the reproposed 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 related parties and relationships and transactions with related parties.

IAASB

Paragraph 11 of ISA 550 states that as part of the risk assessment procedures and related activities required by ISA 315 and ISA 240, the auditor shall perform the audit procedures and related activities set out in paragraphs 12-17 of ISA 550 to obtain



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information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Obtaining an Understanding of the Company's Process (Paragraph 4 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 4 of the reproposed standard would require that in conjunction with obtaining an understanding of internal control over financial reporting, the auditor obtain an understanding of the company's process for:

- a. Identifying related parties and relationships and transactions with related parties;
- b. Authorizing and approving transactions with related parties; and
- c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

IAASB

Paragraph 13 of ISA 550 requires that the auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to:

- a. Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
- b. Authorize and approve significant transactions and arrangements with related parties; and
- c. Authorize and approve significant transactions and arrangements outside the normal course of business.



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ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Performing Inquiries (Paragraphs 5 – 7 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 5 of the repropoed standard would require the auditor to inquire of management regarding:

- a. The names of the company's related parties during the period under audit, including changes from the prior period;
- b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);
- c. The nature of any relationships, including ownership structure, between the company and its related parties;
- d. The transactions entered into, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;
- e. The business purpose for entering into a transaction with a related party versus an unrelated party;
- f. 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; and
- g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

Paragraph 6 of the repropoed standard would require the auditor to inquire of others within the company regarding their knowledge of the matters in paragraph 5 of the repropoed standard. Paragraph 6 also would require the auditor to identify others within the company to whom inquiries should be directed, and determine the extent of



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such inquires, by considering whether such individuals are likely to have knowledge regarding:

- a. The company's related parties or relationships or transactions with related parties;
- b. The company's controls over relationships or transactions with related parties; and
- c. The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Paragraph 7 of the repropoed standard would require the auditor to inquire of the audit committee, or its chair, regarding:

- a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
- b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties, and, if so, the substance of those concerns.

IAASB

Paragraph 13 of ISA 550 requires the auditor to inquire of management regarding:

- a. The identity of the entity's related parties, including changes from the prior period;
- b. The nature of the relationships between the entity and these related parties; and
- c. Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.



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D. Identifying and Assessing Risks of Material Misstatement (Paragraph 10 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 10 of the reproposed standard would align with the existing requirements for the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 10 also would state that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties or relationships or transactions with related parties. Paragraph 59 of Auditing Standard No. 12 requires that the auditor identify which risks are significant risks. Further, paragraph 71 of Auditing Standard No. 12 provides factors that the auditor should evaluate in determining which risks are significant risks. Those factors include: (1) whether the risk involves significant transactions with related parties, (2) whether the risk involves significant transactions that are outside the normal course of business and (3) whether the risk is a fraud risk. The reproposed amendments regarding significant unusual transactions to AU sec. 316.85A.2 would state that a related party transaction that is also a significant unusual transaction (e.g., a significant related party transaction outside the normal course of business) is an example of a fraud risk factor.

A note to paragraph 10 of the reproposed standard would state that in identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4-9 of the proposed standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

IAASB and ASB

ISA 550 and AU-C Section 550 require that the auditor identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. ISA 550 and AU-C Section 550 require the auditor to treat identified significant related party transactions outside the normal course of business as giving rise to significant risks.



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E. Responding to the Risks of Material Misstatement (Paragraphs 11-13 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 11 of the repropoed standard would align with existing requirements that the auditor design and implement audit responses that address the identified and assessed risks of material misstatement. Paragraph 11 of the repropoed standard also would state that this includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.

A note to paragraph 11 of the repropoed standard would state that the auditor should look to the requirements of AU secs. 316.66-.67A for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). That note would further state that for such related party transactions, AU sec. 316.67 would require 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.

IAASB

Paragraph 20 of ISA 550 requires that the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21-24 of ISA 550.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk (Paragraph 12 of the Reproposed Standard in Appendix 1)



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PCAOB

Paragraph 12 of the repropoed standard would require that for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:

- a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. 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;
- c. Determine whether any exceptions to the company's established policies or procedures were granted;
- d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
- e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

A note to paragraph 12 of the repropoed standard would state that 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 in paragraph 12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

IAASB

Paragraph 23 of ISA 550 requires that for identified significant related party transactions outside the entity's normal course of business, the auditor shall:

- a. Inspect the underlying contracts or agreements, if any, and evaluate whether:



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- i. The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
 - ii. The terms of the transactions are consistent with management's explanations; and
 - iii. The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- b. Obtain audit evidence that the transactions have been appropriately authorized and approved.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

F. Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14-16 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 14 of the repropoed standard would require that the auditor evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Paragraph 14 also would require that in making that evaluation, the auditor take into account information gathered during the audit. Paragraph 14 would also require that as part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. A note to paragraph 14 of the repropoed standard would further state that Appendix A describes examples of information and sources of information that could indicate that related parties previously undisclosed to the auditor might exist.

A footnote to paragraph 14 of the repropoed standard would state that evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. That footnote would further state that this evaluation requires the auditor to perform procedures to test the accuracy and completeness of the



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related parties and relationships and transactions with related parties identified by the company.

As described in Section I.F. of Appendix 4, other PCAOB auditing standards might impose requirements relating to the sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist (e.g., reading confirmation responses and responses to inquiries of the company's lawyers).^{5/}

Paragraph 15 of the reposed standard would require that if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Paragraph 15 also would state that those procedures should extend beyond inquiry of management.

Paragraph 16 of the reposed standard would describe the procedures that the auditor would be required to perform if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Paragraph 16 of the reposed standard would require that the auditor:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;

^{5/} See, e.g., AU sec. 330, *The Confirmation Process*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.



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- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of this standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;
- f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
- g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
- h. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor determines that it is likely that an illegal act has or may have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

IAASB

Paragraph 15 of ISA 550 requires the auditor to remain alert, during the audit, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. Paragraph 15 of ISA 550 further requires that, in particular, the auditor inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- (a) Bank and legal confirmations obtained as part of the auditor's procedures;
- (b) Minutes of meetings of shareholders and of those charged with governance; and
- (c) Such other records and documents as the auditor considers necessary in the circumstances of the entity.



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Paragraph 21 of ISA 550 requires that if the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships and transactions.

Paragraph 22 of ISA 550 requires that if the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

- a. Promptly communicate the relevant information to the other members of the engagement team;
- b. Where the applicable financial reporting framework establishes related party requirements;
 - (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation;
 - (ii) Inquire why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
- c. Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions;
- d. Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor and perform additional audit procedures as necessary.
- e. Evaluate the implications for the audit if the nondisclosure by management appears intentional (and, therefore, indicative of a risk of material misstatement due to fraud).

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.



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G. Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17—18 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 17 of the reproposed standard would align with the existing requirement that the auditor evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. Paragraph 17 would state that this includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.

IAASB

Paragraph 25 of ISA 550 requires that in forming an opinion on the financial statements, the auditor shall evaluate:

- a. Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- b. Whether the effects of the related party relationships and transactions:
 - (i) Prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or
 - (ii) Cause the financial statements to be misleading (for compliance frameworks).

ASB

AU-C Section 550 contains similar requirements to the requirements in ISA 550 for fair presentation frameworks.

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (Paragraph 18 of the Reproposed Standard in Appendix 1)



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PCAOB

Paragraph 18 of the repropoed standard would require that if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.

A note to paragraph 18 of the repropoed standard would further state that a preface to a statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

IAASB

Paragraph 24 of ISA 550 states that if management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

H. Communications with the Audit Committee (Paragraph 19 of the Repropoed Standard in Appendix 1)

PCAOB

Paragraph 19 of the repropoed standard would require that the auditor communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. Paragraph 19 of the repropoed standard also would require that the auditor communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;



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- b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and
- e. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

IAASB

Paragraph 27 of ISA 550 requires that the auditor communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

II. Reproposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions (Appendix 2)

A. Identifying Significant Unusual Transactions (Section A of the Reproposed Amendments in Appendix 2)

PCAOB

The repropose amendments to paragraph 56.a. of Auditing Standard No. 12 would require the auditor to inquire of management regarding whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involve related parties. The repropose amendments regarding significant unusual transactions to paragraph 56.b. of Auditing Standard No. 12 would require that the auditor inquire of the audit committee or equivalent, or its chair, regarding whether



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the company has entered into any significant unusual transactions. The repropoed amendments regarding significant unusual transactions to paragraph 56.c. of Auditing Standard No. 12 require similar inquiries of internal audit personnel.

A note to AU sec. 316.66 would state that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. That note would refer the auditor to paragraphs 14-16 of repropoed auditing standard, *Related Parties*. That note would further state that Appendix A of the proposed standard, *Related Parties*, includes examples of such information and examples of sources of such information.

IAASB and ASB

ISA 315, ISA 550, AU-C Section 315, and AU-C Section 550 do not contain similar requirements for the auditor to those in the PCAOB's repropoed amendments.

B. Evaluating Significant Unusual Transactions (Section B of the Repropoed Amendments in Appendix 2)

PCAOB

The repropoed amendments regarding significant unusual transactions would add paragraph .66A to AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. That paragraph would require the auditor to design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. AU sec. 316.66A would require that those procedures include the following:

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been appropriately authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and



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- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

The repropoed amendments to AU sec. 316.67 would require that the auditor evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. The repropoed amendments would require that, in making that evaluation, the auditor evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);
- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor;
- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company;
- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);
- 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 other, more clearly independent, parties on an arm's-length basis;
- The transaction enables the company to achieve certain financial targets;
- 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); and



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- Management has discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Further, the repropoed amendments would add paragraph 11A to Auditing Standard No. 13. That paragraph would require that because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-.67A.

The repropoed amendments to AU sec. 316.67A would require that the auditor evaluate whether significant unusual transactions identified by the auditor have been properly accounted for and disclosed in the financial statements.

IAASB

Paragraph 16 of ISA 550 requires that if the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required by paragraph 15 or through other audit procedures, the auditor shall inquire of management about:

- (a) The nature of these transactions; and
- (b) Whether related parties could be involved.

Paragraph 32(c) of ISA 240 requires the auditor to evaluate whether the business rationale (or the lack thereof) of a significant transaction outside the normal course of business suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. As discussed in Section I.E. of this Appendix, paragraph 23 of ISA 550 requires the auditor to perform certain procedures for identified significant related party transactions outside the entity's normal course of business.

ASB

AU-C Section 550 and AU-C Section 240 contain similar requirements to those in ISA 550 and ISA 240.



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III. **Other Reproposed Amendments to PCAOB Auditing Standards (Appendix 3)**

A. ***Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Appendix 3)***

PCAOB

The other reproposed amendments to paragraph 10A of Auditing Standard No. 12 would require that to assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers. The other reproposed amendments to Auditing Standard No. 12 also include a definition of executive officer that aligns with definitions used in SEC filings.

In addition, the other reproposed amendments would amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider:

- Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers, and
- Obtaining an understanding of the company's established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

IAASB and ASB

ISA 315 and AU-C Section 315 do not contain similar requirements for the auditor to those in the PCAOB's reproposed amendments.



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B. AU sec. 315, *Communications Between Predecessor and Successor Auditors* (Appendix 3)

PCAOB

The other repropoed amendments to other PCAOB Auditing Standards would amend AU sec. 315, *Communications Between Predecessor and Successor Auditors*, to require the auditor to inquire of the predecessor auditor regarding the predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions. The other repropoed amendments also would require the successor auditor to review documentation regarding related parties and significant unusual transactions.

IAASB and ASB

Neither ISA 210 and ISA 510, nor AU-C Section 210 and AU-C Section 510 contain similar requirements to those in the PCAOB's repropoed amendments.

C. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (Appendix 3)

PCAOB

The other repropoed amendments to AU sec. 316.81A would describe the auditor's responsibility, under certain conditions, to disclose possible fraud to the SEC to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change on Form 8-K and the fraud or related risk factors constitute a *reportable event* or are the source of a *disagreement*, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required pursuant to Section 10A(b) of the Exchange Act relating to an illegal act that the auditor concludes has a material effect on the financial statements.

IAASB and ASB

ISA 240 and AU-C Section 240 do not inform the auditor of certain obligations under Section 10A of the Securities Exchange Act of 1934, which is applicable to auditors of U.S. public companies registered with the PCAOB.



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D. AU sec. 333, *Management Representations* (Appendix 3)

PCAOB

The other repropoed amendments to AU sec. 333, *Management Representations*, would require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The other repropoed amendments to AU sec. 333 also would require the auditor to obtain written representation from management if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction.

IAASB and ASB

Neither ISA 580 and ISRE 2410, nor AU-C Section 580, and AU-C Section 930 contain similar requirements to those in the PCAOB's repropoed amendments.

E. AU sec. 560, *Subsequent Events* (Appendix 3)

PCAOB

The other repropoed amendments would amend paragraph .12 of AU sec. 560, *Subsequent Events*, to require that during the "subsequent period" the auditor inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:

- Whether there have been any changes in the company's related parties or significant new related party transactions, and
- Whether the company has entered into any significant unusual transactions.

IAASB and ASB

ISA 560 and AU-C Section 560 do not contain similar requirements to those in the PCAOB's repropoed amendments.



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F. AU sec. 722, *Interim Financial Information* (Appendix 3)

PCAOB

The other repropoed amendments to AU sec. 722, *Interim Financial Information*, would require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The other repropoed amendments to AU sec. 722 also would require the auditor to obtain written representations from management when management has made an assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in arm's-length transactions.

IAASB

ISA 550 and ISRE 2410 do not contain similar requirements to those in the PCAOB's repropoed amendments.

ASB

AU-C Section 550 and AU-C Section 930 do not contain similar requirements to those in the PCAOB's repropoed amendments.



Exhibit 2(a)(F)

**Alphabetical List of Commenters on the Reproposal in
PCAOB Release No. 2013-004**

1	American Accounting Association
2	BDO USA, LLP
3	BlackRock, Inc.
4	California Society of Certified Public Accountants
5	Center for Audit Quality
6	Colorado Public Employees' Retirement Association
7	Crowe Horwath LLP
8	Deloitte & Touche LLP
9	Ernst & Young LLP
10	Federation of European Accountants
11	Financial Executives International
12	Grant Thornton LLP
13	Illinois CPA Society
14	Institut Der Wirtschaftsprüfer
15	The Institute of Chartered Accountants in England and Wales (ICAEW)

16	KPMG LLP
17	McGladrey LLP
18	MetLife Inc.
19	New York State Society of Certified Public Accountants
20	PricewaterhouseCoopers LLP
21	Pw Carey
22	Texas Society of Certified Public Accountants
23	U.S. Chamber of Commerce, Center for Capital Markets Competitiveness
24	Robert N. Waxman, CPA

*Auditing Standards Committee Auditing Section
American Accounting Association*

Re: Invitation to comment on Release 2013-004, Related Parties.

July 3, 2013

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on Release 2013-004, Related Parties, which was recently developed and published by PCAOB.

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that you found our comments useful for your deliberations and incorporate some of our insights into the final version of the standard. Please, feel free to contact our committee chair if you have questions or need further clarifications.

Respectfully submitted,

Auditing Standards Committee
Auditing Section – American Accounting Association.

Chair-Mikhail Pevzner, University of Baltimore
Natalia Mintchik, University of Missouri, St. Louis
Gregory Sierra, Southern Illinois University, Edwardville

*Auditing Standards Committee Auditing Section
American Accounting Association*

Responses to Specific Questions in the Invitation to Comment

Re: Question 1, Are the requirements of the repropoed standard appropriate? Why or why not?

Furthermore, under certain conditions research suggests that judgment can be subject to outside influence and, in such circumstances, required audit procedures may be warranted. For example, Cohen et al. (2008) find in an experiment that even when in a high-risk setting CEOs can adversely influence auditor adjustments. Many related party transactions are opaque, and firm insiders could unduly influence auditor judgment. The repropoed standard's required procedures appropriately sets the auditor default to "yes" for many basic audit procedures/activities and appropriately requires an affirmative support of many basic conclusions. In addition, many of the required procedures or other required activities in the repropoed *Related Parties* standard is enhanced by explicitly requiring auditor judgment of whether to perform additional procedures.

A potential weakness of a required-procedures approach is that auditors and management over-rely on the set of required procedures and underutilize judgment when assessing the need for further procedures (See, Gordon et al 2007). The repropoed auditing standard alleviates some of these concerns where it explicitly leaves lists of procedures open ended. For example, in A-7, paragraph 12(e), the standard explicitly states, "Perform other procedures as necessary." However, other sections of the repropoed standard do not explicitly state that additional procedures or communications or activities are required as the auditor deems necessary. Omitting an explicit reference to "other" procedures or communications or activities in one section and including them in another may leave the unintended impression that lists of requirements in the repropoed standard are exhaustive. If this is what the PCAOB intended, research does not support this view. Instead, the required activities should be augmented with an "other" option in each section to be clear that the auditor must continue to exercise professional judgment with respect to additional audit work.

Re: Question 4, Would the procedures required by the repropoed standard improve the auditor's understanding of a company's relationships and transactions with its related parties? Why or why not?

In the title of the section before paragraph no. 3 of the repropoed standard, the Board should consider replacing the term "Related Parties" with "Related Parties and Potentially-Related Parties". This distinction becomes vital later in the repropoed standard in paragraphs nos. 14-16 where the auditor's requirements to assess the company's proper identification of related parties are discussed. A potentially-related party that the company deemed not to be related is likely to require a much different audit approach from a related party that was never identified by the company.

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Re: Question 5, Is the requirement in the repropose standard to evaluate whether the company has properly identified the company's related parties and relationships and transactions with its related parties appropriate? Why or why not?

The auditors of related parties or potentially-related parties are a seemingly overlooked source of information in repropose standard. Although the repropose standard does not require nor prohibit communication with the auditor of a related party or potentially-related party, the Board should consider explicitly requiring communication between the auditors of potentially-related parties either as an addition to paragraph no. 9 of the standard or as a new paragraph no. 10. If the Board concludes that such a requirement is excessive, it should at a minimum add that auditors should inquire perform inquiries of the potentially-related party's auditor if deemed necessary either (1) to obtain understanding of the company's relationships and transactions with related parties or potentially-related parties or (2) to evaluate whether the company has identified its related parties.

Re: Question 6, Does the repropose standard appropriately allow for the use of auditor judgment? Why or why not?

Conceptually the repropose standard does appropriately allow for the use of auditor judgment. However, the repropose standard as written seems to supplant required procedures for auditor judgment in some sections. In a study of fraud and related-party transactions, research by Louwers et al. (2008) supports more focus on "brainstorming sessions" as required by SAS No. 99 (AICPA 2002). Although the repropose standard obviously does not undermine auditor judgment, it should more explicitly support the judgment component of the "scaled approach". The repropose standard should either be more explicit in its Introduction about requirements versus judgments or place open-ended requirements in more or all of the repropose standard's sections. That is, add explicit references to other procedures or activities as deemed necessary by the auditor. For example on page A1-3 paragraph 5 could add a subparagraph (g) stating, "Other inquiries of management deemed necessary to obtain an understanding of the company's relationships and transactions with its related parties and potentially-related parties."

Re: Question 7, Are the auditor's responsibilities for the examples of information and sources of information contained in Appendix A to the repropose standard clear? Are there other examples that should be included in the repropose standard?

The auditor should be required to search public information. On page A4-12 of the repropose, the Board explains that in response to comment and discussion with SAG it declined to include a requirement to search public information because it might result in unnecessary costs and, furthermore, that existing Auditing Standard No. 12 (PCAOB 2010) required a search of public information. Given that the purpose of the repropose is in part to bolster investor confidence and that investor confidence is rattled when subsequent to a clean audit opinion journalists are able to find evidence of audit failure in the public domain, the Board should reconsider its decision and should require a search of public information to the repropose standard in paragraph no. 14. Appendix A3 bullet one should be changed from "...other relevant company filings..." to "...other relevant filings and communications..", as a large part of regulatory information is

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American Accounting Association*

contained in regulatory examination reports that are not filings but typically are readily available to the auditor.

Re: Question 12, Appropriateness of the Auditor’s Evaluation of Business Purpose of Related Parties’ Transactions

We believe that the Board is taking on a very important task in requiring auditors to be more vigilant in evaluating business purpose, economic substance and potential opportunistic incentives of related parties’ transactions. As stated, we agree with the goals of this evaluation. One concern we have is whether the auditors currently have sufficient expertise to evaluate whether significant related parties transactions lack commercial substance. Such an evaluation may require use of specialists (e.g. valuation appraisals) and may be put an auditor in a significantly adversarial position vs. the client, especially if the auditor does not have significant expertise in the economic evaluation of a transaction in question. In addition, it would be beneficial to more explicitly state achievement of which economic targets the auditor may consider (e.g. meeting analyst expectations, avoidance of violations of debt covenants, meeting earnings growth targets, etc.). The Board may consider requiring auditors to explicitly incorporate in their audit plans an evaluation of firms’ economic incentives to meet certain targets, as mentioned above.

One possibility that could significantly benefit investors is for the Board to require auditors to provide their overall assessment of managerial incentives to meet market or other stakeholders’ expectations in the “Auditor Discussion and Analysis” which had been proposed under the new Auditor Report model, released by the Board last year.

Re: Question 16, Use of Auditor’s Judgment

As proposed, the standard allows for sufficient use of the auditor’s judgment. One concern we have is whether, given potentially unclear nature of the related parties’ transactions, the auditor could unduly rely on the client’s explanations for those transactions. The Board may want to consider release of additional interpretive guidance on how auditors exercise judgment in their analysis of the related parties’ transactions.

Re: Question 18-19, Understanding of Compensation Arrangements

We believe that the requirement on the part of the auditor to obtain deeper understanding of transactions with the senior management is a very important element of an audit which should significantly improve auditors’ assessments of fraud risk. Going back to Watts and Zimmerman (1986), accounting research literature has long maintained that meeting compensation targets

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increases managers' incentives to make opportunistic accounting choices, and in the light of this, auditors' better understanding of compensation arrangements will improve auditors' overall assessment of audit risk. This idea ties back to our previous comment that we believe that it would be highly beneficial to audits to *explicitly* incorporate the analysis of opportunistic incentives into the audit programs and discuss these incentives in the audit reports. It would also be beneficial to communicate such analyses to firms' Audit Committees.

Re: Question 21, Effects on Sustaining Audit Opinions/Professional Skepticism

In our view, deeper analysis of related parties transactions would significantly improve the audits' effectiveness and informational value. Historically, financial statement analysis textbooks and related literature (e.g. Schilit and Perler, 2010) identify related parties transactions as serious factors affecting firms' overvaluation and potential to commit fraud. This view is supported by some academic research (e.g. Gordon and Henry, 2005, Kohlbeck and Mayhew, 2004). However, it is important to bear in mind that presence of related parties transactions alone should not be construed as increasing fraud risk (Gordon et al 2007). Therefore, requiring auditors to more explicitly consider the effects of related parties' transactions on their audit conclusions and use of audit reports by investors is critical.

Re: Question 23, Communicating with Audit Committee

We believe that the success of the implementation of this standard critically hinges upon the auditors' ability to have a direct channel of communication with the Audit Committee. This is because related party transactions represent a potentially very contentious area of the audit work, whereby auditors could be exposed to additional pressures from the upper management. We believe that expanded discussion of related party transactions by the auditor in their report to the audit committee should be given special prominence.

Re: Question 28, Costs to Audit Firms

In our mind, the largest costs to be incurred by audit firms in implementing the standard relate to training audit staff in their analysis of related parties' transactions and potential need to employ specialists in the analysis of those transactions. There could also be additional demand on time of partners and managers in analysis of more complex related parties' transactions (as discussed in AC 3 below).

Additional Comments:

- 1) Par. 2, p. A1-1 of the standard states:

“The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.”

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As written, this statement is somewhat unclear. It might be broadly interpreted as the requirement to obtain sufficient appropriate audit evidence that focuses explicitly on the identification and disclosure of the related parties and transactions with such parties in the financial statements. It does not clarify who is responsible for such identification (i.e., confusion of auditors vs. management responsibilities), and it does not include any notion of materiality. In this connection, we recommend that the regulators make the description of the objective more precise to avoid such interpretations and consequent confusions.

We also want to draw regulators' attention that the proposed guidance with respect to related party transactions increases responsibilities of financial auditors in this area in comparison with those imposed by the current standards. In particular, in many areas the proposal suggests the significant shift in auditors' responsibility from providing *negative* assurance (e.g., lack of evidence that management assertions related to the related parties are false) to the higher level of *positive* assurance (e.g., sufficient evidence that such assertions are true). For example, the current standards focus on audit procedures that *should be considered* by the auditor. So, there is no unconditional requirement in the current standards for auditors to perform those procedures, just the presumptively mandatory requirement to *consider*. In addition, current standards stress that "The procedures set forth in this section should not be considered all-inclusive. Also, not all of them may be required in every audit." (par. 1). Finally, par. 4 of the current standards states: "An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered."

In other words, current standards do not presume auditor's responsibility to identify *all* related party transactions. Current standards also allow more flexibility for auditors' professional judgment in this area. While we applaud the regulators' efforts to increase audit quality and recognize the crucial role of the related party transactions in prior accounting scandals, we are wary about potential risks of micro-managing in this uncertain area. We are not aware of any empirical evidence that would address this issue directly but believe that the case of auditing standard N 2 (hereafter, AS N 2) might serve as an important reminder. In particular, the combination of simultaneous specificity and ambiguity of AS N 2 guidance increased the volume of account-level work and, hence, audit costs but the link between this increased audit effort and audit effectiveness was lacking. In this connection, we would advise the regulators to proceed with caution and to commission more studies to explore how this significant change in audit responsibility affects the audit process, its costs, and effectiveness. We would also recommend that if regulators decide to be specific in their requirements they also should be as precise as possible and give plenty of particular examples for the auditors to avoid potential misunderstandings and unnecessary audit efforts. Such extended guidance is especially crucial in the areas where the proposal significantly changes the current established relationships between the parties, involved in the audit process.

Below are several examples where such additional explanations are warranted:

1) Par 6.: "The auditor should inquire of others within the company regarding their knowledge of the matters in paragraph 5 of this standard. The auditor should identify others within the

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company to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding:...”

No specific advice is given to auditors with respect to par. 6 to guide them in “identifying others to whom such inquiries should be directed”. Regulators should consider extending guidance in this area, including the guidance on potential management motivations that we mention earlier, to avoid unnecessary audit effort.

2) Par. 12 point d.:

“For each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should: Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any”.

This statement presumes that auditors have the sufficient expertise to evaluate the financial capability of the party, but auditors are not credit loan experts. In addition, as was stated in several comments to the original proposal, auditors often lack the access to the necessary information about the related party. While client is related to the related party and might have ability to exercise some control over the actions of the related party, it does not automatically mean that client management can dictate related party to provide any documentation to its auditors. None of such requirements exist in the current standard on the related party. Regulators should consider extending guidance in this area by advising the auditors how to decide whether the help of the evaluation specialist is warranted, what are the channels through which auditors can persuade related party to cooperate fully, what are the confidentiality obligations of the auditors to the related party, etc.

3) Par 18: “If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.”

Similar to prior discussion, this requirement assumes that auditors possess a distinct expertise beyond that of financial reporting – now that of the market specialist, and imposes the requirement for the auditors to collect the additional evidence that those transactions are consummated at arm’s-length *if management want to include such statement in financial statements*. There are several potential consequences of these and similar requirements: 1) management will try to avoid the relationships with the related parties all together because of the additional problems and costs that they create in compliance area, 2) management will not claim that those relationships at arm’s length even if they are, or 3) audit costs will go up since auditors will need to perform more work if an organization conducts significant related party business at arm’s length term, and management wants to stress this point. In all cases, the requirement

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might have some real negative economic consequences for many shareholders while we are not aware of the empirical evidence that such requirement will decrease fraud risk. In particular, the first outcome (e.g., management tries to avoid any related party transactions) might deprive the shareholders of valuable synergies created through variety of inter-company connections. Thus, the requirement that is put in place to mitigate earnings management might instead create incentives for myopic managerial behavior, given global and interconnected world. The second outcome (e.g., no claims that related party transactions are at arms-length) will create the perception that most of related party transactions are not at arm's-length. It remains the empirical question how such perception will affect the shareholders' behavior and market reactions in certain industries. As for the third outcome, more audit work will automatically lead to higher audit cost, that will be eventually bore by the shareholders.

The proposal's approach in this area departs significantly from current auditing standards that state cautiously in par 12: " Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. If such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, he should express a qualified or adverse opinion because of a departure from generally accepted accounting principles, depending on materiality (see section 508.35 and .36)." We recommend that PCAOB will provide more guidance for the auditors on what constitute the sufficient evidence that these transactions were performed at the arms-length in such circumstances. Auditors might lack the prior experience of such evaluation due to different nature of assurance requirements in the current standards. This lack of experience in the absence of the precise guidance might lead to unnecessary audit costs and inefficient audit.

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*Auditing Standards Committee Auditing Section
American Accounting Association*

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July 8, 2013

Via E-mail: comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
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Re: Request for Public Comment: PCAOB Release No. 2013-004, Rulemaking Docket Matter No. 038, *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:

BDO USA, LLP appreciates the opportunity to respond to the request for comments on the Public Company Accounting and Oversight Board's (the "PCAOB" or the "Board") *Proposed Auditing Standard - Related Parties* (the "Proposed Standard"), *Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (the "Release"). Consistent with our letter dated May 31, 2012, on the Board's prior release on this same topic, we continue to support the Board's efforts to update and strengthen the work the auditor does with respect to related party relationships and transactions, as well as significant unusual transactions and financial relationships and transactions with executive officers, through alignment with the standards of the International Auditing and Assurance Standards Board, the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants, and the PCAOB's own risk assessment standards. While overall, we believe the enhancements described in the Release will contribute to the quality of public company audits, we have provided additional suggestions that we believe would further advance audit quality.

Responsibility of the Auditor to Evaluate the Company's Identification of Related Parties

We support the change from the previously proposed related party standard that now recognizes that while the auditor is responsible for evaluating the company's identification of related parties, the company is responsible for establishing and maintaining a process to support that identification. However, while we agree that the auditor's evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, we believe this guidance more appropriately belongs within the body of the standard, rather than within a footnote to paragraph 14 of the Proposed Standard. In our view, auditor requirements are best understood if they are included within the body of the Proposed Standard, to mitigate any possibility that such guidance is either inadvertently overlooked or misunderstood to be of lesser importance. Including required procedures within the body of the standard would clearly communicate the significance of the required procedure. For this



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reason, we suggest deleting footnote 14 and modifying paragraph 14 as follows: (additions are in bold italics and deletions are in strikethrough text)

The auditor should evaluate whether the company has properly identified its related parties and relationships and transactions with related parties ***by assessing the process used by the company and performing procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified.*** In making ~~this~~ evaluation, the auditor should take into account the information gathered during the audit, ~~As part of that evaluation, the auditor should~~ ***including*** reading minutes of the meetings of stockholders, directors, or summaries of actions of recent meetings for which minutes have not yet been prepared ***and such other records or documents as the auditor considers necessary in the circumstances.***

Furthermore, we believe that the auditor's responsibility to perform specific procedures with respect to each type or source of information listed in Appendix A should be clarified. We believe that the intent of paragraph 14 and the related footnote 14 is that auditors should remain alert for arrangements or other information that may indicate the existence of related party relationships or transactions previously undisclosed by management, when inspecting records or documents in the performance of other audit procedures. Accordingly, we suggest revising the Note to paragraph 14 as follows:

Note: ***During the course of the audit, the auditor may inspect records or documents that may provide information about related party relationships and transactions.*** Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Exercise of Professional Judgment

We support the changes from the previous release that now emphasize the use of professional judgment, in particular the revisions that (1) clarify that the auditor exercises discretion in making inquiries of certain individuals within the company regarding the company's relationships and transactions with its related parties, and (2) recognize that each related party transaction previously undisclosed to the auditor by management may not result in a significant risk. However, we believe that the effectiveness of the Proposed Standard could be improved through greater use of professional judgment and an alignment with PCAOB risk standards as described below.

For example, paragraph 16 of the Proposed Standard requires the auditor to perform certain procedures if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists without regard to the significance of the matter. We believe that an approach that considers the auditor's risk assessment would provide for a more effective and targeted method of addressing the risk of material misstatement. For this reason, we believe that the procedures in paragraph 16 of the



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Proposed Standard should be performed for related party transactions that are not clearly trivial¹ rather than for all such transactions.

Another area where we believe expanding the auditor's use of professional judgment would be appropriate is with respect to communications with the audit committee. Paragraph 19 of the Proposed Standard requires the auditor to communicate to the audit committee significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to, certain matters listed in the standard. The matters described in items (b) - (e) of paragraph 19 require the auditor to exercise judgment about the significance of the matter; however, item (a) requires the auditor to communicate "the identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor" without regard to significance. Accordingly, we suggest adding the concept of significance to item (a).

Inclusion of Application Guidance from the Release into the Proposed Standard

We recognize that the Board has explained in Appendix 4 of the Release that examples and other application guidance are not included within the Proposed Standard in order to promote a clear separation between required procedures and application guidance. However, we believe that including such guidance within the Proposed Standard itself could be clearly differentiated from required procedures without too much difficulty. For example, the International Standards on Auditing (the "ISAs") and the ASB's Clarified Auditing Standards provide application guidance and examples after the requirements section of the standard and precede each application paragraph with an "A" to differentiate it from a required procedure. Furthermore, providing application guidance and examples within the Proposed Standard, rather than within a separate Appendix to the Release, would make the relevant guidance easily accessible and understandable in the context of the requirements.

As noted above, we support the use of auditor judgment, as appropriate, and note that paragraph 6 of the Proposed Standard provides for the exercise of auditor judgment in determining those individuals to whom to make inquiries such that they are likely to have knowledge of the matters set out in paragraph 5. We believe that the intent of the requirement would be clarified if examples of "others within the company to whom inquiries should be directed" were provided as application guidance within the Proposed Standard. For example, it may be helpful to include guidance such as that provided in paragraph .A15 of ISA 550, *Related Parties*, which explains that others within the entity likely to have knowledge of the entity's related party relationships and transactions and the entity's controls over such relationships and transactions may include: those charged with governance; personnel in a position to initiate, process, or record transactions that are both significant and outside the entity's normal course of business and those who supervise or

¹ The phrase "clearly trivial" is explained in PCAOB Auditing Standard No. 14, *Evaluating Audit Results*. The Note to paragraph 10 of that standard explains that clearly trivial is not another expression for not material and that matters that are clearly trivial will be of a smaller magnitude than the materiality level established for planning and performing the audit, and will be inconsequential whether taken individually or in the aggregate and whether judged by any criteria of size, nature, or circumstances.



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monitor such personnel; internal auditors; in-house legal counsel; and the chief ethics officer or equivalent person.

Furthermore, we recommend that the discussion in Appendix 4 of the Release, regarding intercompany transactions, be included within the Proposed Standard as application guidance.

Economic Considerations and Emerging Growth Companies

We believe the incremental costs to implement this Proposed Standard would be difficult to measure prior to implementation, and for this reason we have no comment on costs. However, while the costs may be difficult to measure at this time, we believe the Proposed Standard strengthens the existing PCAOB Auditing Standards in a scalable way such that the level of audit effort will vary in proportion to the number and nature of a company's related party relationships and transactions, its significant unusual transactions, financial relationships and transactions with executive officers, and the company's process to identify and reflect such matters in its financial statements. Consequently, we believe the Proposed Standard should apply to all public company audits.

Audits of Brokers and Dealers

The nature of the broker and dealer industry is such that there are often significant related party transactions, including but not limited to commissions and fees charged between affiliated companies. Accordingly, we support the application of the Proposed Standard to the audits of brokers and dealers at such time as the SEC directs that audits of brokers and dealers are to be conducted in accordance with PCAOB standards.

Further, we do not believe that an exception is necessary with respect to audit committee communications for non-issuer broker dealers, as the definition of audit committee is sufficiently broad within Auditing Standard No. 16, *Communications with Audit Committees*, to accommodate the governance structure of non-issuer broker-dealers.

Paragraph-level Comments

The following paragraph-level comments represent clarifications that we believe will strengthen the Proposed Standard.

- Paragraph 5.d. of the Proposed Standard requires the auditor to "inquire of management regarding the transactions entered into, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions." However, modifications to transactions during the period may also give rise to a risk of material misstatement, and for this reason we suggest adding the word "modified" after the phrase "the transactions entered into."



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- Paragraph 16.f. of the Proposed Standard states that the auditor should “evaluate the implications on the auditor’s assessment of internal control over financial reporting, if applicable.” We believe the phrase “if applicable” should be deleted from the requirement since controls are assessed for purposes of assessing risk, regardless of whether or not the engagement contemplates auditor attestation on the effectiveness of internal control.

* * * *

We appreciate your consideration of our comments and suggestions and would be pleased to discuss them with you at your convenience. Please direct any questions to Chris Smith, National Accounting & Auditing Professional Practice Leader at 310-557-8549 (chsmith@bdo.com) and Susan Lister, National Director of Auditing at 212-885-8375 (slister@bdo.com).

Very truly yours,

/s/ BDO USA, LLP

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July 8, 2013

Office of the Secretary
 Public Company Accounting Oversight Board
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 Washington, D.C. 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 038

Members of the Board,

BlackRock, Inc. ("BlackRock") appreciates the opportunity to comment on the following:

- Public Company Accounting Oversight Board ("Board" or "PCAOB") Proposed Auditing Standard – Related Parties ("the Proposed Standard");
- Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions (the "Proposed Amendments"); and
- Other Proposed Amendments to PCAOB Auditing Standards (the "Other Proposed Amendments" and, together with the Proposed Standard and the Proposed Amendments, the "Proposed Standard and Amendments").

BlackRock is a global investment manager, overseeing \$3.94 trillion of assets under management at March 31, 2013. BlackRock and its subsidiaries manage approximately 3,500 investment vehicles, including registered investment companies, hedge funds, private equity funds, exchange-traded funds and collective investment trusts, in addition to separate accounts. Certain of BlackRock's wholly-owned subsidiaries operate as registered broker/dealers, a U.K. registered life insurance company, a U.S. federally-chartered trust bank and numerous investment advisory companies registered in jurisdictions throughout the world.

As an investment manager, BlackRock is in the position to provide commentary on the Proposed Standard and Amendments from the perspectives of a) a corporate preparer, b) an investment fund preparer and c) a user (i.e., BlackRock's research analysts). As such, our comments take into account all three of these distinct perspectives.

Response

Proposed Standard

We support issuance of the Proposed Standard, which underscores management's responsibility for identifying related parties and transactions with related parties; management's process for authorizing and approving transactions with related parties; the controls in place to ensure proper accounting and disclosure in the financial statements; and the auditor's responsibility for obtaining an understanding of these procedures in conjunction with understanding internal control over

financial reporting. We agree that inquiries of management are important to identify related parties and to understand the nature of any relationships that related parties have with management, the business purpose of any transactions with related parties, and the process by which related party transactions are approved.

The procedures required by the auditors to identify and understand related party transactions that are required to be disclosed in the financial statements or that are determined to be a significant risk, already are substantially performed in existing audits. However, we encourage the Board to clarify that the focus should be on significant risks, and that the intent of the Proposed Standard is not to require additional audit effort over all risks, regardless of their significance. The sources of information listed in Appendix A of the Proposed Standard to identify related parties or relationships or transactions with related parties also normally are reviewed as part of existing audit procedures. For example, auditors read periodic financial reports and annual proxy reports (although proxy statements frequently are prepared after the auditor has released the audit opinion), tax filings and internal auditors' reports, as well as significant contracts and compensation arrangements. We encourage the Board to clarify that these sources are only examples, and documentation and evaluation should be based on their relevance and risk. We do not believe that the Proposed Standard would require significant incremental management or auditor resources for BlackRock or its sponsored investment companies, although the amount of resources required could be meaningfully greater for companies with a significant number of related parties and complex related party transactions.

Proposed Amendments

With respect to the Proposed Amendments regarding significant unusual transactions, we believe that it is important for the auditor to understand the business purpose of significant unusual transactions, some of which may have been entered into to engage in fraudulent financial reporting. The criteria identified in revised paragraph .67 are appropriate, and the requirement for the auditors to read the underlying documentation to determine consistency with other audit evidence about business purpose and to determine whether the transaction has been authorized in accordance with company policies and procedures, is appropriate. The criteria in paragraph .67 that should be used to evaluate the business purpose of significant unusual transactions are reasonable. The evaluation of the financial capability of other parties with respect to the financial terms of significant unusual transactions presumably already is performed by the auditor and, as a result, should not result in significant additional time by management or the auditor.

Other Proposed Amendments

With respect to the Other Proposed Amendments, we support the need for the auditor to obtain an understanding of compensation arrangements with the company's executive officers. With respect to the compensation arrangements with senior management other than executive officers mentioned in the preceding sentence, we are concerned that the requirement to obtain an understanding of their compensation arrangements could result in significant additional audit procedures although the risk of material fraud or material misstatement may be negligible. We encourage the Board to consider further clarification that it is important to understand the company's compensation arrangements, which may be achieved by assessing the company's internal control over such arrangements (including senior management compensation), as opposed to reading each compensation agreement. We question the need to inquire of the chair of the compensation committee and any compensation consultants engaged by the

compensation committee or the company regarding structuring of the company's compensation for executive officers, unless the structure and terms are unclear or raise questions about the company's documentation and internal controls over such compensation arrangements. Otherwise, we support the Other Proposed Amendments.

We appreciate the opportunity to share our viewpoints on the Proposed Standard and Amendments. As noted above, we applaud the Board's work in this important area and in its ongoing efforts to enhance auditor independence, objectivity and professional skepticism.

If the Board has any questions regarding our comments, please contact Steven Buller at (212) 810-3501.

Sincerely,

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July 3, 2013

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Re: PCAOB Rulemaking Docket Matter No. 038
Proposed Auditing Standard-Related Parties, Proposed Amendments to Certain PCAOB
Auditing Standards Regarding Significant Unusual Transactions and Other Proposed
Amendments to PCAOB Auditing Standards

The Accounting Principles and Auditing Standards Committee (the "Committee") of the California Society of Certified Public Accountants ("CalCPA") respectfully submits its comments on the referenced proposal. The AP&AS Committee is the senior technical committee of CalCPA. CalCPA has approximately 40,000 members. The Committee is comprised of 53 members, of whom 47 percent are from local or regional firms, 27 percent are from large multi-office firms, 12 percent are sole practitioners in public practice, 10 percent are in academia and 4 percent are in international firms.

The Committee previously submitted its comments in May 2012 on the original proposal, and continues to support the PCAOB's repropoed standard, and the issuance of proposed amendments to PCAOB auditing standards regarding related parties and additional guidance on significant unusual transactions. We have provided our responses to the questions set forth in Appendix 4.

1. Are the requirements of the repropoed standard appropriate? Why or why not?

The Committee believes the requirements of the repropoed standard are appropriate.

2. Do the changes in the repropoal clarify the relationship of the repropoed standard with the risk assessment standards? Why or why not?

The Committee believes the repropoed standard is appropriately aligned with the risk assessment standards.

3. Does the alignment of the repropoed standard with the risk assessment standards enable the auditor to introduce efficiencies in the audit approach? Why or why not?

The Committee believes that applying the risk assessment standards to assess whether a company has the appropriate controls in place to identify related party or unusual transactions is the initial step in developing an efficient audit approach. Obviously, those companies with a less robust system will require greater audit effort.

4. Would the procedures required by the repropoed standard improve the auditor's understanding of a company's relationships and transactions with its related parties? Why or why not?

The Committee believes the additional clarity provided by the repropoed standards should foster an improvement in the auditor's overall understanding of related party transactions.

5. **Is the requirement in the reposed standard to evaluate whether the company has properly identified the company's related parties and relationships and transactions with its related parties appropriate? Why or why not?**

Yes. The entity's decision makers should know when they are dealing with a related party.

6. **Does the reposed standard appropriately allow for the use of auditor judgment? Why or why not?**

The Committee believes the reposed standard can be further enhanced if the concept of materiality could be introduced into the Objective paragraph #2.

7. **(a) Are the auditor's responsibilities for the examples of information and sources of information contained in Appendix A to the reposed standard clear? (b) Are there other examples that should be included in the reposed standard?**

(a) Yes; (b) no

8. **Is the objective of the reposed standard appropriate? Why or why not? Does the reposing release clearly articulate that the objective of the reposed standard works similarly to objectives contained in other PCAOB auditing standards?**

Please refer to the Committee's response to question #6 above.

9. **Does the requirement in the reposed standard to perform specific procedures for each related party transaction required to be disclosed in the financial statements or determined to be a significant risk provide for a scaled approach? Why or why not?**

Yes.

10. **Does the approach in the reposed standard for the auditor to perform specific procedures for related party transactions that are required to be disclosed in the financial statements or that are determined to be a significant risk represent a cost-sensitive, yet effective, approach? Why or why not?**

Yes.

11. **What additional guidance, if any, regarding the auditor's responsibility for performing procedures on intercompany account balances pursuant to paragraph 13 of the reposed standard is necessary?**

The Committee believes that performing audit procedures as of the balance sheet dates of each of the companies is appropriate, even if the fiscal years of the related parties differ. However, if the balance sheet dates of the related parties differ substantially from the balance sheet date of the audit client, the PCAOB may wish to clarify if the auditor is expected to evaluate related party transactions that may have been entered into "at any time" during the audit year, not just at or near the year end of the audit client. In addition, what is the implication about the extent of reliance on controls the farther the date from the balance sheet date of the audit client?

12. **Are the reposed amendments regarding the auditor's identification of significant unusual transactions appropriate? Why or why not?**

The Committee believes that as entity size/complexity increases, the likelihood of an auditor being able to independently identify significant unusual transactions diminishes proportionately. Making inquiry is fine, but just how many people would have to be asked to be sure one has asked all who might know. Another issue will be the interpretation of "significant" and "unusual".

- 13. Are the repropoed amendments regarding the auditor's evaluation of significant unusual transactions appropriate? Why or why not?**

The Committee believes the repropoed amendments are appropriate, but are not substantially different than what the current standards require.

- 14. Would the procedures required by the repropoed amendments regarding significant unusual transactions improve the auditor's identification and evaluation of a company's significant unusual transactions? Why or why not?**

The Committee is hopeful the repropoed amendments will improve the auditor's identification of unusual transactions; however, please see our response to question # 12.

- 15. Are the repropoed amendments regarding significant unusual transactions appropriately aligned with the risk assessment standards? Why or why not?**

Yes.

- 16. (a) Do the repropoed amendments regarding significant unusual transactions appropriately allow for the use of auditor judgment? Why or why not? (b) Does the requirement that the auditor perform specific procedures for each significant unusual transaction identified by the auditor provide for a scaled approach? Why or why not?**

(a) Yes; (b) yes.

- 17. Is the complementary relationship between the amendments regarding significant unusual transactions and the repropoed standard clear? Why or why not?**

Yes.

- 18. Are the other repropoed amendments appropriate to address risks of material misstatement of the financial statements? Why or why not?**

Yes.

- 19. Is it sufficiently clear that the auditor (a) should obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment and (b) should not assess the appropriateness of executive officer compensation? Why or why not?**

(a) The Committee believes the requirement is obvious, but nevertheless needs to be clearly stated in the auditing standards. (b) The Committee agrees that it is inappropriate for the auditor to assess the appropriateness of executive compensation. That role is reserved for the Compensation Committee of the Board of Directors, and shareholder actions.

- 20. Are "executive officers" the appropriate population for the audit procedures designed to provide the auditor with an understanding of the company's financial relationships and transactions as part of its risk assessment process? Why or why not?**

The Committee does not believe this represents the complete population. Anyone holding a material block of stock options that is in a position to influence the company should be a concern, but materiality needs to be considered. The executive officers are most likely to be in positions to perpetrate marketplace frauds, but lower level executives are probably positioned to perpetrate other frauds/manipulations designed to meet their incentive compensation criteria.

21. (a) Would improving the auditor's understanding of a company's relationships and transactions with its related parties assist the auditor in obtaining sufficient appropriate evidence necessary to support the audit opinion? (b) Would improving the auditor's understanding promote the exercise of professional skepticism? (c) Would improving the auditor's understanding increase the likelihood of the auditor identifying material misstatements? (d) Are there additional benefits that the Board should consider?

- (a) Yes.
- (b) No; the Committee believes possessing sufficient professional skepticism drives getting the better understanding.
- (c) Yes.
- (d) No.

22. Could the required communications with audit committees in the reposed standard result in improvements to audit committees' abilities to fulfill their duties?

Yes.

23. Could the improved communications between the audit committee and the auditor lead to an improvement in the company's financial statement disclosures about its relationships and transactions with its related parties?

The assumption is that communications of negative findings will lead to enhanced oversight of management's actions and improvements in systems and procedures designed to identify relationships and transactions with related parties. However, the reposed standard does not address the nature, scope and content of financial statement disclosures of issuers concerning related party transactions or unusual transactions. Therefore, if the PCAOB wishes to influence such disclosures, the matter should be referred to the SEC for their consideration.

24. (a) Would improving the auditor's identification and evaluation of significant unusual transactions increase the likelihood of the auditor identifying potential misstatements, including misstatements due to fraud? (b) Would improving the auditor's identification and evaluation of significant unusual transactions promote the exercise of professional skepticism by the auditor? (c) Are there additional benefits that the Board should consider?

- (a) Yes. However, the Committee wishes to state that while auditors may be trained in identifying evidence that might indicate a potential fraud, they are not trained to establish the intent of the parties, which is best left to law enforcement and the courts. In addition, the auditor is generally not in a position to consider aspects of potential fraud against a third party; e.g., matters involving intellectual property rights, or the compliance with Medicare billing rules. The Committee notes that a significant unusual transaction may be a perfectly legal transaction, just not a good business deal.

The Committee also believes the sentence in bold type contained in the proposed replacement of paragraph 66 of AU sec. 316 "Consideration of Fraud in a Financial Statement Audit", which is presented on page A2-6 of Appendix 2 of the PCAOB Release, and which states: "Evaluating whether the business purpose for significant unusual transactions indicated that the transactions may have been entered into to engage in fraud" be modified to eliminate the possible erroneous conclusion that the auditor is responsible for establishing the parties "intent" to commit fraud. At a minimum, the word "evaluate" should be replaced with the word "consider" along with clarifying language regarding the matter of "intent."

- (b) No; the Committee believes possessing sufficient professional skepticism drives getting the better understanding.
- (c) No.

- 25. Could the repropoed amendments regarding significant unusual transactions lead to an improvement in the company's disclosures about its significant unusual transactions?**

Please refer to the Committee's response to question #23 above as they apply to the identification and disclosure of significant unusual transactions as well.

- 26. (a) What benefits are associated with auditors obtaining an understanding of a company's financial relationships and transactions with its executive officers as part of its risk assessment? (b) Are there additional benefits that the Board should consider?**

- (a) Please see the Committee's response to question #19 above.
(b) No.

- 27. What benefits are associated with the other repropoed amendments?**

The Committee has nothing additional to contribute, and supports the other repropoed amendments.

- 28. What costs will audit firms incur when implementing the repropoed standard and amendments? Please discuss both initial costs and recurring costs.**

It is clear to the Committee that increased audit effort will result in a pass through of marginally higher audit costs to clients. However, if the repropoed standard is adopted by the PCAOB, and subsequently approved with the planned adoption date as set forth herein, implementation costs should be marginal, and the new standard can be incorporated into updated training programs.

- 29. What costs will companies incur as a result of the implementation of the repropoed standard and amendments?**

Please see the Committee's response to question #28 above.

- 30. Could the repropoed standard and amendments lead to other changes in behavior by the auditor, the company, or the audit committee that the Board should consider?**

More effort may go into constructing relationships that do not qualify as related parties in form. However, other companies may be more attentive to written procedures and responsibilities for transactions that are subject to the new requirements. Auditors may increase training and audit procedures.

- 31. (a) Are there considerations relating to smaller companies that the Board should be aware of in considering its repropoal? (b) Do smaller companies share the same risks of material misstatement of the financial statements regarding related party transactions and significant unusual transactions as the broader issuer population? (c) Are related party transactions more common in smaller companies than the broader issuer population? (d) Would the repropoed standard and amendments result in smaller companies experiencing unnecessarily greater or disproportionate costs compared to those experienced by larger companies? (e) If so, how could such costs be controlled while improving audit quality?**

- (a) No.
(b) Yes, but they are easier to see.
(c) It is possible that smaller, less established issuers may be more prone to entering into related party transactions. However, as the PCAOB has pointed out, material frauds have been entered into by global companies abusing their power, and manipulating the information provided to their auditors, regarding structured transactions with related parties or entering into highly unusual transactions.
(d) Yes. Costs of new procedures generally fall disproportionately on smaller companies, because they tend to enter into related party transactions more frequently.
(e) N/A

32. Are there any unique considerations regarding costs for audits of brokers and dealers?

The Committee believes the PCAOB's mandate to inspect the registered audit firms of smaller brokers and dealers will have a pervasive impact on those firms and their clients, regardless of the costs involved.

33. Are there unique considerations regarding costs for specific types of companies based on characteristics other than size of the transaction (e.g., industry)?

The Committee is not in a position to provide a response to this question.

34. (a) Are there additional considerations relating to competition, efficiency, and capital formation that the Board should take into account with respect to the repropoed standard and amendments? (b) Specifically, are there benefits in lowered cost of capital from confidence in audits of issuers with related party disclosures?

(a) No.

(b) No, probably the opposite because of the uncertainty surrounding the accounting.

35. Should the repropoed standard and amendments be applicable for audits of EGCs? Why or why not? Please provide empirical data, examples and explanations for why the requirements should or should not be applicable for audits of EGCs.

Yes. Such focus may be particularly relevant for start-ups.

36. (a) Are related party transactions or significant unusual transactions more common at EGCs than the broader issuer population? (b) Do financial relationships and transactions with executive officers at EGCs give rise to increased risks of material misstatements than the broader issuer population? Please provide any data you have to support your views.

(a) Yes. Please refer to the Committee's response to question #31(c) above.

(b) No.

37. Are there other characteristics of EGCs (e.g., the size of the company and the length of time it has been a reporting company) that the Board should consider?

No.

38. (a) Would EGCs benefit more or less from the repropoed standard and amendments than other companies? (b) Would inherently riskier EGCs receive benefits relative to other EGCs because the market cannot observe certain undisclosed related party risks that the new standards would otherwise make available through better compliance by management with its disclosure obligations?

(a) The Committee does not see any distinction between the benefits an EGC achieves from the repropoed standard vs. an established issuer. All will benefit from the repropoed standard.

(b) The Committee would hope that any company, EGC or an established issuer, with material related party transactions or unusual transactions and their auditors would ultimately provide enhanced disclosures of such transactions, placing themselves on a level playing field with others in their peer group that might not have entered into such transactions.

39. (a) What costs would firms incur when implementing the repropoed standard and amendments for audits of EGCs? (b) How will those costs differ from the costs for the larger issuer population? (c) Which of the costs are initial or recurring or both?

- (a) Firm implementation costs should not differ when implementing the reposed standard for audits of EGCs or established issuers, as firms would apply the reposed standard across their entire audit practice.
- (b) See response to (a) above.
- (c) Firms would incur incremental training costs in the initial year of adoption, and there will likely be increased recurring audit costs and they may fall relatively disproportionately on EGC's.

40. (a) Are there particular costs, benefits, or burdens applicable to EGCs that the Board should consider when determining whether to recommend to the Commission the application of the reposed standard and amendments to audits of EGCs? (b) For example, do EGCs share the same risk of material misstatement of the financial statements as the broader issuer population due to relationships and transactions with related parties?

- (a) No.
- (b) No, risk is greater.

41. Regardless of the applicability of the reposed standard and amendments to audits of EGCs, would an audit firm perform the same procedures for an audit of an EGC and an audit of a non-EGC to ensure a consistency in the training, methodology, and tools in their audit practice or to respond to risks of material misstatement with similar approaches?

Yes.

42. (a) Would the implementation and training costs that a firm would incur be dependent upon whether the standard is applicable to EGCs? (b) Would such costs generally be fixed once required to be implemented, regardless of whether the standard is applicable to audits of EGCs?

- (a) Not unless the firm specialized in EGC.
- (b) No, see answer to question 42(a).

43. For auditors of both EGCs and other SEC registrants, would it be more costly to not apply the reposed standard and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?

The Committee has a mixed response to this question, as some members believed implementation of the reposed standard ought to be universally applicable and any carve out for EGCs would be more costly. A minority view believes that a carve out would be easy to implement.

44. Are there any other considerations relating to competition, efficiency, and capital formation that the Board should take into account when determining whether to recommend to the Commission the application of the reposed standard and amendments to audits of EGCs?

No.

45. Are the reposed standard and reposed amendments appropriate for audits of brokers and dealers? Why or why not?

Yes; the potential for abuse exists for all related party transactions.

- 46. Are there additional procedures specific to audits of brokers and dealers that should be included in the repropoed standard and repropoed amendments?**

The Committee cannot respond to this question.

- 47. Should auditors of brokers and dealers be required to evaluate whether a broker's or dealer's relationships and transactions with its related parties impact that broker's or dealer's compliance with its regulatory requirements? Why or why not?**

The Committee believes that brokers and dealers should be required to evaluate related party relationships and unusual transactions in light of their regulatory requirements, just as any other audit requires an identification of regulatory compliance issues in the client's respective industry.

- 48. Should the auditor's communications to audit committees included in the repropoed 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.**

Yes.

- 49. Is the Board's anticipated effective date appropriate? Why or why not?**

Yes, assuming the final pronouncement is released timely.

- 50. Does the new proposed effective date allow sufficient time for firms to incorporate the new requirements into their methodology, guidance and audit programs, and training for staff? Why or why not?**

See answer to question 49.

The Committee would be glad to discuss its comments further should the Board have any questions or require additional information.

Very truly yours,



Michael D. Feinstein, Chair
Accounting Principles and Auditing Standards Committee
California Society of Certified Public Accountants



July 3, 2013

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Cynthia M. Fornelli

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

Re: Request for Public Comment: Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards, PCAOB Rulemaking Docket Matter No. 038

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ welcomes the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (the Reproposal). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

Consistent with our May 25, 2012 letter¹ to the PCAOB, we continue to support the Board's efforts to improve audit quality through strengthening the requirements relating to the auditor's evaluation of a company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, and through the related amendments included in the Reproposal. We commend the PCAOB for considering the comment letters it has received from the CAQ and others in developing the Reproposal. We have identified additional suggestions for the Board's consideration, primarily related to the proposed auditing standard, *Related Parties* (the Reproposed Standard), that we believe will improve the Reproposal.

¹ See CAQ letter at: <http://www.thecaq.org/newsroom/pdfs/CAQCommentLetter-RelatedParties.pdf>.

Related Parties

The CAQ appreciates the revisions to the Reproposed Standard, which result in improved alignment with the PCAOB's risk assessment standards,² and consistent with such standards, reflect greater use of auditor judgment. However, we believe that the Reproposed Standard still includes some prescriptive requirements that may restrict the auditor's ability to adjust the nature and extent of audit procedures based on the auditor's risk assessment. Included below are some recommendations and suggested edits that we believe reflect an appropriate level of auditor judgment and help achieve the Board's goal of promoting audit quality and investor protection, while avoiding unnecessary costs and implementation issues.

Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties

Footnote 14 of paragraph 14 in the Reproposed Standard requires the auditor, as part of evaluating whether a company has properly identified its related parties and relationships and transactions with related parties, to "perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company." We believe that paragraph 14 should be modified as follows to reflect this requirement in the body of the standard, rather than as a footnote:

"The auditor should evaluate whether the company has properly identified its related parties and relationships and transactions with related parties.^{14/} ~~In making that evaluation, the auditor should take into account the information gathered during the audit.~~^{1514/} Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, taking into account information gathered during the audit. As part of ~~that~~ this evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared."

Additionally, the Note in paragraph 14 makes reference to Appendix A, which describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. This reference, coupled with the requirement currently in footnote 14, might create the impression that the auditor is required to perform specific auditing procedures to identify undisclosed related parties or transactions with related parties with respect to each type or source of information listed in Appendix A. As discussed in the Reproposal, this does not appear to be the Board's intent;³ therefore, in order to clarify the auditor's responsibilities, we believe that the Note in paragraph 14 should include the sentence added below. We also recommend that the last sentence of paragraph A1 be modified to include this additional language:

"Note: Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Appendix A is not intended to represent a comprehensive listing, nor is the auditor required to perform procedures with respect to each type or source of information referenced in Appendix A."

Paragraph 16 of the Reproposed Standard requires the auditor to perform certain steps "[i]f the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists." This could result in the auditor executing procedures (e.g., inquiry, evaluation, and communication) with respect to related party *transactions* which do not merit such procedures based on the auditor's risk assessment. This

² See PCAOB Auditing Standards Nos. 8-15 at: <http://pcaobus.org/Standards/Auditing/Pages/default.aspx>.

³ See Reproposal, page A4-39.

could be remedied by indicating that the procedures in paragraph 16 do not need to be applied to related party transactions that are deemed by the auditor to be “clearly trivial” as described in PCAOB Auditing Standard No. 14, *Evaluating Audit Results*.

Furthermore, we believe that item (e) of paragraph 16 could be misunderstood as requiring the auditor to perform the procedures listed in paragraph 12 of the Reproposed Standard for each “related party or relationship or transaction with a related party previously undisclosed to the auditor,” instead of only for those matters that are, “required to be disclosed in the financial statements or determined to be a significant risk.” Therefore, we suggest the following revisions to item (e) of paragraph 16:

~~“Perform the procedures required by paragraph 12 of this standard f~~For each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk, perform the procedures required by paragraph 12 of this standard.”

Communications with the Audit Committee

Paragraph 19 requires the auditor to communicate to the audit committee “other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to (a) [t]he identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor.” This could be interpreted as suggesting that *all* related parties or relationships or transactions with related parties that were previously undisclosed to the auditor are significant; therefore, we recommend that the word “significant” be added before the first occurrence of the phrase “related parties” in item (a) of paragraph 19 to allow for the exercise of auditor judgment in tailoring these important communications and to align item (a) with items (b)-(e) of paragraph 19.

Scalability and Scope

We believe the Reproposal is scalable in that the level of audit effort will generally correlate with the number, nature, and complexity of a company's related party relationships and transactions; its significant unusual transactions, financial relationships and transactions with executive officers; and the process a company has in place to identify such matters and provide that they are appropriately reflected in the financial statements.

The CAQ believes that the final standard and amendments should be applicable to the audits of Emerging Growth Companies and audits of brokers and dealers that are required to be conducted in accordance with PCAOB standards. The CAQ believes that the financial reporting risks that the Reproposal is designed to target also exist at these entities and in some cases more prevalently.⁴ Additionally, this would avoid bifurcation of the rules applied to financial statement audits performed in accordance with PCAOB standards, which could be confusing to investors and other stakeholders.

Effective Date and Transition

The Board anticipates that the final standard and amendments would be effective, subject to approval by the Securities and Exchange Commission (SEC), for audits of financial statements for fiscal years beginning on or after December 15, 2013. We believe this anticipated effective date is reasonable if the SEC approves the Board's final standard no later than October 31, 2013. Many of the requirements of the Reproposal are focused on planning and risk assessment; it is important to allow sufficient time for auditors to incorporate the new requirements into their audit methodologies and programs, provide necessary training to audit engagement

⁴ Financial reporting risks that are targeted by the Reproposal can be more prevalent with Emerging Growth Companies and brokers and dealers because of the size, nature, and complexity of the business model, capital structure, business processes and controls, and regulatory environment associated with these companies.

personnel, and communicate with audit committees and company personnel responsible for the preparation of the company's financial statements and disclosures.

The CAQ supports the Board's efforts to improve audit quality through the Reproposal. We welcome the opportunity to respond to any questions regarding the views expressed in this letter.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:

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July 8, 2013

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

RE: Proposed *Auditing Standard, Related Parties*, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Amendments to PCAOB Auditing Standards (PCAOB Rulemaking Docket Matter No. 038) (Related Parties Proposal)

Dear Office of the Secretary:

I am submitting the following comments in response to the PCAOB's request for guidance on revisions to related party auditing standards. As an institutional investor with \$40 billion in assets, Colorado PERA has a keen interest in improvements to auditing standards. Colorado PERA provides retirement and other benefits to 500,000 current and former employees of more than 500 public entities in the state of Colorado.

Recognizing that accounting misstatements are often linked to related party transactions, we are supportive of the PCAOB's continued efforts to strengthen related party auditing standards. Also, as investors, we are often concerned that related party transactions may occur at the expense of a company's owners for the benefit of a company's management, and therefore, believe these transactions should gain higher levels of scrutiny from auditors. Further scrutiny and disclosure of related party transactions will go a long way to improve investors' confidence in audited financial statements, which we believe in the long-run will benefit corporations, auditors, and investors.

We believe the draft proposal provides a reasonable compromise to improve the current standards. The proposed changes will benefit the users of financial statements, but do not appear to place too high a burden on the preparers or auditors of financial statements. We believe the additional requirements for auditors are reasonable and are valuable steps to improve auditing quality, such as requiring a minimum level of communication and disclosure with the audit committee.

PCAOB Office of the Secretary
July 8, 2013
Page 2

We are encouraged that the draft standards include not only enhanced requirements to identify significant unusual transactions, but also further requirements for auditors to understand the structure and business rationale of the transactions. The draft standard's requirement for auditors to obtain support in order to verify that related party transactions were conducted at arm's-length seems like a particularly effective step.

Related party transactions are too infrequently discussed between investors and management, which we believe is partly due to a lack of sufficient disclosure in the financial statements. Related party transactions provide a great example where auditors can provide investors more disclosure on a critical issue. Auditor disclosures on related party transactions would provide investors more information to begin a conversation with management about their related party transactions, which would provide even more scrutiny beyond the services that auditors already provide investors.

We appreciate the opportunity to comment on potential changes of the auditing standards for related party transactions, and would welcome additional opportunities to provide input to the PCAOB as this process continues.

Sincerely,



Jennifer Paquette
Chief Investment Officer
Colorado PERA



Crowe Horwath LLP
Independent Member Crowe Horwath International

July 8, 2013

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

RE: PCAOB Rulemaking Docket Matter No. 038,
Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards

Office of the Secretary:

Crowe Horwath LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board'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" (Proposed Standard or Proposed Amendments, as applicable). We also appreciate the Board's consideration of comments previously provided regarding the prior proposed related party standard and amendments.

We support the Board's efforts to improve audit quality by enhancing existing auditing standards, and are pleased to provide our observations regarding areas where we believe the Proposed Standard and Proposed Amendments could be clarified.

Proposed Standard, *Related Parties*

Paragraph 14 provides a requirement for the auditor to evaluate whether a company has properly identified its related parties and relationships and transactions with related parties. This paragraph further states that, in making that evaluation, the auditor should take into account the information gathered during the audit. However, we believe the provisions of paragraph 14, combined with the examples in Appendix A and the text in footnote 14, could be interpreted as requiring the auditor to perform significant procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company without regard to the assessment of risk of material misstatement. We recommend modifying the standard to clarify that the evaluation and testing for the proper identification of related parties and relationships and transactions with related parties should be determined by the auditor based on risk assessment procedures.

Paragraph 16 contains a number of required procedures to be applied to each previously undisclosed related party or relationship or transaction with a related party, without regard to materiality. We believe there may be instances where previously undisclosed related party transactions may not have been disclosed by company management due simply to their inconsequential nature. We believe it is critical that paragraph 16 provide for auditor judgment in determining the extent of procedures necessary for testing previously undisclosed transactions with related parties. Changing the lead in sentence in this paragraph to: – "The auditor should consider the following:" will provide the ability for the auditor to exercise that judgment.

Paragraph 19, item a, requires communication to the audit committee if the auditor identifies related parties or relationships or transactions with related parties that were previously undisclosed to the auditor. Consistent with the approach to items b. and c. of paragraph 19, we suggest modifying item a. to require communication of transactions with related parties that were previously undisclosed when such transactions are considered by the auditor to be significant .

Effective Date of Proposed Standard and Proposed Amendments

PCAOB Release No. 2013-004 indicates that the proposed standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2013. The time and effort necessary to incorporate the proposed standard and amendments into audit methodologies, guidance and audit programs, and to train staff, is anticipated to be significant. Additionally, the proposed standard and amendments would impact audit planning and quarterly review procedures that are performed earlier in the year. As a result, in the event that the proposed standard and amendments are not finalized and approved by the SEC by the end of the third quarter of 2013, we suggest deferring the effective date for fiscal years beginning on or after December 15, 2014.

Crowe Horwath LLP supports the Board's efforts to improve its auditing standards for the benefit of investors and other stakeholders. We appreciate the opportunity to comment on the Proposed Standard and Proposed Amendments, and would be pleased to respond to any questions regarding the comments we have provided. If you have any questions, please contact Mike Yates or Clarence Ebersole.

Sincerely,

Crowe Horwath LLP

Crowe Horwath LLP



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July 3, 2013

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

Re: *Proposed Auditing Standard — Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards*

PCAOB Rulemaking Docket Matter No. 038

Deloitte & Touche LLP (“D&T”) is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the “PCAOB” or the “Board”) on its *Proposed Auditing Standard — Related Parties* (the “reproposed standard”), *Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (the “reproposed amendments”) (collectively “the reproposal”), PCAOB Release No. 2013-004; PCAOB Rulemaking Docket Matter No. 038 (May 7, 2013).

OVERALL COMMENTS

We support the Board’s efforts to strengthen audit quality by enhancing the auditing standards related to the auditor’s consideration and/or evaluation of:

- A company’s identification of, accounting for, and disclosure of its related parties and its relationships and transactions with related parties,
- Significant unusual transactions, and
- The effects of certain executive compensation arrangements on risks of material misstatement.

In responding to the Board’s request for comments on the reproposal, we offer the following overall observations:

Costs and Benefits. In the Release, the Board is soliciting feedback on the costs and benefits of the reproposal and whether the reproposal should be applicable to emerging growth companies (EGCs) and brokers and dealers. We agree with the Board that investors will benefit from the improved audit quality

that may be expected to result from the auditor's implementation of the reproposal. We also believe that to properly apply the requirements of the reproposal and to realize the anticipated benefits, there will be some increased costs in terms of the incremental audit effort that will be necessary.

While precise quantification of the costs is not possible without field testing the proposed standard, in our professional judgment, we would expect that a final standard would produce benefits to the capital markets in excess of the corresponding costs. We also believe a few minor modifications to the reproposal to improve the ability of the auditor to tailor the necessary procedures based on the auditor's identification and assessment of the related risks of material misstatement (as outlined in the remainder of this letter) would be effective at alleviating some of these costs, while still achieving the intended benefits.

Applicability to Emerging Growth Companies and Brokers and Dealers. We do not believe that the classification of an issuer as an EGC will necessarily correlate strongly with the amount of incremental audit work required to properly apply the reproposal, because each issuer will have its own unique facts and circumstances. We expect that costs would vary by audit depending on (1) the number and complexity of an issuer's related parties and relationships and transactions with related parties, (2) the number and complexity of the significant unusual transactions entered into by the issuer, and (3) the number of executive officers of the issuer and the complexity of the compensation arrangements with those executive officers. EGCs may actually, in certain instances, be more prone than other companies to enter into complex financing or other arrangements which give rise to additional related parties or more complex transactions with such related parties. EGCs might also have more complex arrangements with executive officers.

Based on the above, we believe that the risks of material misstatement upon which the proposal is focused are also present in EGCs and brokers and dealers. Accordingly, we do not believe there is a compelling basis for exempting audits of EGCs or audits of brokers and dealers from the requirements of the reproposal; we believe investors and other financial statement users of these companies would benefit from the additional audit procedures on the transactions and arrangements within the scope of the reproposal.

Requirements and Related Implementation Guidance. In Appendix 4 of PCAOB Release No. 2013-004, the Board provides additional discussion and background information regarding certain of the requirements in the repropose standard and amendments, and discusses the basis for the reproposal. In some cases, the discussion in Appendix 4 clarifies a requirement, makes the intended purpose more readily apparent, or provides useful implementation guidance. Such guidance assists the auditor in assessing risks of material misstatement, linking procedures to those risks, and scaling procedures as necessary for the particular circumstances.

In our May 31, 2012, letter on the original proposal,¹ we recommended that the Board consider including additional information from Appendix 4 into the final standard and conforming amendments to provide additional clarity and implementation guidance. We commend the Board on the additional clarity that has

¹ PCAOB Release No. 2012-001, *Proposed Auditing Standard — Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards.*

already been reflected in the proposed standard. We also believe there are certain other places where additional clarity could be achieved by incorporating into the final standard and conforming amendments, wherever possible, the implementation guidance included in Appendix 4. Detailed below are specific recommendations in this regard.

RELATED PARTIES PROPOSED AUDITING STANDARD

Evaluating Company Identification of Related Parties and Corresponding Transactions. We support the Board’s decision to provide “examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist” as an appendix to the repropoed standard, as this will likely help an auditor to identify such information. A note to paragraph 14 of the repropoed standard refers the auditor to this appendix (Appendix A). However, it is not clear whether the auditor would be required, under the repropoal, to search for and evaluate each of the examples listed in Appendix A in conjunction with evaluating whether the company has properly identified its related parties and relationships and corresponding transactions, in particular as it relates to evaluating the completeness and accuracy of the information provided by the company. We observe that the guidance on page A4-39 is helpful in explaining that the intention is not to “require the auditor to perform procedures with respect to each item listed in Appendix A.” Furthermore, the guidance on page A4-44 is helpful in clarifying that Appendix A “was included to assist the auditor’s identification of related parties or relationships or transaction with related parties previously undisclosed to the auditor” and that “the information and sources relevant to a particular audit would depend on the facts and circumstances of the audit, and thus, not all of the information or sources of information in Appendix A would need to be considered in every audit.” Accordingly, we recommend that the Board incorporate the guidance from A4-39 and A4-44 into the final standard.

Addressing Previously Undisclosed Related Parties or Related-Party Relationships and Transactions. Paragraphs 15 and 16 of the repropoed standard address the auditor’s responsibilities with respect to previously undisclosed related parties or related-party relationships or transactions. We support the need for heightened scrutiny and increased audit attention to identify, assess, and respond to risks of material misstatement related to undisclosed related parties or related-party relationships and transactions; however, we believe paragraphs 15 and 16 could provide for greater flexibility and scalability to permit appropriate use of auditor judgment in assessing risk and designing and performing responsive audit procedures, consistent with the objectives of the Board’s risk assessment standards. Specifically our observations include the following:

- Paragraph 15 requires procedures in addition to inquiry to determine whether previously undisclosed related parties or relationships or transactions exist. Footnote 14 to paragraph 14 requires the auditor to do “more than assessing the process used by the company,” including requiring “the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.” Accordingly, it is not clear what the incremental procedures referred to in paragraph 15 are intended to be, as compared to the procedures already contemplated by the footnote to paragraph 14. The Board’s expectations of the auditor would be more clear if the guidance related to paragraph 14 indicated that, if the auditor believes a greater risk of previously undisclosed

related-party transactions or related-party relationships or transactions exist, the auditor would need to perform more extensive procedures to address the requirement in paragraph 14. Paragraph 15 could then be deleted as the requirement would be included in paragraph 14. Alternatively, paragraph 15 could be clarified to describe the incremental procedures sought by the Board.

- Paragraph 16 includes procedures to perform when previously undisclosed related parties or related-party relationships or transactions exist. We understand the Board’s intent for a basic level of procedures to be performed in all these situations; however, we believe there may be circumstances in which the auditor’s performance of the basic level of procedures (and preparing the related audit documentation) might not be warranted based on the specific facts and circumstances and the auditor’s risk assessment — for example, when the situation is clearly unintentional and inconsequential. We recommend that parts a through c of paragraph 16 be revised to allow for the auditor to make the judgment that the matter is clearly trivial²; and, therefore, no further action is needed.

PROPOSED AMENDMENTS TO OTHER AUDITING STANDARDS

Financial Relationships and Transactions with Executive Officers and Senior Management. We continue to support the Board’s efforts to strengthen audit quality by enhancing the existing requirements relating to understanding financial relationships with senior management. Appendix 4-81 states that “the proposed amendments would not have required the auditor to evaluate management’s identification of its ‘executive officers,’ for other regulatory and SEC filing purposes.” We believe additional clarity can be achieved by stating within the final standard that the auditor would not be responsible for auditing the completeness of the executive officer listing.

OTHER MATTERS

Effect on other PCAOB Auditing Standards. We support the PCAOB’s recent initiative to develop a new framework³ for the reorganization of its auditing standards. In light of that effort, the Board may consider whether certain aspects of the repropoed standard and the repropoed amendments might be organized differently. For example, the Board may consider whether the requirements in the proposed standard relating to communications with the audit committee about related-party matters might be more appropriately finalized as conforming amendments to PCAOB Auditing Standard No. 16, *Communications with Audit Committees*, in order to keep requirements related to such communications in one place within the proposed reorganization. Furthermore, we recommend that the Board assess the effect of the standard on other PCAOB guidance including PCAOB Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*, and PCAOB Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets*, including determining whether such guidance should be amended, updated, or superseded as a result of finalizing the repropoed standard and other repropoed amendments.

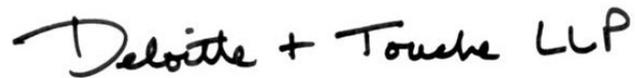
* * *

² PCAOB Auditing Standard No. 14 paragraph 10.

³ *Proposed Framework for Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Auditing Standards and Rules*, PCAOB Release No. 2013-002; PCAOB Rulemaking Docket Matter No. 040 (March 26, 2013).

D&T appreciates the opportunity to provide our perspectives on these important topics. Our comments are intended to assist the PCAOB in analyzing the relevant issues and potential impacts. We encourage the PCAOB to engage in active and transparent dialogue with commenters as the proposed standard is evaluated and changes are considered. If you have any questions or would like to discuss these issues further, please contact William Platt at 203-761-3755 or Megan Zietsman at 203-761-3142.

Very truly yours,

A handwritten signature in black ink that reads "Deloitte + Touche LLP". The signature is written in a cursive, flowing style.

cc: James R. Doty, PCAOB Chairman
Lewis H. Ferguson, PCAOB Member
Jeanette M. Franzel, PCAOB Member
Jay D. Hanson, PCAOB Member
Steven B. Harris, PCAOB Member
Martin F. Baumann, PCAOB Chief Auditor and Director of Professional Standards

Mary Jo White, SEC Chairman
Luis A. Aguilar, SEC Commissioner
Daniel M. Gallagher, SEC Commissioner
Troy A. Paredes, SEC Commissioner
Elisse B. Walter, SEC Commissioner
Paul A. Beswick, SEC Chief Accountant
Brian T. Croteau, SEC Deputy Chief Accountant



Ernst & Young LLP
5 Times Square
New York, NY 10036

Tel: +1 212 773 3000
ey.com

8 July, 2013

Ms. Phoebe W. Brown, Secretary
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

PCAOB Rulemaking Docket Matter No. 038 - 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 Ms. Brown:

EY is pleased to submit comments on the auditing standard the Public Company Accounting Oversight Board (PCAOB or Board) proposed on related parties, the proposed amendments to certain PCAOB auditing standards regarding significant unusual transactions and other proposed amendments to PCAOB auditing standards (collectively, the Reproposal). We continue to support the Board's efforts to update its interim standards. As we said in our letter dated 31 May 2012, we believe that updating the requirements of AU Section 334, *Related Parties*, and adopting other proposed amendments have the potential to improve audit quality.

While we do not necessarily agree with all aspects of the requirements of the Reproposal, we appreciate the Board's detailed description of the results of its deliberations and its rationale for accepting or not accepting various comments. We believe that the Board's commentary assists constituents in understanding the Board's due process. We have one concern with the Reproposal regarding the proposed effective date.

Effective date

The Board proposes that the Reproposal would be effective, subject to approval by the Securities and Exchange Commission (SEC), for audits of financial statements for fiscal years beginning on or after 15 December 2013. We believe that this effective date is operational only if the SEC approves the proposal before 31 October 2013.

Our belief is based on the time we would need to incorporate the new requirements into our methodology and provide necessary training to our staff. Because the requirements of the Reproposal are closely tied to risk assessment procedures, which generally commence early in the audit process, we do not believe that an approval date after 31 October 2013 would afford us sufficient time to implement required changes for audits of fiscal years beginning after 15 December 2013.



* * * * *

We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

Ernst & Young LLP



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

25 June 2013

Ref.: AUD/AKI/HBL/NRO

Dear Sir or Madam,

Re: FEE Comments on PCAOB Rulemaking Docket Matter No. 038 - Proposed Auditing Standard on Related Parties - Proposed Amendments to Certain PCAOB Auditing Standards regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards

FEE¹ (the Federation of European Accountants) is pleased to provide you with its comments on the PCAOB Rulemaking Docket Matter No. 038 - Proposed Auditing Standard on Related Parties -

¹ FEE is the Fédération des Experts comptables Européens (Federation of European Accountants). It represents 45 professional institutes of accountants and auditors from 33 European countries, including all of the 27 European Union (EU) Member States. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 700.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent and sustainable European economy.

FEE's objectives are:

- To promote and advance the interests of the European accountancy profession in the broadest sense recognising the public interest in the work of the profession;
- To work towards the enhancement, harmonisation and liberalisation of the practice and regulation of accountancy, statutory audit and financial reporting in Europe in both the public and private sector, taking account of developments at a worldwide level and, where necessary, promoting and defending specific European interests;
- To promote co-operation among the professional accountancy bodies in Europe in relation to issues of common interest in both the public and private sector;
- To identify developments that may have an impact on the practice of accountancy, statutory audit and financial reporting at an early stage, to advise Member Bodies of such developments and, in conjunction with Member Bodies, to seek to influence the outcome;
- To be the sole representative and consultative organisation of the European accountancy profession in relation to the EU institutions;
- To represent the European accountancy profession at the international level.



Proposed Amendments to Certain PCAOB Auditing Standards regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards.

1. Issues taken on board in the reproposal

FEE already commented on the Proposal made in 2012 and we are now pleased to notice that some of our main concerns have been tackled, namely:

- ✓ FEE previously suggested that it would be appropriate to highlight throughout the standard that the **responsibility to identify related parties** rests with the company and not with the auditor. Therefore, it is not appropriate to require the auditor to “identify” related parties. The re-proposal includes changes addressing this significant issue.
- ✓ However, FEE notes a similar issue with regard to **significant unusual transactions**. Indeed, the discussion in Appendix 4 implies that the auditor is required to “identify” significant unusual transactions, especially in the re-proposed wording (new Note to AU 316.66). FEE notes that the Board recognises that the relevant procedures (inquiring of management and others; understanding controls relating to significant unusual transactions; and, taking into account other information obtained during the audit) are performed as part of the auditor’s risk assessment process rather than to enable the auditor to perform an initial identification of such transactions, which is the role of management (Ref: Page A4-61 as well as the changes to AS 12). Thus FEE believes this is a matter of misaligned wording, and suggests this be rectified.
- ✓ FEE previously suggested that a true **two-way communication** between the **auditor** and the **audit committee** regarding related parties should be further highlighted. FEE also recommended that due consideration should be given to a global solution on the matter, in light of the current European debate on strengthening the role of audit committees and the communication between the auditor and the audit committee. We are delighted to share some work we recently did on this subject matter:
 - A Discussion Paper on ‘The Functioning of Audit Committees’² that FEE published in July 2012; as well as
 - ‘Global Observations on the Role of the Audit Committee - A Summary of Roundtable Discussions’³ organised by FEE, the CAQ and ICAA
 - Highlights of a Roundtable we organised in February 2013 on ‘How to improve the functioning of audit committees further’⁴

² http://www.fee.be/index.php?option=com_content&view=article&id=519&Itemid=106&lang=en

³ http://www.fee.be/index.php?option=com_content&view=article&id=1330&Itemid=106&lang=en

⁴ http://www.fee.be/index.php?option=com_content&view=article&id=1295&Itemid=106&lang=en



2. Remaining issues

Our general comments on the remaining issues re the PCAOB proposed standard that are relevant from a European or international perspective are set out below and can be summarised as follows:

- ✓ FEE previously suggested that it would be appropriate to explicitly include **fraud risk** in the objective of an audit standard on related parties. Whilst recognising that the PCAOB does have a separate fraud standard, FEE stresses that the very limited mention of fraud (not significantly changed from the 2012 proposal) in the re-proposal is a mismatch with the amount of coverage in the accompanying material that lengthily deals for instance with recent fraud cases. At the very least, it would be helpful for practitioners if material would be included in this standard – currently there is just one note referencing AU 316.
- ✓ In general, FEE believes that **alignment in auditing standards worldwide**, to the maximum degree possible, is beneficial for capital market participants with cross-border interests and global activities. The new proposed standard on related parties introduces a closer alignment with the equivalent ISA issued by the IAASB. However, differences remain as displayed in the comparative analysis. Given that related parties often have cross-border elements in large companies, FEE believes that differences in audit standards regarding the audit of related parties should be kept to a minimum with differences only arising from specific national requirements.

3. Further considerations to international alignment

With regard to **international alignment**, we would like to emphasise that this alignment of auditing standards enhances the quality of audits based on globally accepted auditing standards at national level, including the acceptance of audit reports beyond home jurisdictions. In addition, aligning requirements worldwide regarding communication with audit committees facilitates the participation of non-national members in audit committees which is a corporate governance consideration that multinational companies face.

The new proposed standard on related parties introduces a closer alignment with the equivalent ISA issued by the IAASB. In this context, FEE welcomes the comparison between the proposed standard and the ISAs included in Appendix 5. Currently, this appendix is mainly descriptive with references to the requirements in each set of standards. Although the comparison with equivalent ISAs is useful, it would be beneficial to users if the PCAOB provided detailed comments as to why the PCAOB believes that specific differences remain necessary. Given that related parties often have cross-border elements in large companies, FEE believes that differences in audit standards regarding the audit of related parties should be kept to a minimum with differences only arising from specific national requirements.

In future projects, increased transparency regarding the standard setting process would facilitate those commenting on the proposals performing an analysis of the proposals as well as the application of the PCAOB audit standards by auditors of multinational companies that normally



operate in an ISA environment. This would altogether lead to higher quality standards. Such transparency could be achieved by providing mark-up texts of the proposals and through providing further arguments as to why the amendments proposed would lead to higher audit quality. In this context, it should be borne in mind that higher audit quality is only achieved through changing of behaviour by auditors, which is not necessarily achieved by setting standards, but through their application.

Appendix 4 is quite extensive and could benefit from having more concise conclusions that clearly set out the reasons for the decision to amend a specific provision. With these amendments to Appendix 4, FEE recommends that it is published as a “Basis for Conclusions” or, where appropriate guidance could be added to the text of the Standard. Both Basis for Conclusions and explanatory guidance is found very useful in practice, as acknowledged by other standard setters, such as the IASB and the IAASB.

For further information on this FEE letter, please contact Hilde Blomme, Deputy Chief Executive at +32 2 285 40 77 or via email at hilde.blomme@fee.be or Noémi Robert, Project Manager at +32 2 285 40 80 or via email at noemi.robert@fee.be from the FEE Secretariat.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'AK', written in a cursive style.

André Killesse
President

A handwritten signature in blue ink, appearing to be 'OBT', written in a cursive style.

Olivier Boutellis-Taft
Chief Executive



COMMITTEE ON CORPORATE REPORTING

July 18, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 38

Dear Board:

The Committee on Corporate Reporting (“CCR”) of Financial Executives International (“FEI”) appreciates the opportunity to share its views on the Public Company Accounting Oversight Board’s (“PCAOB” or “Board”) 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” (“the Release”). FEI is a leading international organization of senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

Related parties and significant transactions outside the normal course of business are critical areas requiring auditor focus to address potential risks of material misstatement to a Company’s financial statements. We appreciate the Board’s efforts in undertaking this project and also in putting it forward as a reproposal at this time. We support the repropose standard, along with the improvements made from the original proposal.

Because related party transactions and significant transactions outside the normal course of business are critical areas of potentially significant audit risk, we believe that this proposed standard should apply to all companies, including Emerging Growth Companies. Overall, we believe the frequency and relative magnitude of related party transactions is greater at smaller companies and start-up companies; therefore, the audit risk of material misstatement from such activity is higher and audit focus in these areas is even more important at such companies.

* * * * *

We appreciate the Board's consideration of these matters and welcome the opportunity to discuss any and all related matters. If you have questions, please contact Lorraine Malonza at (973) 765-1047 or lmalonza@financialexecutives.org.

Sincerely,

A handwritten signature in cursive script that reads "Stephen J. Cosgrove". The signature is written in black ink and includes a long horizontal flourish extending to the right.

Stephen J. Cosgrove
Chair, Committee on Corporate Reporting
Financial Executives International

cc: Martin F. Baumann, Chief Auditor and Director of Professional Standards



July 3, 2013

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Via Email to comments@pcaobus.org

Audit - Tax - Advisory

Grant Thornton LLP
175 W Jackson Boulevard, 20th Floor
Chicago, IL 60604-2687

T 312.856.0200
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www.GrantThornton.com

Re: PCAOB Rulemaking Docket Matter No. 038 – Proposed Auditing Standard on Related Parties and Related Amendments to PCAOB Auditing Standards

Dear Board Members and Staff:

Grant Thornton LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") repropoed auditing standard, *Related Parties*, amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other amendments to PCAOB auditing standards. We recognize the Board's considerable efforts in responding to comments received on the original proposal, and we value the importance and ability to provide additional comments on the Board's related revisions.

Overall, we support the issuance of the repropoed auditing standard and amendments, which seem to be more closely aligned with the Board's risk assessment standards. We believe that the repropoed auditing standard and amendments will likely strengthen the auditor's procedures with regard to related parties and relationships and transactions with related parties, as well as significant unusual transactions, ultimately resulting in enhanced audit quality and investor confidence. However, we also believe that the important changes that the PCAOB has made to align the proposal with the risk assessment standards and to allow for more auditor judgment can be strengthened if the Board were to revisit its standard-setting approach, particularly with respect to the use of application guidance, as described further below. In our view, it is unlikely that the key considerations embedded in the Board's views on the application of the requirements that are included in the current release of the repropoal will be considered in the implementation of the final standard unless they are appropriately carried forward.

In Appendix 4, *Additional Discussion of the Repropoed Standard and Amendments and Questions for Public Comment*, of the PCAOB release, the Board indicates that, consistent with other projects, it includes performance requirements in the standard, while providing additional discussion and examples in an appendix. This approach is intended to promote "...a clear separation between the required procedures in the standard and the Board's discussion regarding the potential application of the standard." We do not disagree with separating the requirements from the additional discussion that provides application guidance, but we have significant concerns with a commenter's ability to provide, and the PCAOB to obtain, beneficial feedback on a proposal

when it is unclear the extent to which the additional discussion in a particular release will be carried forward to a final standard, such as in an appendix thereto.

We believe that some of the requirements can be vastly misinterpreted with respect to the extent to which they should be performed, when read out of context, without the benefit of the additional discussion addressing the Board's intent. In this particular release, the Board has included an extensive discussion pertaining to the underlying requirements, such as guidance regarding the purpose of performing procedures to understand compensation arrangements and the extent of testing related to the accuracy and completeness of related parties and relationships and transactions with related parties, including the auditor's responsibilities with respect to the sources of information that could indicate that undisclosed related parties or relationships and transactions with related parties may exist (for example, the auditor is not required to perform procedures with respect to each source referenced in Appendix A). We would expect the Board to carry forward the essential guidance currently in Appendix 4 of the release in a separate appendix to the final standard, thus making such guidance part of the standard as well as readily accessible and searchable. Without doing so, we believe that the Board may inadvertently affect the consistency of implementation and the initial and recurring implementation costs, including costs resulting from future interpretations of the Board's requirements as part of internal or external inspections or even potential litigation. We also respectfully suggest that all future releases more clearly separate the Board's analyses, questions, initial conclusions, and considerations of comments received from the essential guidance that needs to, and is expected to, remain as part of the final standard in order for auditor's to fully understand the Board's expectations and to implement appropriate policies and procedures to meet those expectations.

Below please find additional comments and suggestions for the Board's consideration related to specific aspects of the repropoed auditing standard and amendments and comments related to certain questions raised by the Board in Appendix 4.

Applicability and scalability

Related parties and relationships and transactions with related parties or significant unusual transactions may exist at any entity, regardless of its size. Accordingly, we believe that the repropoed auditing standard and amendments should be applicable to all audits performed under PCAOB standards, including audits of emerging growth companies and audits of brokers and dealers. However, scalability is fundamental for the auditor to be able to appropriately apply skepticism and judgment to assess and respond to risks of material misstatement.

Generally, we believe that the repropoed auditing standard and amendments are scalable and that specific requirements to address certain types of entities, such as emerging growth companies and brokers and dealers, need not be separately included. The requirements in any one standard need to be broad so that they can be applied in each audit, regardless of the type of entity or the nature of its activities. In addition, we believe that the expected costs of initial implementation, including training, would generally be the same, as a firm's methodology, tools, and guidance would be based on the broad principles and requirements that are to be adapted for the entity under audit, while considering the industries in which the firm focuses. For

instance, in an audit of a broker and dealer, a firm may indicate that the risks related to expense sharing and related cost allocations may be elevated. Specific industry related guidance also tends to be enhanced over time by standard-setters, regulators, and firms alike.

Linking the repropoed auditing standard and amendments more closely to the risk assessment standards promotes scalability. Critical to the appropriate application of scalability, however, is the varying extent to which audit procedures need to be performed and documented to demonstrate the auditor's compliance with the requirements, particularly in situations in which the risks of material misstatement are not significant. For example, the extent to which the auditor performs procedures to test the accuracy and completeness of related parties and relationships and transactions with related parties, to determine whether any exceptions to the company's established policies or procedures were granted, or to evaluate the financial capability of related parties will vary with each audit. Although the Board recognizes that audit procedures would vary, the requirements themselves without the inclusion of the additional, essential guidance may drive auditors to perform more audit procedures when unnecessary to do so.

Relationships and transactions with executive officers

We continue to support the amendments related to understanding the company's financial relationships and transactions with its executive officers to identify pressures or incentives that may heighten risks of material misstatement. We also commend the PCAOB for clarifying, as suggested by commenters, the purpose of the related requirements and that such requirements are not intended for the auditor to assess the appropriateness of compensation arrangements. However, in connection with our previous comments, we believe that the statements made in Appendix 4 relative to these requirements are essential and need to be carried forward to the final standard to provide context for the auditor as to the nature of the risks that should be evaluated when obtaining an understanding of those arrangements.

Identifying and responding to risks of material misstatement

We agree with the requirements in the repropoed auditing standard for the auditor to identify and assess the risks of material misstatement associated with related parties and relationships and transactions with related parties and to design and implement audit responses that address the identified and assessed risks. We believe that it may be helpful to include a reference to the requirements pertaining to past audits within the Board's risk assessment standards to further enhance the effectiveness of the audit process, particularly in reference to reading underlying documents and evaluating terms and other information concerning significant ongoing matters, while also reminding auditors of their responsibility related to the continued relevance and reliability of information previously obtained.

Undisclosed related parties or relationships or transactions

We support the Board's revision to remove the requirement in the original proposal to treat each previously undisclosed related party transaction as a significant risk. In our comment letter, dated May 31, 2012, on the original proposal, we expressed our concerns with several fairly prescriptive requirements, including this particular requirement, which did not seem to take into account the auditor's reassessment of the risk of material misstatement. The Board's

revision introduces a more principles- and risk-based approach. Nevertheless, we believe that additional revisions are necessary to the repropose requirement in paragraph 16.

Paragraph 16 continues to include an extensive list of procedures that apply when the auditor determines that a previously undisclosed related party or relationship or transaction with a related party exists. The nature and extent of several procedures, however, is dependent on the results of the auditor's inquiries of management (paragraph 16a) and the auditor's evaluation of why the related party or relationship or transaction with a related party was previously undisclosed (paragraph 16b). In this regard, we believe that the requirement in paragraph 16 may be bifurcated so that the auditor takes such information into account in determining whether the risk of material misstatement needs to be reassessed and the additional audit procedures necessary to respond to the increased or newly identified risks. We further believe that the requirements in paragraphs 16e and 16h can be moved to a note that more simply refers to the applicability of paragraph 12 when related party transactions are required to be disclosed or determined to be a significant risk and to the auditor's responsibilities related to identified or suspected fraud and illegal acts.

Audit committee communications

The repropose auditing standard would require auditors to communicate other *significant* matters arising from the audit, including, among other things, the identification of undisclosed related parties or relationships or transactions with related parties (paragraph 19a). We believe that this requirement can be interpreted in varying ways, such as requiring the auditor to communicate only those undisclosed related parties or relationships or transactions with related parties that the auditor deems to be a significant matter or to communicate all undisclosed related parties or relationships or transactions with related parties because they are considered by the repropose auditing standard to be a significant matter.

As indicated in Appendix 4 of the PCAOB release, the repropose auditing standard intends to allow for more auditor judgment by not requiring that each undisclosed related party transaction be treated as a significant risk. Relative to communications with the audit committee, Appendix 4 also indicates that concerns regarding the original proposal were expressed by certain commenters that suggested additional auditor judgment so as to avoid unnecessary costs. Accordingly, to allow for more auditor judgment as intended by the Board with regard to the procedures related to undisclosed related party transactions and to eliminate the potential for misapplication of the requirement by various auditors, we believe that the communication requirement in paragraph 19a should be revised to pertain to the identification of "significant" related parties or relationships or transactions that were previously undisclosed. This would also seem consistent with the nature and extent of the other required audit committee communications.

Effective date

We acknowledge the importance of adopting the repropose auditing standard and related amendments as soon as practicable. However, we believe that the feasibility of the anticipated effective date is dependent on the SEC's date of approval and the lead time provided for firms to appropriately update their policies and guidance and develop and deliver training prior to the

first quarter subject to the new requirements. For an entity with a calendar year-end, it may be difficult and sometimes disadvantageous for firms to adopt new policies and procedures and provide training in the midst of “busy season.” Accordingly, we suggest that the Board consider, based on the potential timing of the SEC’s approval, whether an effective date for fiscal years beginning on or after December 15, 2014, with early implementation permitted, may be more suitable. A later effective date can promote audit quality by allowing firms to early adopt and to further refine the policies, procedures, and guidance for questions and other matters that arise during implementation.

If you have any questions about our response, or wish to further discuss our comments, please contact Karin A. French, National Managing Partner of Professional Standards, at Karin.French@us.gt.com or at (312) 602-9160.

Sincerely,





July 1, 2013

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

Dear Board Members:

The Audit and Assurance Services Committee of the Illinois CPA Society (“Committee”) is pleased to comment on the Reproposed Auditing Standard, *Related Parties, Proposed Amendment to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (Docket Matter No. 38). The organization and operating procedures of the Committee are reflected in the attached Appendix A to this letter. These comments and recommendations represent the position of the Illinois CPA Society rather than any members of the Committee or of the organizations with which such members are associated.

The Committee reviewed and commented on the original proposal in 2012. We thank the PCAOB for considering our comments and specifically addressing them on page A4-46 of Appendix 4. We also thank the PCAOB for considering all comments received, editing the original proposal, and reproposing this standard. We fully believe that this open process and full discourse leads to a superior set of standards.

Our committee studied the reproposed standard and all of the release materials. The documentation is thorough, but quite lengthy. We agree with Board Member Steven Harris’ encouragement to look for ways to streamline future releases. Accordingly, our comments do not follow the prescribed set of questions; instead we include some comments on the docket in this letter. Additionally because of the lengthy materials, we urge the Board to reconsider the effective date. We recommend that the effective date be no earlier than fiscal years beginning on or after June 15, 2014.

Related Parties

We support the PCAOB’s efforts to create a standard responsive to risks associated with related parties and significant unusual transactions. Overall, we agree with the PCAOB’s comments on page A4-46 and believe that auditors should perform specific procedures “to determine whether related parties and relationships and transactions with related parties have been identified, accounted for, and disclosed in the company’s financial statements.” However, we diverge over the extent of investigative procedures necessary as part of a financial statement audit. As written, the reproposed standard’s objective appears, to us, to require performance of procedures equivalent to a stand-alone forensic engagement to uncover all related parties and transactions regardless of quantitative or qualitative risk factors.

The release documentation states that one of the reasons for replacing AU sec. 334 is alignment with the risk assessment standards. We support this goal. We agree that auditor judgment is paramount when performing audit procedures over related parties. We agree that only certain related party transactions may rise to the level of a “significant risk.” This scaled approach is both effective and cost-sensitive.

Regardless of the risks assessed, the reproposed standard includes a requirement (paragraph 14) for the auditor to evaluate whether management identified all of the related parties. We disagree with this requirement on every audit engagement as it does not allow for auditor judgment that the Board incorporated in other areas. We agree that inquiring of management and obtaining representations about the existence of related parties is one way to identify their existence. If the requirement is retained, we urge the Board to include additional methods auditors can use to test for the existence of related parties. For example, we particularly like Appendix A, which includes examples for the auditors to consider. If possible, we request the Board to expand this Appendix to include additional examples and guidance. (We recommend including this type of guidance whenever possible as part of all future standards.)



ILLINOIS CPA SOCIETY

We support increased discourse between the auditor and the audit committee, which will hopefully lead to increased audit committee knowledge and responsibility. The repropoed standard includes a requirement (paragraph 19) for the auditor to communicate the results of the related party procedures and a requirement (paragraph 7) for the auditor to inquire of the audit committee about related party relationships as part of the risk assessment procedures both which we believe are positive improvements.

The repropoed standard includes five required procedures (paragraph 12) that the auditor should perform for transactions required to be disclosed or determined to be a significant risk. While we agree that the auditor should perform procedures for both of these situations, we do not agree that the same response is sufficient for both situations. From our reading, it is also unclear as to whether the auditor should perform additional procedures beyond those in paragraph 12 if a significant risk associated with related parties is identified.

Additionally, paragraph 12 includes a requirement at d for the auditor to “evaluate the financial capability of the related parties.” We agree that evaluating a related party’s financial health can be an appropriate response to related party risks. However, the auditor should be able to use judgment to determine whether or not this procedure is necessary. Due to the difficulty in obtaining such information, the auditor should be allowed to select a more effective or more economical response. Additionally, we request the Board to add guidance regarding appropriate alternative procedures if information regarding the related parties’ financial capability is not readily available.

Paragraph 14 includes a requirement for the auditor to evaluate the sufficiency of the company’s related party identification. As written, this requirement suggests that an auditor needs to perform a forensic audit of all transactions to search for any and all related party transactions, regardless of risk (qualitative factors) or materiality (quantitative factors). The risk assessment and response sections of the repropoed standard allow the auditor to use judgment as part of the risk assessment process (one of the adjustments we support). Additionally, the required procedures are not sufficient to draw a conclusion that all related parties were identified. We think this requirement will mislead investors. The paragraph includes a requirement to read the minutes of applicable meetings. We agree with this requirement, but we do not think it is sufficient to identify all related party transactions.

Unusual Transactions and Other Comments

The Committee believes the repropoed amendments related to unusual transactions are aligned with the risk assessment standards. We think these procedures are properly responsive and could assist the auditor in identifying a related party.

The adjustments with respect to understanding the company’s financial relationships with its executives as part of risk assessment appear appropriate to the Committee. However, the Committee strongly believes auditors should not be responsible for assessing the appropriateness of executive compensation. This type of assurance is not required to opine on whether or not the financial statements are fairly stated. If the executive compensation plans do not warrant an audit response based upon the risk assessment procedures performed, the auditor should not be required to perform any additional procedures.

The Committee thanks the PCAOB for considering companies other than the Fortune 500 when developing its standards. These companies are critical to the success of the economy. We believe the auditing standards should apply to all entities. We do not support carve-out or add-on pieces for entities of differing sizes. The standards should be written to allow for auditor judgment in determining the appropriate related party and unusual transaction response. Small companies may have many related parties and large companies may have very few related party transactions.



ILLINOIS CPA SOCIETY

The financial thresholds that make sense for scalable financial reporting does not transfer to audit scope because each entity is unique.

The Illinois CPA Society appreciates the opportunity to express its opinion on this matter. We would be pleased to discuss our comments in greater detail if requested.

Sincerely,

James J. Gerace, CPA

Chair, Audit and Assurance Services Committee

Elizabeth J. Sloan, CPA

Vice Chair, Audit and Assurance Services Committee



ILLINOIS CPA SOCIETY.

APPENDIX A

AUDIT AND ASSURANCE SERVICES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2013 – 2014

The Audit and Assurance Services Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members. The Committee seeks representation from members within industry, education and public practice. These members have Committee service ranging from newly appointed to almost 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of audit and attestation standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of audit and attestation standards. The Subcommittee develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

Public Accounting Firms:**National:**

Scott Cosentine, CPA	Ashland Partners & Company LLP
Eileen M. Felson, CPA	PricewaterhouseCoopers LLP
Angela Francisco, CPA	McGladrey LLP
Robert D. Fulton, CPA	Baker Tilly Virchow Krause, LLP
James J. Gerace, CPA	BDO USA, LLP
Jon R. Hoffmeister, CPA	CliftonLarsonAllen LLP
James R. Javorcic, CPA	Mayer Hoffman McCann P.C.
Matthew G. Mitzen, CPA	Plante & Moran, PLLC
Elizabeth J. Sloan, CPA	Grant Thornton LLP
Kevin V. Wydra, CPA	Crowe Horwath LLP

Regional:

Jennifer E. Deloy, CPA	Frost, Ruttenberg & Rothblatt, P.C.
Barbara F. Dennison, CPA	Selden Fox, Ltd.
Andrea L. Krueger, CPA	Corbett, Duncan & Hubly, P.C.
Stephen R. Panfil, CPA	Bansley & Kiener LLP

Local:

Scott P. Bailey, CPA	Bronner Group LLC
Matthew D. Cekander, CPA	Doehring, Winders & Co. LLP
Lorena C. Johnson, CPA	CJBS LLC
Loren B. Kramer, CPA	Kramer Consulting Services, Inc.
Carmen F. Mugnolo, CPA	Mugnolo & Associates, Ltd.
Geoff P. Newman, CPA	Weiss & Company LLP
Steven C. Roiland, CPA	Kessler Orlean Silver & Co., P.C.,
Jodi Seelye, CPA	Jodi Seelye, CPA
Richard D. Spiegel, CPA	Steinberg Advisors, Ltd.
Timothy S. Watson, CPA	Benford Brown & Associates, LLC

Industry:

Todd W. Bailey, CPA	kCura Corporation
George B. Ptacin, CPA	The John D & Catherine T MacArthur Foundation

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July 5, 2013

Mr. Martin F. Baumann
Chief Auditor and Director of Professional
Standards
Public Company Accounting Oversight Board
c/o Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 20006-2803
USA

By E-mail: comments@pcaobus.org

Dear Mr. Baumann,

**Re.: PCAOB Rulemaking Docket Matter No. 038:
PCAOB Release No. 2013-004, May 7, 2013
Proposed Auditing Standard – Related Parties
Proposed Amendments to Certain PCAOB Auditing Standards
Regarding Significant Unusual Transactions
And Other Proposed Amendments to PCAOB Auditing Standards**

The IDW would like to thank you for the opportunity to comment on the PCAOB's Re-Proposed Auditing Standard – Related Parties and Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions And Other Proposed Amendments to PCAOB Auditing Standards (hereinafter collectively referred to as the "re-proposed standard").

We refer to our letter dated May 15, 2012, in which we had previously commented on the original proposal.

We are pleased to note that the PCAOB has now addressed a significant concern we had pointed out in the afore-mentioned letter, i.e., the need to recognize that it is a company's management and not the auditor that has a responsibility to identify related parties. Rather the auditor should take a risk-based approach to evaluate whether the company has properly identified related parties and relationships and transactions with related parties. This is a significant improvement to the standard and clarifies to the public the respective roles of management and the auditor in this regard. We had also commented on

GESCHÄFTSFÜHRENDER VORSTAND:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
Dr. Klaus-Peter Feld, WP StB CPA;
Manfred Hamann, RA



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inconsistencies in the explanation of the term “significant unusual transactions” and had suggested the term be defined. We are pleased to note that, although the Board did not define the term as such, it has agreed to the need for consistency.

In this letter we have chosen not to respond to individual questions raised, but comment instead on those areas with which we have concerns. We submit our comments as follows:

Alignment with Auditing Standards Promulgated by the IAASB

We had also repeated our fundamental concerns as to the differences between the PCAOB’s and the IAASB’s sets of standards, citing the PCAOB’s adoption of a more rules-based approach as opposed to the IAASB’s principles-based approach specifically. In this context we had also questioned the prescriptive nature of certain requirements as well as the lack of specific guidance material, e.g., equivalent to paragraphs A16 and A18 of ISA 550. In our opinion, the inclusion of a note similar to that included under paragraph 18 of the re-proposed standard regarding arm’s-length transactions would be appropriate to draw attention to potential issues regarding related party relationships and transactions.

We note that in re-proposing the standard these concerns have not been addressed, and thus remain concerned that the Standard may result in a public perception that auditors are in a position to obtain more assurance in relation to related parties than is attainable in practice.

Furthermore, in regard to the question of whether Standards could include certain guidance material, we note that the PCAOB has retained its previous stance i.e., “to include performance requirements in the standard and to provide additional discussion and examples in an appendix to the release” (page A4-35). However, both the length of the PCAOB’s release(s) and the nature of the discussions therein make it difficult for practitioners to be sure of having located all relevant guidance. We would therefore urge the Board to consider whether a more efficient approach to guidance, such as that adopted by the IAASB throughout its Clarity Project, would be more appropriate.

Prescription of Substantive Procedures

In our previous letter we had expressed our general concern about the level of prescription of requirements in the proposed standard, by stating: “In comparing the proposed standard with the IAASB’s corresponding standards we note a



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number of instances where the relevant ISAs require the auditor to perform procedures directed toward a certain aim, but provide flexibility by guiding the auditor with application material suggesting possible ways in which it might be appropriate for the auditor to tackle this, rather than prescribing a list of procedures to be performed. In contrast, the proposed standard often specifies outright certain, or all, of these possibilities as required procedures.”

On page A4-23 the Board recognizes that: “Depending on the facts and circumstances, risks of material misstatement associated with related parties and relationships and transactions with related parties might also represent fraud risks or other significant risks.” Thus, the Board also recognizes that there may be cases in which risks of material misstatement associated with related parties and relationships and transactions with related parties do not represent fraud risks or other significant risks.

The various paragraphs of AS-13 that deal with fraud risks and other significant risks require substantive procedures responsive to those assessed risks so classified. Where, however, the assessed risk is neither a fraud risk nor other significant risk there is no such stipulation, and thus, depending on the individual engagement circumstances, the auditor may determine that tests of controls suffice. The level of prescription for substantive procedures in paragraph 12 of the re-proposal – whilst likely constituting appropriate responses where there is a fraud risk or other significant risk – may be to some extent excessive for related party transactions that do not represent such risks. As we observed in our previous letter, the re-proposed new paragraph 10A of AS-12 is also one such example. It therefore appears to us that the PCAOB has either effectively “earmarked” some risks as always posing significant risks without being clear as to its intention, or may need to give greater consideration as to the necessity for certain requirements. We note the discussion on pages A4-26 et seq. in regard to comments received, and would like to suggest the wording of the re-proposed Standard be revised to clarify more explicitly – as explained in the text towards the bottom of A4-31 concerning aggregated related party disclosures and at the top of A4-32 regarding the use of auditor judgement – that the procedures required by section a.-d. do not apply to individual related party transactions when the assessed risk is neither a fraud risk nor other significant risk (i.e., in these circumstances the procedures would be used to test the effectiveness of controls) and that more in-depth procedures required by section e. are intended to be supplemental procedures commensurate with the auditor’s evaluation of the company’s facts and circumstances, and thus the auditor will exercise professional judgement in determining the appropriate audit procedures in each case.



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Purpose and Scope of the Objective

In its introduction to the release, the PCAOB has again repeatedly emphasized the significance of related party transaction in numerous prominent financial reporting frauds over the last few decades.

In our previous letter we had commented on the difference between the PCAOB's objective and that of ISA 550. The latter specifically mentions fraud risk factors that may be associated with related parties and related party transactions, whereas the former does not. We had expressed our concern that when an auditor considers whether the procedures he or she has performed in accordance with the relevant standards are sufficient to meet the objective applicable to related parties, the absence of any mention of fraud risk factors in the objective could be counterproductive. Furthermore, such absence might lead to public perceptions that related party relationships and transactions form a relatively straightforward aspect of an audit.

However, in making the re-proposal, the PCAOB has chosen not to change the objective at all. Indeed, we note that the Board has proposed instead to remove the requirement to perform other procedures as appropriate to meet the objectives of the standard (compare proposed paragraph 15d. with re-proposed paragraph 14e.), which does not alleviate this particular concern. We do not believe that the explanation given on Page A4-8 sufficiently justifies the continued exclusion of a particular mention of fraud as a potential audit risk factor that may be associated with related parties. The very limited mention of fraud in the re-proposal is, at the very least, a mismatch with the amount of coverage in the accompanying material. In our opinion, it would be helpful to practitioners and the public if further material were included in this standard.

If you have any further questions about our comments, we would be pleased to discuss our comments with you.

Yours very truly,

Klaus-Peter Feld
Executive Director

Gillian Waldbauer
Technical Manager



24 June 2013

Our ref: ICAEW Rep 92/13

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

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

ICAEW welcomes the opportunity to comment on the Re-Proposed Auditing Standard: *Related Parties - Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other PCAOB Amendments to PCAOB Auditing Standards* published by the PCAOB on 7 May 2013, a copy of which is available from this [link](#).

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 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

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Main Comments

Support for the revised proposals

We welcome the re-proposed standard which is an improvement on the original proposals published in February 2012.

In particular, we support clarification that the audited entity has the primary responsibility for the collection and disclosure of information about related parties and transactions with them. We also note the importance of alignment with the risk assessment standards.

Our outstanding substantive concerns

We have outstanding concerns in a number of areas which we set out in the remainder of this letter. The requirements of paragraph 13 on intercompany transactions in particular are still unclear. Although we acknowledge that the requirement to perform procedures on intercompany transactions at a concurrent date is an existing requirement, we believe that the standard could provide more insightful guidance. The auditors' response should be based on the assessed risk of material misstatement which will be influenced by *inter alia*, the nature and materiality of the intercompany transactions, whether the intercompany transactions are eliminated on consolidation, whether the auditor is responsible for the audit of both entities, and so on. In our view it would be helpful to include such guidance in the final standard.

We believe a full year is needed for implementation of this standard to allow training to take place in the quieter months for the revision of audit methodologies. If the standard cannot be issued until the third quarter of 2013, it will be too late for implementation in the following audit season.

Our continued concern about shortcomings in the transparency of the PCAOB's standard-setting process

We continue to be disappointed and concerned that the quality of the analysis of differences between the PCAOB's requirements and the related IAASB and AICPA requirements remains so poor. It amounts to little more than statements of the existing positions with no attempt to explain or justify the differences. A significant amount of audit work under these standards will be performed by auditors outside the United States by, among others, non-US accounting firms who are auditors of registrants or auditors of components of US domestic registrants. These auditors will likely have been trained in ISAs and have extensive experience in applying such standards. Furthermore, where companies are either dual listed or have local statutory reporting requirements they will need to be audited in accordance with local auditing standards. Such standards are ISAs in many jurisdictions. These auditors will look to 'bridge the gap' between ISA requirements and PCAOB standards rather than prepare a separate audit file under PCAOB standards, which would be wasteful where differences are very limited. An analysis that clearly articulates the additional requirements of PCAOB standards will likely lead to better execution of PCAOB audit work outside the United States. The absence of a better analysis also compromises the PCAOB's ability to influence the IAASB.

We have made this point in all of our recent responses to the PCAOB's exposures. We are also disappointed that no marked-up version of the repropounded standard has been made available. This lack of transparency compromises the quality of respondent comments and can appear to be a deliberate attempt to discourage detailed scrutiny. We are sure that this is not intended and we encourage the PCAOB to have more confidence in the changes it makes. A move in this direction, even if it amounted to highlighting the significant paragraphs that had changed would elicit better quality responses and ultimately result in better quality standards, audits and investor protection. This method is adopted by most standard-setters including the IAASB.

Costs and benefits

The PCAOB asks several questions about costs and benefits and asks respondents for data supporting cost-benefit analyses. These questions are disingenuous. The PCAOB would very likely already have scrutinised them, if they existed and we do not believe that the PCAOB or other standard-setters can continue to ask questions about costs, benefits or impacts without making some attempt, however rudimentary, to perform such analyses itself, or at least to provide some criteria to guide respondents in this area. Absent a framework, statements about costs, benefits and impacts whether made by standard-setters or respondents, amount to speculation.

We have made very similar points to the IAASB in several recent responses to them.

Answers to the PCAOB's specific questions

The appendix to this letter contains our answers to the PCAOB's specific questions. While we understand the PCAOB's desire to solicit comment, we believe that the volume of questions, many of which are repetitive and overlap, risks diminishing the quality of the feedback received. Respondents can always comment on any aspect of a proposal in the absence of a specific question soliciting input. Better responses might also be elicited were the PCAOB to consider focussing the attention of respondents on what they consider to be the key aspects of the proposals.

Yours Faithfully



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APPENDIX

1. Are the requirements of the repropoed standard appropriate? Why or why not?

The requirements of the repropoed standard are an improvement on the original proposals although as set out above and below, we have outstanding concerns on a number of areas.

2. Do the changes in the reproposal clarify the relationship of the repropoed standard with the risk assessment standards? Why or why not?

The changes in the reproposal have helped clarify the relationship of the repropoed standard with the risk assessment standards.

3. Does the alignment of the repropoed standard with the risk assessment standards enable the auditor to introduce efficiencies in the audit approach? Why or why not?

Efficiencies in the audit approach will be facilitated but not guaranteed by the improved alignment.

4. Would the procedures required by the repropoed standard improve the auditor's understanding of a company's relationships and transactions with its related parties? Why or why not?

The procedures required by the repropoed standard should improve the auditor's understanding of a company's relationships and transactions with its related parties to the extent that the proposals now require more of the audited entity. The success of such changes is of course partly contingent on the actions of the audited entity.

5. Is the requirement in the repropoed standard to evaluate whether the company has properly identified the company's related parties and relationships and transactions with its related parties appropriate? Why or why not?

The requirement to evaluate whether the company has properly identified the company's related parties and transactions with them is appropriate. The responsibility for accounting for such transactions lies with the audited entity.

6. Does the repropoed standard appropriately allow for the use of auditor judgment? Why or why not?

7. Are the auditor's responsibilities for the examples of information and sources of information contained in Appendix A to the repropoed standard clear? Are there other examples that should be included in the repropoed standard?

The repropoed standard allows for some use of auditor judgment but it remains prescriptive in its overall tone and does not encourage the exercise of judgement in general. The repropoed standard no longer mandates the treatment of certain transactions as significant risks which allows for some use of auditor judgment. While we welcome clarification that the sources of information in appendix A are not necessarily required to be reviewed in all circumstances, we trust that PCAOB inspectors will also recognise this during inspections.

8. Is the objective of the repropoed standard appropriate? Why or why not?

Does the repropoing release clearly articulate that the objective of the repropoed standard works similarly to objectives contained in other PCAOB auditing standards?

The objective of the repropoed standard is clear although we remain of the view that it would be better, and certainly do no harm, to include a reference to fraud in the objective for the better alignment of

PCAOB standards with ISAs, and in view of the fact that transactions with related parties are a common feature of fraud.

9. Does the requirement in the repropoed standard to perform specific procedures for each related party transaction required to be disclosed in the financial statements or determined to be a significant risk provide for a scaled approach? Why or why not?

10. Does the approach in the repropoed standard for the auditor to perform specific procedures for related party transactions that are required to be disclosed in the financial statements or that are determined to be a significant risk represent a cost-sensitive, yet effective, approach? Why or why not?

Where these proposals are applied to smaller entities, a scaled, cost-effective approach is difficult to achieve if specific procedures are required. However, it is arguable the pressures to which smaller entities are subjected means that the requirements are just as necessary as they are for larger entities. Cost-sensitivity, effectiveness and scalability cannot always be achieved at the same time, particularly in areas such as these.

11. What additional guidance, if any, regarding the auditor's responsibility for performing procedures on intercompany account balances pursuant to paragraph 13 of the repropoed standard is necessary?

As noted in our main comments above, the requirements of paragraph 13 remain unclear. Furthermore the paragraph can be read as requiring reconciliation at the period-end date for the audited entity, at the period-end date for the correspondent entity if different, or both.

12. Are the repropoed amendments regarding the auditor's identification of significant unusual transactions appropriate? Why or why not?

Yes.

13. Are the repropoed amendments regarding the auditor's evaluation of significant unusual transactions appropriate? Why or why not?

Yes.

14. Would the procedures required by the repropoed amendments regarding significant unusual transactions improve the auditor's identification and evaluation of a company's significant unusual transactions? Why or why not?

Possibly.

15. Are the repropoed amendments regarding significant unusual transactions appropriately aligned with the risk assessment standards? Why or why not?

Yes.

16. Do the repropoed amendments regarding significant unusual transactions appropriately allow for the use of auditor judgment? Why or why not? Does the requirement that the auditor perform specific procedures for each significant unusual transaction identified by the auditor provide for a scaled approach? Why or why not?

Yes.

17. Is the complementary relationship between the amendments regarding significant unusual transactions and the repropoed standard clear? Why or why not?

Yes.

18. Are the other repropoed amendments appropriate to address risks of material misstatement of the financial statements? Why or why not?

Yes,

19. Is it sufficiently clear that the auditor (a) should obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment and (b) should not assess the appropriateness of executive officer compensation? Why or why not?

Yes, it is clear that the auditor should not assess the appropriateness of executive officer compensation.

20. Are 'executive officers' the appropriate population for the audit procedures designed to provide the auditor with an understanding of the company's financial relationships and transactions as part of its risk assessment process? Why or why not?

Domestic registrants are required to name their executive officers in filings with the United States Securities and Exchange Commission. Foreign private issuers are not subject to similar requirements. Therefore the auditor would need to separately determine which individuals fall within the definition of executive officers under Rule 3b-7 of the Exchange Act. Since this is ultimately a legal determination we do not believe this is appropriate.

The proposals also do not support all board structures. There may be persons falling outside the definition of 'executive officers' whose compensation arrangements might create incentives and pressures that could create risks of material misstatement. In some companies, such as financial institutions, some of the most highly compensated individuals may not meet the definition of executive officers.

21. Would improving the auditor's understanding of a company's relationships and transactions with its related parties assist the auditor in obtaining sufficient appropriate evidence necessary to support the audit opinion? Would improving the auditor's understanding promote the exercise of professional skepticism? Would improving the auditor's understanding increase the likelihood of the auditor identifying material misstatements?

Yes.

Are there additional benefits that the Board should consider?

No.

22. Could the required communications with audit committees in the repropoed standard result in improvements to audit committees' abilities to fulfill their duties?

Yes.

23. Could the improved communications between the audit committee and the auditor lead to an improvement in the company's financial statement disclosures about its relationships and transactions with its related parties?

While the company's financial statement disclosures are for the company, improved communications between the audit committee and the auditor may support higher quality disclosures.

24. Would improving the auditor's identification and evaluation of significant unusual transactions increase the likelihood of the auditor identifying potential misstatements, including misstatements due to fraud?

Yes.

Would improving the auditor's identification and evaluation of significant unusual transactions promote the exercise of professional skepticism by the auditor?

Possibly.

Are there additional benefits that the Board should consider?

No.

25. Could the repropoed amendments regarding significant unusual transactions lead to an improvement in the company's disclosures about its significant unusual transactions?

While the company's disclosures about significant unusual transactions are for the company, improved communications between the audit committee and the auditor may support higher quality disclosures.

26. What benefits are associated with auditors obtaining an understanding of a company's financial relationships and transactions with its executive officers as part of its risk assessment? Are there additional benefits that the Board should consider?

27. What benefits are associated with the other repropoed amendments?

28. What costs will audit firms incur when implementing the repropoed standard and amendments? Please discuss both initial costs and recurring costs.

29. What costs will companies incur as a result of the implementation of the repropoed standard and amendments?

Please refer to the comments in our covering letter regarding costs and benefits.

30. Could the repropoed standard and amendments lead to other changes in behavior by the auditor, the company, or the audit committee that the Board should consider?

No.

31. Are there considerations relating to smaller companies that the Board should be aware of in considering its repropoal? Do smaller companies share the same risks of material misstatement of the financial statements regarding related party transactions and significant unusual transactions as the broader issuer population? Are related party transactions more common in smaller companies than the broader issuer population? Would the repropoed standard and amendments result in smaller companies experiencing unnecessarily greater or disproportionate costs compared to those experienced by larger companies? If so, how could such costs be controlled while improving audit quality?

While we have no empirical data to support our view, on the face of it, smaller entities in general seem more likely to be at risk of materially misstated related party transactions than other entities, due to less well developed systems and pressures to perform well. The same procedures should be applied to all audits.

32. Are there any unique considerations regarding costs for audits of brokers and dealers?

33. Are there unique considerations regarding costs for specific types of companies based on characteristics other than size of the transaction (e.g., industry)?

34. Are there additional considerations relating to competition, efficiency, and capital formation that the Board should take into account with respect to the repropoed standard and amendments? Specifically, are there benefits in lowered cost of capital from confidence in audits of issuers with related party disclosures?

We make no comment on the audit of broker-dealers.

35. Should the repropoed standard and amendments be applicable for audits of EGCs? Why or why not? Please provide empirical data, examples and explanations for why the requirements should or should not be applicable for audits of EGCs.

36. Are related party transactions or significant unusual transactions more common at EGCs than the broader issuer population? Do financial relationships and transactions with executive officers at EGCs give rise to increased risks of material misstatements than the broader issuer population? Please provide any data you have to support your views.

37. Are there other characteristics of EGCs (e.g., the size of the company and the length of time it has been a reporting company) that the Board should consider?

38. Would EGCs benefit more or less from the repropoed standard and amendments than other companies? Would inherently riskier EGCs receive benefits relative to other EGCs because the market cannot observe certain undisclosed related party risks that the new standards would otherwise make available through better compliance by management with its disclosure obligations?

39. What costs would firms incur when implementing the repropoed standard and amendments for audits of EGCs? How will those costs differ from the costs for the larger issuer population? Which of the costs are initial or recurring or both?

40. Are there particular costs, benefits, or burdens applicable to EGCs that the Board should consider when determining whether to recommend to the Commission the application of the repropoed standard and amendments to audits of EGCs? For example, do EGCs share the same risk of material misstatement of the financial statements as the broader issuer population due to relationships and transactions with related parties?

41. Regardless of the applicability of the repropoed standard and amendments to audits of EGCs, would an audit firm perform the same procedures for an audit of an EGC and an audit of a non-EGC to ensure a consistency in the training, methodology, and tools in their audit practice or to respond to risks of material misstatement with similar approaches?

42. Would the implementation and training costs that a firm would incur be dependent upon whether the standard is applicable to EGCs?

Would such costs generally be fixed once required to be implemented, regardless of whether the standard is applicable to audits of EGCs?

43. For auditors of both EGCs and other SEC registrants, would it be more costly to not apply the repropoed standard and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?

44. Are there any other considerations relating to competition, efficiency, and capital formation that the Board should take into account when determining whether to recommend to the Commission the application of the repropoed standard and amendments to audits of EGCs?

While we have no empirical data to support our view, on the face of it, EGCs in general seem more likely to be at risk of materially misstated related party transactions than other entities, due to less well developed systems and pressures to perform well. The same procedures should be applied to all audits.

49. Is the Board's anticipated effective date appropriate? Why or why not?

50. Does the new proposed effective date allow sufficient time for firms to incorporate the new requirements into their methodology, guidance and audit programs, and training for staff? Why or why not?

We believe a full year is needed for implementation in order (a) for sufficient training to take place in the typically quieter months and (b) for the development or refinement of audit methodologies to reflect the requirements of the proposed standard and amendments. If the standard cannot be issued until the

third quarter of 2013, it will be too late for implementation in the following audit season. We therefore suggest an effective date of audits of financial periods ending on or after 15 December 2014.

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July 8, 2013

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
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PCAOB Rulemaking Docket Matter No. 038

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 Ms. Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) 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* (the Release).

Overview

As noted in our original comment letter dated May 30, 2012, we support the Board's initiative to improve the independent auditor's evaluation of a company's identification of, accounting for, and disclosure of its relationships and transactions with related parties by proposing a new auditing standard that would replace the Board's interim auditing standard, AU sec. 334, *Related Parties*. We also support the Board's initiative to improve audit quality through its proposed amendments that are intended to enhance the auditor's identification and evaluation of a company's significant unusual transactions and to improve the auditor's understanding of a company's financial relationships and transactions with its executive officers. We continue to believe that these areas can pose significant risks of material misstatement of the financial statements and deserve the Board's attention.

Reproposed Standard, *Related Parties*

We believe that the revisions that the PCAOB has made when drafting the reproposed auditing standard, *Related Parties* (the Reproposed Standard), allow for greater use of auditor judgment, and result in the Reproposed Standard being better aligned with the PCAOB's risk assessment standards. However, we believe that there are certain prescriptive requirements in the Reproposed Standard that limit the auditor's ability to exercise professional judgment in designing audit procedures responsive to assessed risks. Included below are recommended changes that we believe would allow for an appropriate level of auditor judgment, as well as other comments that we have concerning the Reproposed Standard, all of which we believe will promote the Board's goal of enhancing audit quality.

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Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties

The first sentence to paragraph 14 of the Reproposed Standard states that the “auditor should evaluate whether the company has properly identified its related parties and relationships and transactions with related parties.” Footnote 14 to that sentence indicates that the aforementioned evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company. The second sentence of paragraph 14 then goes on to indicate that “[i]n making that evaluation, the auditor should take into account the information gathered during the audit.” It is unclear to us whether the evaluation that is described in the first sentence of paragraph 14 can be fulfilled solely through the auditor considering information gathered during the audit, or whether the auditor would need to design specific audit procedures to perform such evaluation, while also considering other information gathered during the audit. We recommend that the Board make appropriate revisions to paragraph 14 to clarify its intent as it relates to the second sentence of that paragraph.

The Note in paragraph 14 of the Reproposed Standard states that “Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.” As noted on page A4-39 of the Release, it is not the Board’s intent for the auditor to be required to perform procedures with respect to each source of information referenced in Appendix A. In order to explicitly state the Board’s intent within the Reproposed Standard, we recommend that a sentence be added to the Note that indicates that the auditor is not required to perform procedures with respect to each source of information referenced in Appendix A.

Paragraph 16 of the Reproposed Standard requires the auditor to perform certain procedures if the auditor determines that a related party or relationship or transaction with a related party exists that was previously undisclosed to the auditor. The procedures described in items (a) through (c) of paragraph 16 are required to be performed in all cases if a previously undisclosed related party or relationship or transaction with a related party exists. Depending on the facts and circumstances, we believe that there could be related party transactions that are noted by the auditor that previously were undisclosed to the auditor that do not warrant the performance of the procedures in items (a) through (c), based on the auditor’s risk assessment. We recommend that the Board consider implementing a materiality screen (e.g., “clearly trivial,” as used in PCAOB Auditing Standard No. 14, *Evaluating Audit Results*) for related party transactions in items (a) through (c) of paragraph 16, in order to remove the need to perform those procedures on such transactions.

Communications with the Audit Committee

Paragraph 19 of the Reproposed Standard addresses communications with the audit committee, relative to related parties or relationships or transactions with related parties. Items (b), (c), and (e) of paragraph 19 contain a materiality threshold, in the sense that such communications are only required for significant related party transactions. We note that no such materiality threshold is present in item (a). We recommend that the word “significant” be inserted before the

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first occurrence of “related parties” in item (a) of paragraph 19 in order to conform the level of communication with that in items (b), (c), and (e).

Appendix A – Examples of Information and Sources of Information That Could Indicate That Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor Might Exist

Appendix A of the Reproposed Standard includes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties that were previously undisclosed to the auditor might exist. We recommend that the third bullet (“Bill and hold” type transactions) be removed from paragraph A2 of Appendix A. While we acknowledge that bill and hold transactions may be a vehicle for fraudulent financial reporting, we do not believe such transactions are indicative that a related party or relationship or transaction with a related party might exist. In addition, we recommend that the 12th bullet (Significant contracts renegotiated by the company during the period under audit) be removed from paragraph A3 of Appendix A, as we do not believe that such source would normally assist an auditor in identifying a related party or relationship or transaction with a related party.

Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

We acknowledge that the tenth bullet to paragraph 55 of AU sec. 722, *Interim Financial Information*, currently uses the word “infrequently,” however we would recommend that the concept of infrequent transactions be removed from the proposed revision to this bullet and inserted as its own bullet, in order to align the revisions that are being made elsewhere throughout the Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions related to the phrase “significant unusual transactions.”

Other Proposed Amendments to PCAOB Auditing Standards

The Release proposes an amendment to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, to add a sixth bullet to paragraph 11 to state that the auditor should consider “[o]btaining an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.” On page A4-85 of the Release, it states that “obtaining an understanding of the company’s policies and procedures would not require the auditor to examine all of a company’s executive officer reimbursements” (emphasis added). Since the requirement relates to obtaining an understanding, we believe that it may not be necessary to examine any of a company’s executive officer reimbursements, depending on the facts and circumstances that affect the auditor’s risk assessment. Therefore, in order to alleviate any potential confusion through the use of the word “all,” we recommend that the PCAOB make appropriate changes in the final version of the Release, if comparable language as that found on page A4-85 of the Release is brought forward.

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Page 4

Scalability and Scope

We believe that the amount of incremental audit effort that will be required pursuant to the Release will have a direct relationship to the number, nature, and complexity of a company's related parties and relationships and transactions, its significant unusual transactions, its financial relationships and transactions with executive officers, and the processes and controls a company has implemented to identify those matters and evaluate their effect on the financial statements. In addition, in response to Question 41 in the Release, our intention would be to perform the same procedures for an audit of an emerging growth company (EGC), regardless of the applicability to audits of EGCs of the Reproposed Standard and amendments, as the cost to develop and maintain two separate methodologies and the related training would be cost-prohibitive to do otherwise.

Effective Date

Many of the requirements of the Release impact the planning and risk assessment aspects of an audit, and therefore it is critical that sufficient lead time be provided to audit firms so that they can incorporate the required changes arising from a final standard and amendments into their audit policies, methodologies, and tools, as well as preparing and delivering training to their audit personnel on such changes, prior to the required changes becoming effective. The Board currently has proposed that the Reproposed Standard and amendments would be effective, subject to approval by the Securities and Exchange Commission (SEC), for audits of financial statements for fiscal years beginning on or after December 15, 2013. In order to provide adequate lead time, as described above, we believe that it would be necessary for the SEC to approve the PCAOB's final standard and amendments by no later than October 31, 2013. If it appears that the SEC will not approve the final standard and amendments by such date, we recommend that the PCAOB defer the effective date by one year. In any case, we further recommend that the PCAOB align the effective date for the amendments to AU sec. 722, such that those amendments become effective in the first interim period following the first annual period that the other changes are effective (e.g., for the quarter ending March 31, 2015 for a company with a calendar year end, assuming that the final standard and amendments are effective for the year ending December 31, 2014).

* * * * *

We appreciate the Board's careful consideration of our comments. If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or George Herrmann, (212) 909-5779, gherrmann@kpmg.com.

Very truly yours,

KPMG LLP

cc:

PCAOB

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Lewis H. Ferguson, Member

Jeanette M. Franzel, Member

Jay D. Hanson, Member

Steven B. Harris, Member

Martin F. Baumann, Chief Auditor and Director of Professional Standards

SEC

Paul A. Beswick, Chief Accountant

Brian T. Croteau, Deputy Chief Accountant

July 2, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 038

McGladrey LLP appreciates the opportunity to offer our comments on the PCAOB's May 7, 2013 *Proposed Auditing Standard – Related Parties; Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions; and Other Proposed Amendments to PCAOB Auditing Standards*. We support the PCAOB's repropose auditing standard and related repropose amendments to other auditing standards intended to strengthen existing audit procedures for identifying, assessing, and responding to the risks of material misstatement associated with a company's related party transactions. However, we have the following comments related to specific paragraphs of the reproposal that we believe should be clarified or modified.

Objective

We believe the objective in paragraph 2 of the repropose standard should be revised to clarify that the auditor is not required to determine whether *related parties* have been properly accounted for. Rather, the auditor is required to determine whether *relationships and transactions with related parties* have been properly accounted for. We therefore suggest paragraph 2 be clarified to read as follows (proposed additions are shown in bold font):

The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties **have been identified** and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties

Because the procedures in paragraph 3 of the repropose standard require the auditor 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 in conjunction with performing risk assessment procedures in accordance with PCAOB Auditing Standard (AS) 12, *Identifying and Assessing Risks of Material Misstatement*, we believe the requirements in paragraph 3 of the repropose standard should be incorporated into AS 12 so that all the requirements related to identification and assessment of risks of material misstatement would be located in a single standard. The repropose standard on related parties could then include a cross-reference to the requirements in AS 12.

In addition, we recommend the word "Note:" be removed from the second paragraph of paragraph 3 because we are concerned that auditors will not readily identify the requirement contained in this "Note." We recommend placing all requirements in the body of the standard and using "Notes" to clarify how auditors might implement the requirements.

Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties

Footnote 14 includes requirements, which we believe should be explicitly stated in paragraph 14 as follows (proposed deletions are struck through, and proposed additions are shown in bold font):

“The auditor should evaluate whether the company has properly identified its related parties and relationships and transactions with related parties.^{14/} ~~In making that evaluation, the auditor should take~~ **Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, taking** into account information gathered during the audit.^{15/} As part of ~~that~~ **this** evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.”

In addition, the Note in paragraph 14 makes reference to Appendix A, which contains examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. This reference, coupled with the requirement in the first sentence of paragraph 14, could create the impression that the auditor is required to evaluate all of the information and sources of information in Appendix A to identify undisclosed related parties or relationships or transactions with related parties. As discussed on page A4-39 of the reproposal, the repropoed standard is not intended to require the auditor to perform procedures with respect to each source of information referenced in Appendix A. To align the auditor’s responsibilities with respect to the information and sources of information in Appendix A with the discussion on page A4-39 of the reproposal, we believe the following sentence should be added at the end of the Note in paragraph 14:

Appendix A is not intended to represent a comprehensive listing of information or sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, nor is the auditor required to evaluate all of the information or sources of information in Appendix A to identify undisclosed related parties or relationships or transactions with related parties.

As stated, the procedures enumerated in paragraph 16 would be required to be performed with respect to *all* transactions with a related party previously undisclosed to the auditor – even those transactions that are clearly trivial and would not merit the performance of such procedures based on the auditor’s risk assessment. We suggest the PCAOB clarify whether the procedures in paragraph 16 are required to be applied to related party transactions that are deemed by the auditor to be clearly trivial, as described in AS 14, *Evaluating Audit Results*.

Communications with the Audit Committee

We believe all required auditor communications with the audit committee should be codified in one standard. Therefore, we suggest the requirements in paragraph 19 of the repropoed standard be moved to AS 16, *Communications with Audit Committees*. The repropoed standard on related parties could then include a cross-reference to the requirements in AS 16.

In addition, paragraph 19.a. requires the auditor to communicate to the audit committee the identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor. This could be interpreted as requiring communication of *all* relationships and transactions with related parties that were previously undisclosed to the auditor. We recommend inserting the word “significant” in front of the word “transactions” to align requirement “a.” with the remaining requirements of paragraph 19.

Public Company Accounting Standards Board
Proposed Auditing Standard – Related Parties; Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions; and Other Proposed Amendments to PCAOB Auditing Standards
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Scalability

Compliance with the repropoed standard begins with basic required procedures, such as obtaining an understanding of the company's process and performing inquiries, which are then supplemented by more in-depth procedures as needed. Therefore, we believe the repropoed standard is scalable and allows the auditor to focus on the significant risks, regardless of the size or nature (e.g., broker dealer or emerging growth company) of the issuer.

Effective Date

The repropoal states the repropoed standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2013. Audit firms will need sufficient time to incorporate the new requirements of the repropoed standard and amendments in audit methodologies, programs, and training. Therefore, we believe the proposed date is reasonable as long as the standard is finalized by September 30, 2013.

We appreciate this opportunity to provide feedback on the repropoal and would be pleased to respond to any questions the Board or its staff may have concerning our comments. Please direct any questions to John Keyser, National Director of Assurance Services, at 702-759-4046.

Sincerely,

A handwritten signature in cursive script that reads "McGladrey LLP".

McGladrey LLP

1095 Avenue of the Americas
New York, NY 10036



Peter M. Carlson
Executive Vice President and
Chief Accounting Officer
pcarlson@metlife.com

July 8, 2013
Office of Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Request for Public Comment: *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* [PCAOB Rulemaking Docket No. 38], PCAOB Release 2013-004 (May 7, 2013)

Dear Office of Secretary:

MetLife, Inc. (MetLife) appreciates the opportunity to provide comments to the Public Company Accounting Oversight Board's (PCAOB) Request for Public Comment regarding the Board's reproposing (i) an auditing standard, *Related Parties*; (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions; and (iii) other amendments to PCAOB auditing standards, (PCOAB Release 2013-004), which are updates to the Board's original Proposed Standard issued in 2012.

MetLife is a leading global provider of insurance, annuities and employee benefit programs, serving 90 million customers in over 50 countries. Through its subsidiaries and affiliates, MetLife holds leading market positions in the United States, Japan, Latin America, Asia Pacific, Europe and the Middle East. MetLife supports the objective of the Proposed Standard to improve the auditor's evaluation of, identification of, accounting for, and disclosure about related parties and significant unusual transactions.

To reiterate our May 31, 2012 comment letter, we generally agree with the Board that improvements in this area are important to the protection of the interests of investors and to the preparation of informative, accurate, and independent audit reports.

Upon review of PCAOB Release 2013-004, we believe the Board has addressed the key concerns raised in our 2012 comment letter about certain aspects of the Proposed Standard, specifically (i) the potential limitations on auditor judgment and use of materiality in deciding on the extent of procedures regarding related party and significant unusual transactions and (ii) the extent of involvement of auditors in reviewing and/or questioning executive compensation contracts.

We concur with the reproposed standard for Related Parties, as it:

- acknowledges the integration of auditors' evaluation of related party risks with the risk assessment procedures performed pursuant to Auditing Standard No. 12

- clarifies the role of the auditor regarding understanding and evaluating management's identification of related parties and requirements to follow when obtaining a company's relationships and transactions with related parties, and
- recognizes the need for the use of auditor judgment regarding (a) when and if inquiries should be made of specific individuals within the company regarding the company's relationships and transactions with related parties; (b) whether to perform additional procedures; and (c) whether more in-depth procedures are required for related party transaction requiring disclosure; or if deemed a significant risk.

The amendments to Significant Unusual Transactions standard are an improvement to the existing standards, with a more uniform definition of significant and unusual transactions and enhanced requirements for identifying and evaluating significant unusual transactions, while recognizing the need for auditor judgment.

Finally, with regard to financial relationships and transactions with executive officers, we are pleased that Release 2013-004 has removed the originally proposed requirement for the auditor to evaluate the appropriateness of executive compensation.

We once again thank you for the opportunity to respond to your reproposal and amendments; and for taking into consideration our previous observations and comments when preparing Release 2013-004. If you have any questions regarding the contents of this letter, please do not hesitate to contact me.

Sincerely,

A handwritten signature in blue ink, appearing to read "Peter M. Carlson". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Peter M. Carlson

cc: John Hele
Executive Vice President and
Chief Financial Officer

Karl Erhardt
Senior Vice President and
General Auditor

July 2, 2013

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

Submitted via e-mail to comments@pcaobus.org

**Re: Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain
PCAOB Auditing Standards Regarding Significant Unusual Transactions,
and Other Proposed Amendments to PCAOB Auditing Standards**

(PCAOB Release No. 2013-004, Rulemaking Docket Matter No. 038)

Dear Madam Secretary:

The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 29,000 CPAs in public practice, industry, government and education, welcomes the opportunity to provide comments on the above captioned release.

The NYSSCPA's Auditing Standards and SEC Committees deliberated the release, and prepared the attached comments. If you would like additional discussion with us, please contact Julian Jacoby, Chair of the Auditing Standards Committee at (212) 755-4482, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,



J. Michael Kirkland
President

Attachment



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**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

COMMENTS ON

**PROPOSED AUDITING STANDARD – RELATED PARTIES, PROPOSED
AMENDMENTS TO CERTAIN PCAOB AUDITING STANDARDS REGARDING
SIGNIFICANT UNUSUAL TRANSACTIONS,
AND OTHER PROPOSED AMENDMENTS TO PCAOB AUDITING STANDARDS**

**PCAOB RELEASE NO. 2013-004
PCAOB RULEMAKING DOCKET MATTER NO. 038**

July 2, 2013

Principal Drafters

From the Auditing Standards Committee:

**Fred R. Goldstein
Jan C. Herringer
Mark Mycio**

From the SEC Committee:

Tammy E. Straus

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New York State Society of Certified Public Accountants

Comments on Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards

The New York State Society of Certified Public Accountants (NYSSCPA) appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB, the Board) release, *Proposed Auditing Standard – Related Parties* (Proposed Standard), *Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions* (Proposed Amendments), and *Other Proposed Amendments to PCAOB Auditing Standards* (Other Proposed Amendments) (the Release). We support the Board's initiative to strengthen the existing public company auditing standards and believe that the improvements being proposed in the Release with respect to related parties and significant unusual transactions will have a positive impact on audit quality.

We appreciate the Board's consideration of our comments, as set out in our previous letter dated May 17, 2012, on the initial PCAOB proposal on the topic of related parties and significant unusual transactions, and have the following additional comments for the Board's consideration.

Responsibility of the Auditor to Evaluate the Company's Identification of Related Parties

We support the change from the previously proposed standard that focuses in the first instance on the responsibility the company has with respect to the preparation of the financial statements as specifically delineated in the identification of the company's related parties. We support the proposal to include a statement by management within the management representation letter that the company has provided the names of all related parties and all relationships and transactions with related parties.

We note that the Proposed Standard requires an auditor to perform specific procedures to evaluate whether a company has properly identified its related parties, such as evaluating information obtained from identifying and evaluating unusual transactions and obtaining an understanding of a company's financial relationships and transactions with its executive officers which could indicate that relationships or transactions with related parties previously undisclosed to the auditor may exist. In that regard, paragraph A2 of Appendix A of Appendix 1 of the Proposed Standard includes examples of information that could indicate that such relationships or transactions with related parties might exist, and paragraph A3 provides examples of sources of information that could indicate these relationships or transactions might exist. While the discussion on pages A4-39 to A4-40 of Appendix 4 of the Proposed Standard provides some commentary about how these Appendices are to be used, we believe moving that explanatory information into the Proposed Standard would help clarify how Appendix A is to be used and make it easier for an auditor to find the applicable interpretive information.

Although we acknowledge that an auditor is responsible for obtaining reasonable assurance to support the assertions within the financial statements, including those relating to the accuracy and completeness of related parties and related party transactions and that current guidance requires an auditor to perform procedures to address these assertions, we are concerned that the requirement included within footnote 14 to paragraph 14 of Appendix 1 of the Proposed Standard might imply that an auditor is responsible for identifying all related parties and transactions without limitation. We believe that additional context should be provided, similar to that provided in paragraphs 2 and 6-7 of International Standard on Auditing (ISA) 550, *Related Parties*, which explains that the nature of related party relationships and related party transactions may, in some circumstances, result in higher risks of material misstatement than non-related party transactions given the potential for undisclosed related party relationships and transactions. The ISA further explains that related party relationships might present a greater opportunity for collusion, concealment or manipulation by management and, therefore, an auditor's ability to detect material misstatements may be impacted even though the audit is properly planned and performed.

Communications with Audit Committees

We believe effective and timely communication with audit committees is an important and integral aspect of the performance of a quality audit, and, for this reason, we believe that communication is most effective when an auditor takes care to communicate those matters most important to the audit committee's oversight responsibilities, rather than discussing a checklist of matters that may not be significant to their oversight role. Therefore, we suggest revising paragraph 19. a. of Appendix 1 as follows: "The identification of ***significant*** related parties or relationships or transactions with related parties that were previously undisclosed to the auditor." (Added text is included in bold italics).

Applicability to Emerging Growth Companies

We recognize that the Proposed Standard and Proposed Amendments are designed to address critical areas that warrant heightened scrutiny. Given that Emerging Growth Companies (EGC), as defined in Section 3(a)(80) of the Securities Exchange Act, are likely to have less formal processes for dealing with related party relationships and transactions, and that they may have more extensive related party relationships and transactions, we support the applicability of the Proposed Standard and Proposed Amendments to such entities.

Audits of Brokers and Dealers in Securities

The nature of the broker and dealer industry is such that there are often numerous related party transactions, which suggests that it would be appropriate for the Proposed Standard and Proposed Amendments to apply to these audits. Further, we do not believe that an exception is necessary with respect to audit committee communications for the non-issuer brokers and dealers as the definition of an audit committee is sufficiently broad within Auditing Standard No. 16, *Communications with Audit Committees*, to accommodate the governance structure of non-issuer brokers and dealers.



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

July 3, 2013

RE: PCAOB Rulemaking Docket Matter No. 038, *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 Madam Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (the "reproposed standard," "reproposed amendments," or "reproposal"). Overall, we support the Board's reproposal and believe it will strengthen the auditor's ability to identify, assess, and respond to risks of material misstatement arising from relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers. We appreciate the Board's responsiveness in considering and providing feedback on comments received on the original proposal. We believe the reproposed standard has been improved by greater alignment with the Board's risk assessment standards. We also believe the suggestions we offer below for your consideration will further improve the reproposal.

In the remainder of our letter, we have organized our suggestions about the reproposal into the following topical areas:

- Evaluating whether the company has properly identified its related parties and relationships and transactions with related parties
- Communications with the audit committee
- Reproposed amendments to AU 722, "Interim Financial Information"
- Economic considerations
- Effective date

Evaluating whether the company has properly identified its related parties and relationships and transactions with related parties

Paragraph 14 of the reproposed standard requires the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. In making that evaluation, the auditor should take into account the information gathered during the audit. A note to paragraph 14 states that "Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist." Finally, footnote 14 to paragraph 14 requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and



transactions with related parties identified by the company. We agree the auditor should perform procedures to test accuracy and completeness; however, the expected audit effort and extent of procedures to be completed are unclear, which may result in inconsistent practices among auditors.

As a result, we believe paragraph 14 should clarify the auditor's responsibility with respect to Appendix A. We acknowledge (as does the Board on pages 40 and 44 of Appendix 4) that other auditing standards might require the auditor to examine certain items listed in Appendix A including, for example, reading confirmation responses and responses to inquiries of the company's lawyers, and in those circumstances, the auditor should take that information into account in evaluating whether the company has properly identified its related parties and relationships and transactions with related parties. We believe the note in paragraph 14 discussing Appendix A, as well as the lead in to Appendix A, should be clarified to state that the auditor should perform procedures on the information to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties when the auditor is already required to perform audit procedures on the information or sources of information by other auditing standards or through the performance of auditing procedures in other areas. We believe this would clarify the Board's intent as discussed in Appendix 4.

Paragraph 16 requires certain procedures to be performed if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Step (a) requires the auditor to "inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor." If, after performing this step, the auditor concludes that a related party transaction that was previously undisclosed to the auditor is clearly trivial, we believe that the auditor should not be required to perform steps (b)-(f), and we suggest that the Board revise paragraph 16 accordingly.

Communications with the audit committee

Paragraph 19 of the repropoed standard includes a list of matters that the auditor is required to communicate to the audit committee regarding the company's relationships and transactions with related parties. Item (a) in the list is "the identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor." We believe paragraph 19(a) should be revised to communicate "the identification of ***significant*** related parties or relationships or transactions with related parties that were previously undisclosed to the auditor." We agree with the Board's removal in the repropoed standard of the requirement from the original proposal that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk, and we believe this proposed change to paragraph 19(a) would be consistent. Furthermore, adding "significant" to paragraph 19(a) would align it better with other items required by paragraph 19 to be communicated to the audit committee.

Proposed amendment to AU 722, "Interim Financial Information"

The repropoed amendments to AU 722, "Interim Financial Information," include the addition of the following language, shown below in boldface italics, to item 2.a. in the second illustrative representation letter for a review of interim financial information:

2. We have made available to you—



- a. All financial records and related data, ***including the names of all related parties and all relationships and transactions with related parties***

We believe this additional language should also be included in item 2.a. in the first illustrative representation letter (that is, the illustrative short-form representation letter) for a review of interim financial information.

Economic considerations

We believe the level of audit effort required to implement the repropoed standard and amendments will correlate with the number and nature of a company's related party relationships and transactions, significant unusual transactions, and financial relationships and transactions with executive officers, and with the process the company has in place to identify such matters. We also agree with the Board's observation that smaller companies, some of which may be Emerging Growth Companies (EGCs) and brokers and dealers, may engage in more related party transactions compared to other companies, which will result in higher audit costs but is commensurate with the risk of material misstatement. As a result, we support the application of the repropoed standard and amendments to all audits performed in accordance with PCAOB standards, including audits of EGCs and audits of brokers and dealers.

Effective date

The Board anticipates that the repropoed standard and amendments would be effective, subject to approval by the Securities and Exchange Commission (SEC), for audits of financial statements for fiscal years beginning on or after December 15, 2013. Because the repropoal will affect audit planning for calendar year 2014 audits, updates to audit policy and methodology will need to occur before planning for 2014 audits commences. Accordingly, we believe the Board's anticipated effective date is reasonable only if the SEC approves the Board's final standard no later than mid-November 2013.

* * * * *

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact George Kennedy (973-236-5361) or Marc Panucci (973-236-4885) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

From: [Pw Carey](#)
To: [Comments](#)
Cc: [Pw Carey](#); [Pw Carey](#)
Subject: PCAOB Rulemaking Docket Matter No. 038.....
Date: Monday, July 08, 2013 10:01:10 AM
Attachments: [Pws COMMENTS Re PCAOB Docket No. 038 Comments Due Back July 8th Release 2013-004 Related Parties.pdf](#)
[Deloitte Risk Map for Cloud Computing.pdf](#)

Dear PCAOB Folks:

Good morning and hope all is well way back East.....

- Please Note: We appreciate your time and attention, and will continue to follow your efforts in this regard as they are most welcome, long over due and necessary, as in very necessary....
- also, we've attached an example of an Auditor's Assessment Risk Tool within a Cloud Eco-system, just in case you all missed it.....

In closing, best wishes for a nice and relaxing work week, and happy reading, too.....

Respectfully yours,

Pw

--

Respectfully yours,
Regards / Met vriendelijke groet
Pw Carey
GRC Application Security Analyst, (CISA, CISSP)
Compliance Partners, LLC
250 South Grove Ave.
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PROPOSED AUDITING STANDARD –)

RELATED PARTIES)

PROPOSED AMENDMENTS TO CERTAIN)
PCAOB AUDITING STANDARDS REGARDING)
SIGNIFICANT UNUSUAL TRANSACTIONS)

AND OTHER PROPOSED AMENDMENTS TO)
PCAOB AUDITING STANDARDS)

PCAOB Release No. 2013-004
May 7, 2013

PCAOB Rulemaking
Docket Matter No. 038

Summary: The Public Company Accounting Oversight Board is reproposing: (i) an auditing standard, *Related Parties*; (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions; and (iii) other amendments to PCAOB auditing standards. The proposed auditing standard would supersede the Board's auditing standard AU sec. 334, *Related Parties*.

Public

Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 038 in the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on July 8, 2013.

Board

Contacts: Greg Scates, Deputy Chief Auditor (202/207-9114, scatesg@pcaobus.org), Brian F. Degano, Associate Chief Auditor (202/207-9113, deganob@pcaobus.org), and Nicholas Grillo, Assistant Chief Auditor (202/207-9104, grillon@pcaobus.org).

I. Introduction

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is reproposing a new auditing standard, *Related Parties* (the "reproposed standard");

Summary of Comments on Microsoft Word - PCAOB Release No. 2013-004 - Related Parties.docx

Page: 1

Number: 1 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/5/2013 8:56:01 AM

Since the inter-dependencies between IT and Audits....citing the tools, standards and references to the following professional societies and standards development organizations would be welcome:

IEEE
ISO
ITO
NIST
CSA
CISSP
CISA
et al....

Number: 2 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/8/2013 9:52:59 AM

Dear Folks:

Please accept our comments with the same spirit they are being submitted.....and congratulations upon a task long overdue.....we hope your efforts will survive the convoluted and disingenuous intellectual critiques that will be tossed in your path by certain individuals who are sometimes referred to as...and with all due respect of course as.... " ...those back stabbing little weasels with poor oral hygiene..." usually made by folks who live elsewhere, that would be anywhere but in the zip code.....2004....but not by us of course.....

Your efforts are well deserved the merit they will eventually receive...notwithstanding the machinations of the previously mentioned...." certain individuals"....

In closing, thank you and our best wishes for a nice and relaxing future implementation of your efforts....

Respectfully yours,

Pw Carey
GRC App Security Analyst CISA, CISSP
Compliance Partners, LLC
Barrington, Illinois 60010 USA
pwc.pwcarey@gmail.com

Please Note: What has gone before hasn't worked, otherwise why would we be here.....so, a re-evaluation of what has gone before must be performed....by placing a greater emphasis upon identifying the red flag triggers associated with the psychological motivations for fraud and bad behavior.....also the use of the "Rule of Bread Crumbs" whenever conducting an audit....must be followed....always.....

Number: 3 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/8/2013 8:58:10 AM

Pw believes the following two references should guide this standard design and development and upgrade Re-Proposal effort regarding the PCAOB's Rulemaking Docket Matter No. 038....In this regard, who all looked away between September 17th, 2004 to August 31st, 2009 and beyond?

**FBI warns of mortgage fraud 'epidemic' Seeks to head off 'next S&L crisis'
From Terry Frieden CNN Washington Bureau
Friday, September 17, 2004 Posted: 5:44 PM EDT (2144 GMT)**

**U.S. Securities and Exchange Commission
Office of Investigations
Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme
- Public Version - August 31, 2009 Report No. OIG-509**

Comments from page 1 continued on next page

Number: 4 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/5/2013 9:00:18 AM

As a wise man once wrote a couple of days ago:

""Why are some companies being treated better than others? Why the inconsistency?

Our kafkaesque tax system is bonkers and broken. We need to tear it up and start again...."

For example a Regulatory Road Map (aka:Map the Regulators)...aka: connect the dots.....would both be swell as well as useful.....in this process of doing what's right...

Number: 5 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/5/2013 9:07:56 AM

Include examples of the following best practices and life cycle requirements for conducting Audits (steps & checklists):

How to identify the personalities of fraud

How to perform risk assessments to detect fraud

How to perform tests to detect fraud and/or bad behavior

In addition, include the public records available for recent fines and penalties associated with fraud and bad behavior....

Number: 6 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Highlight Date: 7/4/2013 8:54:07 AM



amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "reproposed amendments regarding significant unusual transactions"); and other amendments to PCAOB auditing standards (the "other reproposed amendments").^{1/} The reproposed standard would supersede the Board's existing auditing standard on related parties, AU sec. 334, *Related Parties* (the "existing standard").

Related party transactions have been contributing factors in numerous prominent financial reporting frauds over the last few decades.^{2/} Financial reporting frauds also have involved 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"); and a company's financial relationships and transactions with its executive officers. Corporate scandals involving these areas, such as financial reporting frauds at Enron Corporation, Tyco International, Ltd., Refco, Inc., and WorldCom, Inc., undermined investor confidence, resulted in significant losses for investors, as well as the loss of many jobs for employees. These critical areas have continued to be a contributing factor in more recent cases.^{3/} The reproposed standard and amendments would update and strengthen auditor performance requirements in these critical areas, which could pose significant risks of material misstatement in company financial statements. The critical areas addressed by the reproposed standard and amendments include:

^{1/} The reproposed amendments regarding significant unusual transactions and the other reproposed amendments are collectively referred to in this release as the "reproposed amendments." In addition, all the Board's repropoals contained in this release may be referred to globally as the "reproposed standard and amendments" or as the Board's "reproposal."

^{2/} See *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2012-001 (Feb. 28, 2012), (the "proposing release"), available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx> for a discussion of these financial reporting frauds.

^{3/} See e.g., Securities and Exchange Commission ("SEC") v. Keyuan Petrochemicals, Inc. and Aichun Li, SEC Accounting and Auditing Enforcement Release ("AAER") No. 3447 (Feb. 28, 2013), and SEC v. China Natural Gas, Inc. and Qinan Ji, AAER No. 3385 (May 14, 2012).



Relationships and Transactions with Related Parties: Relationships and transactions with related parties can pose increased risks of material misstatement, as their substance might differ materially from their form. Related party transactions also may involve difficult measurement and recognition issues that can lead to errors in financial statements. Moreover, in some instances, related party transactions have been used to engage in fraudulent financial reporting and to conceal misappropriation of assets – misstatements that are relevant to the auditor's consideration of fraud.^{4/} The importance to investors of auditing related party transactions is recognized by Section 10A of the Securities and Exchange Act of 1934 ("Exchange Act"), which requires each audit of financial statements of an issuer to include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."^{5/}

The repropoed standard would strengthen existing audit performance requirements by setting forth new, specific audit procedures that would include: (i) obtaining an understanding of the company's relationships and transactions with its related parties; (ii) performing specific procedures for related party transactions that require disclosure in the financial statements or that are determined to be a significant risk; (iii) evaluating whether the company has properly identified its related parties and relationships and transactions with related parties; and (iv) communicating with the audit committee. The repropoed standard would supersede the existing auditing standard, AU sec. 334.

^{4/} See paragraph .06 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, which states that two types of misstatements are relevant to the auditor's consideration of fraud – misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. Misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the financial statements not to be presented, in all material respects, in conformity with generally accepted accounting principles ("GAAP"). Misstatements arising from misappropriation of assets (sometimes referred to as theft or defalcation) involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented, in all material respects, in conformity with GAAP.

^{5/} See Section 10A(a)(2) of the Exchange Act, 15 U.S.C. §78j-1(a)(2), which was added to the Exchange Act by the Private Securities Litigation Reform Act, enacted by Congress in 1995.



Significant Unusual Transactions: A company's significant unusual transactions can create complex accounting and financial statement disclosure issues posing increased risks of material misstatement. In some instances, significant unusual transactions have been used to engage in fraudulent financial reporting. For example, significant unusual transactions, especially those close to period end that pose difficult "substance-over-form" questions, may have been entered into to obscure a company's financial position or operating results.^{6/} In such cases, management may place more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction. Existing auditing standards relating to significant unusual transactions are principally contained in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. The repropoed amendments regarding significant unusual transactions are designed to focus the auditor's identification and evaluation of a company's significant unusual transactions, and, among other things, enhance the auditor's evaluation of (i) whether such transactions have been appropriately accounted for and adequately disclosed in company financial statements; and (ii) whether the lack of a business purpose indicates that they may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

Financial Relationships and Transactions with Executive Officers: A company's executive officers are in a unique position to influence a company's accounting and disclosures. A company's financial relationships and transactions with its executive officers (as one example, executive compensation) can create incentives and pressures for executive officers to meet financial targets, which can result in risks of material misstatement to a company's financial statements. Other repropoed amendments would modify Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, to require the auditor to perform specific procedures to obtain an understanding of the potential risks of material misstatement posed by incentives and pressures arising from a company's financial relationships and transactions with its executive officers. For issuers, the term "executive officer" is the definition contained in Rule 3b-7 under the Exchange Act, while for brokers and dealers, the term "executive officer" is based on a list in Schedule A of Form BD (as required by Item 2(a) of the schedule). In response to comments, the repropoed amendments have been revised to clarify that the auditor's procedures in this area would be performed as part of the auditor's risk assessment process^{7/} and would not require the auditor to make any

^{6/} See, e.g., *In the Matter of Dynegy Inc.*, AAER No. 1631 (Sept. 24, 2002), and *In the Matter of Michael Lowther, CPA* AAER No. 2775 (Jan. 28, 2008).

^{7/} In 2010, the Board adopted Auditing Standards Nos. 8-15 on assessing and responding to risk in an audit (the "risk assessment standards"), which cover the entire audit process, from initial planning activities to evaluating audit evidence to



determination regarding the reasonableness of compensation arrangements or recommendations regarding compensation arrangements.

The Board notes that the existing auditing requirements that address these critical areas warrant updating. Since the issuance of the existing standard, AU sec. 334, significant financial reporting frauds involving related party transactions have occurred.^{8/} The need to update AU sec. 334 has been supported by a number of prominent studies, including one produced by the auditing profession.^{9/} Moreover, the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the AICPA ("ASB") revised their auditing standards on related parties in 2008 and 2011, respectively. In addition, AU sec. 334 does not reflect the enactment in 2010 of the risk assessment standards, which provide an overall

forming the opinion to be expressed in the auditor's report. See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release No. 2010-004 (Aug. 5, 2010).

^{8/} In 1983, AU sec. 334 replaced AU sec. 335, *Related Party Transactions*, which was issued in July 1975. AU sec. 334 removed guidance in AU sec. 335 relating to accounting considerations and disclosure standards for related parties (in response to the issuance of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*) and included other related technical changes. Thus, the nature and extent of the auditor's responsibilities and procedures pertaining to related parties reflected in AU sec. 334 have not changed since 1975.

^{9/} See the Report of the Quality Control Inquiry Committee ("QCIC") of the AICPA's SEC Practice Section ("SECPS"), which analyzed more than 200 alleged audit failures from December 1997 to October 2002 and recommended that, among other things, "required audit procedures be broadened to help ensure the auditor gains a more complete understanding of related-party transactions, including the business aspects of the transactions." See, AICPA SEC Practice Section, Memo to Managing Partners of SECPS Member Firms, "Recommendations for the Profession Based on Lessons Learned from Litigation" (Oct. 2002). The QCIC report and other reports and studies supporting the need for improvements to existing auditing standards in these three critical areas are discussed in the proposing release. See PCAOB Release No. 2012-001.



framework for the auditor's assessment of and response to the risk of material misstatement.^{10/}

The Board is proposing changes in these three critical areas contemporaneously because it believes that the auditor's efforts in these areas complement each other. For example, focusing the auditor's identification and evaluation of significant unusual transactions might assist the auditor in identifying related parties or relationships or transactions with related parties that management has not previously disclosed to the auditor. Similarly, performing procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers might provide the auditor with information that indicates the existence of related party relationships or transactions previously undisclosed to the auditor. Both the auditor and the investor benefit from a comprehensive and consistent examination of these areas, not only because of the risk of material misstatement due to fraud, but also because these transactions, due to their nature, pose a risk of material misstatement due to error.

The repropoed standard and amendments would update the Board's standards and focus the auditor's efforts on these critical areas that could pose significant risks of material misstatement to company financial statements. In the Board's view, this update is particularly appropriate due to the number and magnitude of financial reporting frauds, and resulting investor losses, associated with these areas.

II. Background and Considerations in Developing the Repropoed Auditing Standard and Amendments

On February 28, 2012,^{11/} the Board proposed an auditing standard, *Related Parties* (the "proposed standard"), proposed amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "proposed amendments regarding significant unusual transactions"), and other proposed amendments to PCAOB auditing standards (the "other proposed amendments").^{12/}

^{10/} See PCAOB Release No. 2010-004.

^{11/} See PCAOB Release No. 2012-001.

^{12/} The proposed amendments regarding significant unusual transactions and the other proposed amendments are collectively referred to in this release as the "proposed amendments." In addition, the proposed standard and proposed amendments may be globally referred to as the "proposed standard and amendments" or as the Board's "proposal."



The Board's proposal reflected several years of careful consideration. For example, the issue of related parties was discussed with the Board's Standing Advisory Group ("SAG") on several occasions prior to the Board's decision to issue the proposed standard.^{13/} The Board discussed with its SAG a variety of issues and alternative approaches relevant to developing the proposed standard and proposed amendments.

The Board developed its proposed standard and amendments after receiving input from its SAG and considering current audit requirements and developments, including the work of other standard setters and international developments.^{14/} In addition, the Board took note of observations from the PCAOB's oversight activities, including that the facts underlying a significant number of the Board's settled disciplinary actions to date involved auditors' failures to perform sufficient procedures regarding related party transactions. These observations from the PCAOB's oversight activities primarily relate to audits of financial statements performed by triennially-inspected firms.^{15/}

The Board's goal – both in developing its proposal as well as its reproposal – has been to develop an approach that promotes audit quality and investor protection, while at the same time considering economic considerations, including avoiding unnecessary costs and implementation issues. Before developing its proposal, the Board considered whether it could achieve sufficient improvements in audit quality through its inspection and enforcement programs without amending its standards and requirements.^{16/}

^{13/} The SAG discussed the topic of related parties at a number of its meetings prior to the issuance of the Board's proposal, including at meetings occurring on: October 14-15, 2009; June 21, 2007; and September 8-9, 2004. See the SAG meeting archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>.

^{14/} These matters are discussed in detail in Section III. of the proposing release. See PCAOB Release No. 2012-001.

^{15/} See, e.g., *Report On 2007-2010 Inspections Of Domestic Firms That Audit 100 Or Fewer Public Companies* PCAOB Release No. 2013-001, (Feb. 25, 2013) at 29, available at: http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf.

^{16/} For example, before deciding to issue its proposal, the Board issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010), available at http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf, which discusses a range of auditor practice issues identified by the PCAOB staff pertaining to significant unusual transactions.



However, the existing standards allow the auditor significant latitude in auditing these critical areas. Thus, since the nature and extent of audit procedures can vary widely, the Board concluded that new requirements were appropriate as these critical areas could pose significant risks of material misstatement. The Board also concluded that it was appropriate to propose a new auditing standard regarding related parties rather than to amend the existing standard because of, among other things, the nature and extent of changes necessary to align the existing standard with the risk assessment standards. On the other hand, the Board concluded that appropriate improvements in audit quality could be achieved by amending its existing requirements regarding significant unusual transactions as opposed to issuing a new separate standard.

As noted above, the Board issued the proposed standard and amendments for public comment on February 28, 2012.^{17/} The Board received 37 comment letters on the proposal.^{18/} In addition, the Board discussed the proposed standard and amendments with its SAG at a May 17, 2012 meeting.^{19/} The comment period was extended to May 31, 2012 to allow commenters an opportunity to consider the SAG's discussion. Comments received from the SAG members were considered together with the comment letters received. The Board took all comments received (from both comment letters and the SAG discussion) into consideration in developing the repropoed standard and amendments.

In general, commenters were supportive of the Board's efforts to enhance the auditor's efforts regarding related party and significant unusual transactions and agreed that improvements to the auditing standards were appropriate at this time. While the proposed changes regarding financial relationships with a company's executive officers drew support from a range of commenters, some commenters raised concerns that performing such procedures could have unintended consequences, including impacting the design of compensation arrangements. Commenters also identified a number of areas in which the proposed standard and amendments could be clarified or improved.

^{17/} See PCAOB Release No. 2012-001.

^{18/} The comment letters are available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>.

^{19/} The transcript of the SAG's discussion of the proposed standard and proposed amendments is available at http://pcaobus.org/Rules/Rulemaking/Docket038/2012-05-17_Transcript-Related_Parties.pdf.



In response, the Board has revised its proposal and is now seeking comment on a repropoed standard and amendments. Although the overall approach and many of the performance requirements remain the same in the repropoed standard and amendments, the Board is proposing certain changes to align more closely with the risk assessment standards and to respond to some commenters' suggestions. The Board is issuing the repropoed standard and amendments to provide an opportunity for commenters to provide input on the changes reflected in the repropoal.

The Board also is requesting comments on the potential economic implications of the repropoed standard and amendments. In addition, subsequent to the publication of the Board's proposal, the Jumpstart Our Business Startups Act ("JOBS Act") was enacted.^{20/} The Board therefore is specifically requesting comments on considerations raised by the JOBS Act, including the application of the repropoed standard and amendments to audits of emerging growth companies ("EGCs").

Appendix 4 of this release describes the Board's consideration of significant comments received as well as changes reflected in the repropoed standard and amendments. Appendix 4 also contains questions for commenters related to specific aspects of the repropoed standard and amendments.

The Board's Approach for Promoting Audit Quality in These Critical Areas

In developing its approach to promote audit quality, the Board made a number of key decisions to make its auditing standards in these critical areas more effective. The Board also was mindful of the need for standards that can be implemented efficiently. The following discussion summarizes the Board's approach and highlights its considerations in the choices made and alternatives considered, both in crafting its proposal as well as its repropoal.

Overall Approach: The repropoed standard and amendments would establish new requirements designed to sharpen the auditor's focus on critical areas prone to material misstatements of the financial statements, including material misstatements associated with fraudulent financial reporting, with the goal of promoting the auditor's ability to identify, assess, and respond to such risks. Thus, the performance requirements could improve audit quality, help protect the interests of investors, and

^{20/} Pub. L. No. 112-106 (April 5, 2012). See Section 103(a)(3)(C) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. §7213(a)(3)), as added by Section 104 of the JOBS Act.



further the public interest in the preparation of informative, accurate, and independent audit reports.

Opportunity for Scalability: The reproposed standard and amendments would establish basic required procedures that would be supplemented by more in-depth procedures, as needed, commensurate with the auditor's evaluation of the risks posed by the company's facts and circumstances. Relevant facts and circumstances include the nature, size, or complexity of the transaction and the related risk of material misstatement in the financial statements. This provides the opportunity for the auditor to scale the audit and focus his or her attention on the most critical aspects of the audit.

Alignment with the Risk Assessment Standards: The reproposed standard and amendments have been designed to align with and build upon the requirements in the risk assessment standards.^{21/} The reproposed standard would require the auditor to perform specific risk assessment procedures to obtain an understanding of the company's relationships and transactions with its related parties. Performing these risk assessment procedures required by the reproposed standard in conjunction with the auditor's risk assessment procedures is intended to provide the auditor with a basis for identifying and assessing risks of material misstatement associated with related parties and related party transactions. This cohesive approach would provide opportunities to integrate audit effort, where appropriate, and, at the same time, position the auditor to identify areas in which there may be increased risks of material misstatement of financial statements posed by a company's related party relationships and transactions. Similarly, the reproposed amendments also would include amendments to the Board's existing standards intended to focus the auditor's attention, in a targeted way, on potential issues associated with a company's significant unusual transactions and its financial relationships and transactions with its executive officers as part of the auditor's risk assessment process.

Complementary Audit Areas: The reproposed standard and amendments are complementary and offer opportunities for efficient implementation as well as more effective audits. For example, obtaining an understanding of financial relationships and transactions with executive officers can help the auditor identify incentives and pressures that could cause management to use related party or significant unusual transactions to meet financial goals.

^{21/} The risk assessment standards include a focus on the auditor's responsibilities to consider the risks of, and possibilities for, material misstatement, whether due to error or fraud, throughout the entire audit process. See PCAOB Release No. 2010-004.



Retaining Existing Concepts and Procedures: The repropoed standard and amendments would incorporate, and where appropriate, strengthen many of the audit procedures rooted in existing auditing standards and common in practice today. For example, the repropoed standard would include as new requirements certain procedures that are included in AU sec. 334 as procedures for the auditor to consider, such as obtaining an understanding of the business purpose of the transaction and reading the underlying documentation. This approach would permit auditors that have such procedures as part of their existing methodologies to build upon their existing knowledge and training. As a result, this approach could minimize their incremental costs of implementing the repropoed standard and amendments.

Improving the Auditor's Communication with the Audit Committee: The repropoed standard and amendments would establish new requirements relating to the auditor's communications with the company's audit committee regarding related parties. The communications requirements in the repropoed standard would work in concert with Auditing Standard No. 16, *Communications with Audit Committees*, to ensure that the auditor has a forum to discuss the auditor's evaluations regarding the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. In addition, the repropoed amendments regarding significant unusual transactions would complement the recently enacted auditor communication requirements regarding significant unusual transactions in Auditing Standard No. 16.

III. Overview of Reproposal and Improvements from Existing Standards

This section provides an overview of the repropoed standard and amendments, and key proposed improvements from existing standards. This section also summarizes certain changes from the proposed standard and amendments based upon comments received. Appendix 4 of this release contains a more detailed discussion of these matters.

Relationships and Transactions with Related Parties

Overview of the Repropoed Standard: The repropoed standard would strengthen existing auditing procedures associated with identifying, assessing, and responding to the risks of material misstatement associated with a company's relationships and transactions with its related parties. Among other things, the repropoed standard would require the auditor to:

- Perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties, including 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



transactions involving related parties. The new procedures are intended to be performed in conjunction with the auditor's risk assessment procedures pursuant to Auditing Standard No. 12.

- Evaluate whether the company has properly identified its related parties and its relationships and transactions with related parties. In making that evaluation, the auditor should take into account information gathered during the audit. As part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. If the auditor identifies information that indicates that related parties or relationships or transactions with a related party previously undisclosed to the auditor might exist, the auditor would perform procedures necessary to determine whether undisclosed relationships or transactions with related parties, in fact, exist.
- Perform specific procedures if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists.
- Perform specific procedures regarding each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk. Focusing the auditor's attention on these transactions is intended to enhance the effectiveness of the auditor's evaluation of whether the company's related party transactions are properly accounted for and disclosed.
- Communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, and other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

The Existing Standard: As previously noted, the existing requirements for auditing relationships and transactions with related parties are contained primarily in AU sec. 334.

AU sec. 334 recognizes that the auditor performs procedures to identify and evaluate a company's relationships and transactions with its related parties as part of performing an audit of financial statements. In doing so, AU sec. 334 provides "guidance" and examples of procedures, for the auditor's consideration for identifying and evaluating related party transactions. Examples of procedures in AU sec. 334



include procedures to obtain information from management (such as obtaining the names of all related parties and inquiring whether there were any transactions with these parties during the period) as well procedures intended to assist the auditor in identifying related parties that have not been disclosed to the auditor by management (such as reviewing filings with the Securities and Exchange Commission ("SEC"), reviewing company accounting records and certain invoices, and making inquiries of other auditors). Notably, AU sec. 334 provides that the procedures set forth in AU sec. 334 should not be considered all-inclusive and that not all of them may be required in every audit. Further, AU sec. 334 states that, in the absence of evidence to the contrary, related party transactions should not be assumed to be outside the ordinary course of business.^{22/} Finally, AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions.

Key Improvements from the Existing Standard: The reproposed standard retains certain concepts and procedures from AU sec. 334 that relate to identifying and evaluating related parties and related party transactions. However, the reproposed standard differs from AU sec. 334 in a number of key respects.

- *Enhanced Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties:* Unlike AU sec. 334 which includes limited direction for obtaining an understanding of the company's relationships and transactions with its related parties (e.g., AU sec. 334.05), the reproposed standard would require the performance of specific procedures in this area, including obtaining an understanding of the terms and business purposes (or the lack thereof) of related party transactions.
- *Alignment with the Risk Assessment Standards:* Since the adoption of AU sec. 334, the Board has adopted and amended several auditing standards, including its risk assessment standards. The reproposed standard would align with and build upon the risk assessment framework. This alignment could provide an opportunity for efficient implementation. For example, the auditor could perform the inquiries that would be required by the reproposed standard contemporaneously with inquiries required by the risk assessment standards.

^{22/} Thus, AU sec. 334 could be misunderstood to create a "presumption of validity" for the business purpose of related party transactions in situations where experience suggests a need for heightened scrutiny.



- *Addition of Basic Requirements:* AU sec. 334 suggests procedures for the auditor's consideration, noting that the suggested procedures should not be considered all-inclusive and not all of them may be required in every audit. As noted above, the repropoed standard would require basic procedures for the auditor's assessment of and response to risks of material misstatement. The repropoed standard also would require more in-depth procedures commensurate with the auditor's assessment of the risks posed by the company's facts and circumstances.
- *Broader Focus on Accounting:* As noted above, AU sec. 334.02 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions. The repropoed standard would require that the auditor evaluate the accounting for and disclosure of related party transactions.

Key Changes from the Proposed Standard: The repropoed standard reflects clarifying changes and improvements in response to comments received. Some of the changes address the following:

- *Clarifying the Relationship between the Repropoed Standard and the Risk Assessment Standards:* In response to requests to clarify the relationship between the proposed standard and the risk assessment standards, the Board made several revisions to better integrate the proposed requirements with those standards. For example, the revisions would clarify, among other things, that the risk assessment procedures performed to obtain an understanding of the company's relationships and transactions with its related parties are performed in conjunction with the risk assessment procedures performed pursuant to Auditing Standard No. 12. In addition, the repropoed standard would add a number of references to other auditing standards that may be relevant to the auditor's consideration of related parties and related party transactions.
- *Responsibility of the Auditor to Evaluate the Company's Identification of Related Parties:* Some commenters suggested that the Board clarify the auditor's responsibility to perform procedures to identify the company's related parties. In response, the repropoed standard has been revised to focus more directly on a key aspect of the audit objective, that is, whether relationships and transactions with related parties have been properly identified by the company under audit.

As repropoed, the standard would include a new requirement for the auditor to evaluate whether the company has properly identified its related parties.



Evaluating whether a company has properly identified its related parties involves more than assessing the process used by the company to identify its related parties. The new evaluation contained in the repropoed standard would require the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company. The repropoed standard would include focused audit procedures intended to support the auditor's required evaluation. Such steps, which closely mirror the auditor's risk assessment process, would include: (i) performing risk assessment procedures to obtain an understanding of the company's relationships and transactions with its related parties; (ii) identifying and assessing risks relating to a company's relationships and transactions with its related parties, including whether the company has properly identified its related parties; (iii) designing and performing audit procedures that address and respond to the risks of material misstatement associated with the company's related parties and transactions; and (iv) performing enhanced procedures that address related party relationships or transactions identified by the auditor that were previously undisclosed by company management.

In the Board's view, the clarifications in the repropoed standard represent a more effective audit approach that recognizes that the company is responsible for the preparation of its financial statements, including, in the first instance, the identification of the company's related parties, and that the auditor begins the audit with information obtained from the company.^{23/}

- *Requests for Additional Auditor Judgment:* Several commenters suggested that the proposed standard allow more room for the use of auditor judgment.

^{23/} To further assist the auditor's efforts in identifying related parties, the repropoed other amendments include a complementary provision that would expand existing management representations contained in AU sec. 333, *Management Representations*, to state that the company has provided the names of all related parties and all relationships and transactions with its related parties to the auditor. However, the auditor may not rely solely on management's representations. Representations from management are not a substitute for the application of those audit procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit. The auditor's new required evaluation should be supported by auditing procedures and evidence obtained from procedures designed to test the accuracy and completeness of the related parties and transactions disclosed by the company to the auditor.



In response, the Board has revised a number of the requirements, including: (i) clarifying that the auditor exercises discretion in making inquiries of certain individuals within the company regarding the company's relationships and transactions with its related parties and (ii) removing the requirement that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk.

The Board is seeking comment on whether the repropoed standard is appropriate, including proposed revisions that have been made, and has included specific questions for respondents at the end of Section I. of Appendix 4 to this release.

Significant Unusual Transactions

Overview of the Repropoed Amendments Regarding Significant Unusual Transactions: The repropoed amendments regarding significant unusual transactions would revise AU sec. 316 and other PCAOB auditing standards to strengthen the auditor's identification and evaluation of significant unusual transactions.

Among other things, the repropoed amendments regarding significant unusual transactions would:

- Require the auditor to perform procedures to identify significant unusual transactions;
- Require the auditor to perform procedures to obtain an understanding of, and evaluate, the business purpose (or the lack thereof) of identified significant unusual transactions; and
- Add factors for the auditor to consider in evaluating whether significant unusual transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

The repropoed amendments regarding significant unusual transactions would include substantive enhancements to AU sec. 316, as well as amendments to Auditing Standard Nos. 12 and 13. The repropoed amendments regarding significant unusual transactions also would include conforming changes to other Board auditing standards to provide for consistency in the use of the term "significant unusual transactions" throughout the Board's standards.

Existing Standards Regarding Significant Unusual Transactions: Existing auditing requirements regarding significant unusual transactions are principally contained in AU



sec. 316.^{24/} Specifically, AU sec. 316.66 recognizes that during a financial statement audit, the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment. AU sec. 316.66 also requires that, if the auditor becomes aware of significant unusual transactions during the course of an audit, the auditor should gain an understanding of the business rationale of such transactions and evaluate whether that rationale (or the lack thereof) suggests that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.

In addition, the risk assessment standards also anticipate that the auditor will consider risks of material misstatement that are posed by significant unusual transactions. For example, one factor to be considered currently in the auditor's risk assessment is whether a risk involves a significant transaction outside the normal course of business for the company or otherwise appears to be unusual due to its timing, size, or nature.^{25/}

Key Improvements from the Existing Standards: The repropoed amendments regarding significant unusual transactions constitute targeted changes to existing Board standards in a number of areas.

- *Descriptions of Significant Unusual Transactions:* The repropoed amendments regarding significant unusual transactions would amend paragraph 66 of AU sec. 316 to describe significant unusual transactions as 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. The repropoed amendments regarding significant unusual transactions also would include conforming changes to introduce a uniform description of "significant unusual transaction" throughout the Board's standards.
- *Enhancing Requirements for Identifying Significant Unusual Transactions:* The repropoed amendments regarding significant unusual transactions would require the performance of specific procedures intended to improve the auditor's identification of significant unusual transactions, for example, by making inquiries of management and others.

^{24/} See AU secs. 316.66-.67.

^{25/} See paragraph 71.g. of Auditing Standard No. 12.



- *Enhancing Requirements for Evaluating Significant Unusual Transactions:* The repropoed amendments to AU secs. 316.66-.67A would include basic procedures, which may be expanded based upon the auditor's identification and assessment of the risks of material misstatement, for evaluating the business purpose (or the lack thereof) of significant unusual transactions.

The basic procedures would include: (i) reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction; (ii) determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures; and (iii) evaluating the financial capability of the other parties with respect to significant uncollected balances, guarantees, and other obligations. Further, the repropoed amendments to AU secs. 316.66-.67 would enhance the auditor's evaluation of the business purpose of significant unusual transactions by, among other things, expanding the factors considered by the auditor in evaluating whether the business purpose (or the lack thereof) of significant unusual transactions indicates that such transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

- *Emphasizing Accounting and Disclosure:* The repropoed amendments to AU sec. 316.67 regarding significant unusual transactions would heighten the auditor's attention to accounting matters relative to significant unusual transactions by emphasizing that existing requirements include evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

Key Change from the Proposed Amendments Regarding Significant Unusual Transactions: The repropoed amendments regarding significant unusual transactions reflect certain changes made in response to comments received. The key change from the proposed amendments would enhance the linkage between the repropoed standard and the repropoed amendments in the area of significant unusual transactions. Specifically, the repropoed amendments regarding significant unusual transactions would add:

- (i) a note to AU sec. 316.66 that would state that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions;



(ii) a note to the repropoed standard that would state that, for a related party transaction that is also a significant unusual transaction pursuant to AU secs. 316.66-.67A, the auditor should evaluate whether the business purpose (or the lack thereof) of the transaction indicates that the transaction was entered into to engage in fraudulent financial reporting or conceal asset misappropriation; and

(iii) a footnote to the repropoed standard that would state that information obtained from identifying and evaluating a company's significant unusual transactions (as well as from obtaining an understanding of a company's financial relationships and transactions with its executive officers) could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

The Board is seeking comment on whether the repropoed amendments regarding significant unusual transactions are appropriate, including proposed revisions that have been made, and has included specific questions for respondents at the end of Section II. of Appendix 4 to this release.

Financial Relationships and Transactions with Executive Officers

Overview of Other Repropoed Amendments: The other repropoed amendments provide for improved audit procedures in complementary areas, such as a company's financial relationships and transactions with its executive officers.^{26/} The other repropoed amendments would require that the auditor perform procedures, as part of the auditor's risk assessment, to obtain an understanding of the company's financial relationships and transactions with its executive officers (including executive compensation arrangements). The other repropoed amendments would establish new procedures to heighten the auditor's attention to incentives or pressures for the

^{26/} For issuers, the term "executive officer" is based on the definition contained in Rule 3b-7 under the Exchange Act. This definition includes a company's president, any vice president of the company in charge of a principal business unit, division, or function (such as sales, administration or finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the company. Executive officers of subsidiaries may be deemed executive officers of the company if they perform such policy making functions for the registrant. For brokers and dealers, the term "executive officer" is based on the list in Schedule A of Form BD, which includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions.



company to achieve a particular financial position or operating result, recognizing the key role that a company's executive officers may play in the company's accounting decisions or in a company's financial reporting. The other repropoed amendments would not require the auditor to assess the appropriateness or reasonableness of a company's compensation arrangements with its executive officers.

The Existing Standards and Key Improvements: The risk assessment standards require the auditor to consider obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses, as part of obtaining an understanding of the company.

The other repropoed amendments would strengthen existing requirements in the risk assessment standards by requiring the auditor, as part of the audit risk assessment process, to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers, a group that, because of their position in the company, can exert influence over the company's accounting and financial statement presentation.

Key Change from the Other Proposed Amendments: The other repropoed amendments relating to executive officers reflect certain changes made in response to comments received. The key change from the other proposed amendments would clarify that procedures regarding a company's financial relationships and transactions with its executive officers would be performed as part of the auditor's risk assessment process and would not require the auditor to make any determination regarding the appropriateness or reasonableness of a company's compensation arrangements with its executive officers or recommendations regarding such compensation arrangements.

The Board is seeking comment on whether the repropoed amendments regarding a company's financial relationships and transactions with its executive officers are appropriate, including proposed revisions that have been made, and has included specific questions for respondents at the end of Section III. of Appendix 4 to this release.

Other Repropoed Amendments to PCAOB Auditing Standards

In addition to the other repropoed amendments relating to financial relationships and transactions with executive officers, the other repropoed amendments would revise other auditing standards to conform them to the repropoed standard and amendments and, where appropriate, include new requirements that complement the repropoed standard and repropoed amendments regarding significant unusual transactions. For example, among other things, the other repropoed amendments



would require the auditor to obtain written representations from management (a) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor; and (b) if the company's financial statements include assertions that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction. In addition, the repropoed amendments also would include changes to management's written representations to provide that they have made available the names of all related parties and relationships and transactions with related parties. The other repropoed amendments are discussed in detail in Appendix 4 of this release.

The Board is seeking comment on whether the other repropoed amendments are appropriate, including proposed revisions that have been made, and has included specific questions for respondents at the end of Section III. of Appendix 4 to this release.

IV. Economic Considerations, Including Audits of Emerging Growth Companies

As described above, the repropoed standard and amendments are designed to address critical areas that warrant heightened scrutiny by auditors. As previously described, the Board's approach for promoting audit quality in these critical areas takes into account both the effectiveness of the auditing standards and the potential efficiency of implementation. Appendix 4 of this release provides additional discussion regarding the need for improvements to the existing standards, the Board's approach for promoting audit quality, and how the Board's approach reflects economic considerations. The discussion in Section IV. of Appendix 4 builds on the discussion of the repropoed standard and amendments in Sections I. through III. of Appendix 4 and seeks input on the potential economic implications of the repropoal.

Further, pursuant to Section 104 of the JOBS Act, any rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs (as defined in Section 3(a)(80) of the Exchange Act) unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."^{27/}

The repropoed standard and amendments are being issued by the Board for public comment, in part, to solicit views of commenters on the application of the

^{27/} See Section 103(a)(3)(a) of the Sarbanes-Oxley Act of 2002.



reproposed standard and amendments to audits of EGCs. The Board specifically requests comments, including empirical data, regarding (1) whether the application of the reproposed standard and amendments to audits of EGCs would promote efficiency, competition, and capital formation and (2) whether there are unforeseen consequences of the reproposed standard and amendments of which the Board should be aware. The Board also requests comments, including empirical data, regarding incremental costs that may be imposed by the reproposed standard and amendments, and in particular, their application to audits of EGCs.

Section IV. of Appendix 4 contains specific questions for commenters regarding economic considerations more generally, as well as questions regarding the application of the reproposed standard and amendments to audits of EGCs.

V. Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")^{28/} gave the Board explicit oversight authority over audits of brokers and dealers that are required under SEC rules. In light of the authority granted to the Board by the Dodd-Frank Act to establish standards governing audit reports to be included in broker-dealer filings with the Commission, the Commission issued transitional interpretive guidance in September 2010 to clarify that references in Commission rules, staff guidance, and in the federal securities laws to generally accepted auditing standards ("GAAS"), which are established by the ASB, or to specific standards under GAAS, as they relate to non-issuer brokers or dealers, should continue to be understood to mean auditing standards generally accepted in the U.S., in addition to any applicable rules of the Commission. The guidance also stated that the Commission intended to revisit this interpretation in connection with a rulemaking project to update the audit and attestation requirements under the federal securities laws for brokers and dealers. On June 15, 2011, the SEC proposed to amend its rules, including SEC Rule 17a-5 under the Exchange Act, to require, among other things, that audits of brokers' and dealers' financial statements and examinations of reports regarding compliance with SEC requirements be performed in accordance with the standards of the PCAOB.^{29/}

^{28/} Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

^{29/} SEC, *Broker-Dealer Reports*, Exchange Act Release No. 64676 (June 15, 2011).



The Board requested comments on the application of the proposed standard and amendments to audits of brokers and dealers in its proposing release. As discussed in Appendix 4, a number of commenters stated that the proposed standard and amendments were appropriate for audits of brokers and dealers. The Board is continuing to solicit comments regarding issues that may be raised by the application of the Board's reproposal to audits of brokers and dealers in view of the revisions that are being proposed.

The Board requests comments from auditors of brokers and dealers and others regarding the application of the repropoed standard and amendments to audits of brokers and dealers. Specific questions are included at the end of Section V. of Appendix 4 to this release.

VI. Effective Date

The repropoed standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2013. The Board seeks comment regarding the feasibility of this date in Section VI. of Appendix 4 to this release.

VII. Appendices

The release contains the following appendices:

- Appendix 1 to this release contains the text of the repropoed standard, *Related Parties*.
- Appendix 2 to this release contains the repropoed amendments to certain PCAOB auditing standards regarding significant unusual transactions.
- Appendix 3 to this release contains the other repropoed amendments to PCAOB auditing standards.
- Appendix 4 provides additional discussion of the repropoed standard and amendments. Appendix 4 also includes discussion of the existing standards and discussion of significant comments and Board responses. This Appendix further contains information regarding the applicability of the repropoed standard and amendments to audits of brokers and dealers and audits of EGCs. Appendix 4 also contains questions that solicit comments regarding specific provisions in the repropoed standard and amendments, including the potential costs associated with the implementation of those provisions. Questions are included in each of the following sections of Appendix 4:



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- Appendix 5 to this release discusses certain significant differences between the objectives and requirements of the repropose standard and the amendments and the analogous standards of the IAASB and the ASB.

VIII. Opportunity for Public Comment

The Board solicits comments on any and all aspects of its reproposal, as well as seeking specific comments on the repropose standard, the repropose amendments regarding significant unusual transactions, and other repropose amendments to other PCAOB auditing standards. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's Web site at: www.pcaobus.org. All comments should refer to the PCAOB Rulemaking Docket Matter No. 038 on the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on July 8, 2013.

The Board will consider carefully all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are rules of the Board under the Act.



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On the 7th day of May, in the year 2013, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary
May 7, 2013



APPENDIX 1

Proposed Auditing Standard, *Related Parties*

Introduction

1. This standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.^{1/}

Objective

2. The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.^{2/}

Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties

3. The auditor should 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 in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. The procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company's process (paragraph 4);

^{1/} The auditor should look to the requirements of the U.S. Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties" and the financial statement disclosure requirements with respect to related parties.

^{2/} See, e.g., paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*. See also paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.



- b. Performing inquiries (paragraphs 5-7); and
- c. Communicating with the audit engagement team and other auditors (paragraphs 8-9).

Note: 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.

Note: Performing the risk assessment procedures described in paragraphs 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 related parties and relationships and transactions with related parties.

Obtaining an Understanding of the Company's Process

4. In conjunction with obtaining an understanding of internal control over financial reporting, the auditor should obtain an understanding of the company's process for:^{3/}
- a. Identifying related parties and relationships and transactions with related parties;
 - b. Authorizing and approving transactions with related parties; and
 - c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

^{3/} See, e.g., paragraph 18 of Auditing Standard No. 12 which requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures. See *also* paragraph 20 of Auditing Standard No. 12, which states that obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.



Performing Inquiries

5. The auditor should inquire of management regarding:^{4/}
- a. The names of the company's related parties during the period under audit, including changes from the prior period;
 - b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);
 - c. The nature of any relationships, including ownership structure, between the company and its related parties;
 - d. The transactions entered into, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;
 - e. The business purpose for entering into a transaction with a related party versus an unrelated party;
 - f. 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; and
 - g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.
6. The auditor should inquire of others within the company regarding their knowledge of the matters in paragraph 5 of this standard. The auditor should identify others within the company to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding:

^{4/} See also AU sec. 333, *Management Representations*. Obtaining such representations from management complements the performance of procedures in paragraph 5 and is not a substitution for those inquiries.



- a. The company's related parties or relationships or transactions with related parties;
 - b. The company's controls over relationships or transactions with related parties; and
 - c. The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.^{5/}
7. The auditor should inquire of the audit committee,^{6/} or its chair, regarding:
- a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
 - b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

Communicating with the Audit Engagement Team and Other Auditors

8. The auditor should communicate to engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.^{7/}

^{5/} For purposes of this standard, the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties.

^{6/} The term "audit committee" has the same meaning as the term used in Auditing Standard No. 16, *Communications with Audit Committees*.

^{7/} This communication complements the discussion among engagement team members regarding risks of material misstatement in accordance with paragraph 49 of Auditing Standard No. 12. See also, paragraph 5 of Auditing Standard No. 10, *Supervision of the Audit Engagement*, which establishes requirements regarding supervision of the engagement team members, including directing engagement team members to bring significant accounting and auditing issues arising during the audit to



9. 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.^{8/} The auditor also should inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.

Identifying and Assessing Risks of Material Misstatement

10. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level.^{9/} This includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties.

Note: In identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4-9 of this standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

the attention of the engagement partner or other engagement team members performing supervisory activities.

^{8/} See AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements.

^{9/} See paragraph 59 of Auditing Standard No. 12.



Responding to the Risks of Material Misstatement

11. The auditor must design and implement audit responses that address the identified and assessed risks of material misstatement.^{10/} This includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.^{11/}

Note: The auditor also should look to the requirements in proposed paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). For such related party transactions, AU sec. 316.67 requires 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.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk

12. For each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:

- a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

^{10/} See paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

^{11/} See *generally*, Auditing Standard No. 13 and paragraph 17 of Auditing Standard No. 15, *Audit Evidence*, which provides that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.



- b. 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;
- c. Determine whether any exceptions to the company's established policies or procedures were granted;^{12/}
- d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;^{13/} and
- e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Note: 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 in paragraph 12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

Intercompany Transactions

13. The auditor should perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

^{12/} Information gathered while obtaining an understanding of the company also might assist the auditor in identifying agreements prohibiting or restricting related party transactions (for example, loans or advances to related parties).

^{13/} Examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.



Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties

14. The auditor should evaluate whether the company has properly identified its related parties and relationships and transactions with related parties.^{14/} In making that evaluation, the auditor should take into account the information gathered during the audit.^{15/} As part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

Note: Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

15. If the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist.^{16/} These procedures should extend beyond inquiry of management.

^{14/} Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

^{15/} Information obtained from identifying and evaluating a company's significant unusual transactions and obtaining an understanding of a company's financial relationships and transactions with its executive officers could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

^{16/} See paragraph 29 of Auditing Standard No. 15, which states that if audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.



16. If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;^{17/}
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of this standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;
- f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
- g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
- h. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related

^{17/} See AU sec. 333.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.



party indicates that fraud or an illegal act may have occurred. If the auditor determines that it is likely that an illegal act has or may have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

Evaluating Financial Statement Accounting and Disclosures

17. The auditor must evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. This includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.^{18/}

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions

18. If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.^{19/}

Note: Transactions with related parties might not be conducted on terms equivalent to those prevailing in arm's-length transactions (e.g., a company may receive services from a related party without cost). Except for routine transactions, it may not be possible for management to determine whether a particular transaction would have taken place, or

^{18/} See paragraph 31 of Auditing Standard No. 14.

^{19/} See proposed paragraph .06.l. of AU sec. 333, which would require the auditor to obtain written representations from management if the financial statements include such an assertion. Representations from management alone are not sufficient appropriate audit evidence. See also paragraphs .35-.36 of AU sec. 508, *Reports on Audited Financial Statements*.



what the terms and manner of settlement would have been, if the parties had not been related. Accordingly, it may be difficult for the auditor to obtain sufficient appropriate audit evidence to substantiate management's assertion that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. A preface to a statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

Communications with the Audit Committee

19. The auditor should communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.^{20/} The auditor also should communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and
- e. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

^{20/} See Auditing Standard No. 16 regarding the timing of the communications to the audit committee.



APPENDIX A – Examples of Information and Sources of Information That Could Indicate That Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor Might Exist

A1. This Appendix contains examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Specifically, paragraph A2 of this Appendix contains examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, and paragraph A3, similarly, contains examples of sources that could contain such information. The examples contained in this Appendix are not intended to represent a comprehensive listing.

A2. The following are examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Buying or selling goods or services at prices that differ significantly from prevailing market prices;
- Sales transactions with unusual terms, including unusual rights of return or extended payment terms generally not offered;
- "Bill and hold" type transactions;
- Borrowing or lending on an interest-free basis or with no fixed repayment terms;
- Occupying premises or receiving other assets or rendering or receiving management services when no consideration is exchanged;
- Engaging in a nonmonetary transaction that lacks commercial substance;
- Sales without economic substance (e.g., funding the other party to the transaction to facilitate collection of the sales price, or entering into a transaction shortly prior to period end and unwinding that transaction shortly after period end);
- Loans to parties that, at the time of the loan transaction, do not have the ability to repay and possess insufficient or no collateral;
- Loans made without prior consideration of the ability of the party to repay;



- A subsequent repurchase of goods that indicates that at the time of sale an implicit obligation to repurchase may have existed that would have precluded revenue recognition or sales treatment;
- Advancing company funds that are used directly or indirectly to pay what would otherwise be an uncollectible loan or receivable;
- Sales at below market rates to an intermediary whose involvement serves no apparent business purpose and who, in turn, sells to the ultimate customer at a higher price, with the intermediary (and ultimately its principals) retaining the difference;
- Guarantees and guarantor relationships outside the normal course of business; or
- Transactions between two or more entities in which each party provides and receives the same or similar amounts of consideration (e.g., round-trip transactions).

A3. The following are examples of sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies;
- Confirmation responses and responses to inquiries of the company's lawyers;
- Tax filings and related correspondence;
- Invoices and correspondence received from the company's professional advisors, for example, attorneys and consulting firms;
- Relevant internal auditors' reports;
- Conflicts-of-interest statements from management and others;
- Shareholder registers that identify the company's principal shareholders;
- Life insurance policies purchased by the company;
- Records of the company's investments, pension plans, and other trusts established for the benefit of employees, including the names of the officers and trustees of such investments, pension plans, and other trusts;
- Contracts or other agreements (including, for example, partnership agreements and side agreements or other arrangements) with management;



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- Contracts and other agreements representing significant unusual transactions;
- Significant contracts renegotiated by the company during the period under audit;
- Records from a management, audit committee, or board of directors' whistleblower program;
- Expense reimbursement documentation for executive officers; or
- The company's organizational charts.



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APPENDIX 2 – Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

A. Identifying Significant Unusual Transactions (Section II.A. of Appendix 4)

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

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, as amended, is amended as follows:

In paragraph 14:

- The first bullet point is replaced with:

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 those that result in late or unusual journal entries;^{10A/} and

- Footnote 10A is added at the end of the first bullet:

^{10A/} See paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

Auditing Standard No. 9, *Audit Planning*

Auditing Standard No. 9, *Audit Planning*, as amended, is amended as follows:

In paragraph 12, subparagraph a. is replaced with:

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.^{14/}



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Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

a. In paragraph 13:

- The fifth bullet point is replaced with:

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");^{7A/} and

- Footnote 7A is added after the semicolon (;) at the end of the fifth bullet:

^{7A/} See AU secs. 316.66-.67A.

b. In paragraph 56.a.:

- In item (6), delete the word "and" at the end of the item.
- In item (7), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
- Add Item (8):

(8) Whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties.^{31A/}

- Add footnote 31A at the end of item (8):

^{31A/} See AU secs. 316.66-.67A.

c. In paragraph 56.b.:



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- In item (3), delete the word "and" at the end of the item.
 - In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add item (5):
 - (5) Whether the company has entered into any significant unusual transactions.
- d. In paragraph 56.c.:
- In item (3), delete the word "and" at the end of the item.
 - In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add item (5):
 - (5) Whether the company has entered into any significant unusual transactions.
- e. In paragraph 57, the third bullet point is replaced with:
- Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements, a significant unusual transaction, or a significant related party transaction;
and
- f. Paragraph 71.g., is replaced with:
- Whether the risk involves significant unusual transactions.
- g. Paragraph 73A is added after paragraph 73:
- 73A. The auditor should obtain an understanding of the controls that management has established to identify, authorize and approve, and account for and disclose significant unusual transactions in the financial statements, if the auditor has not already done so when



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obtaining an understanding of internal control, as described in paragraphs 18-40 and 72-73 of this standard.

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, as amended, is amended as follows:

- a. The second sentence of footnote 3 to paragraph 5.d. is replaced with:

See also paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and paragraphs .04 and .06 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

- b. Paragraph 15.c. is replaced with:

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 may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. (AU secs. 316.66-.67A).

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. The first item in paragraph .85A.2, section a., under "Opportunities" is replaced with the following two items:
- Related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business)
 - Significant transactions with related parties whose financial statements are not audited or are audited by another firm



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- b. The fourth item in paragraph .85A.2, section a., under "Opportunities" is replaced with:
 - o Significant or highly complex transactions or significant unusual transactions, especially those close to period end, that pose difficult "substance-over-form" questions
- c. The following item is added as the last item to paragraph .85A.2, section a., under "Opportunities":
 - o Contractual arrangements lacking a business purpose

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

- a. In paragraph .55, Appendix B, paragraph B1., the tenth bullet is replaced with:
 - The occurrence of infrequent or significant unusual transactions

B. Evaluating Significant Unusual Transactions (Section II.B. of Appendix 4)

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, as amended, is amended as follows:

- a. Paragraph 11A is added after paragraph 11:
 - 11A. *Responding to Risks Associated with Significant Unusual Transactions.* Paragraph 71.g. of Auditing Standard No. 12 indicates that one of the factors to be evaluated in determining significant risks is whether the risk involves significant unusual transactions. Also, AU secs. 316.66-.67A establish requirements for performing procedures to respond to fraud risks regarding significant unusual transactions. Because significant unusual transactions can affect the risks of material misstatement due to



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error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-.67A.

Auditing Standard No. 16, *Communications with Audit Committees*

Auditing Standard No. 16, *Communications with Audit Committees*, is amended as follows:

- a. In paragraph 13.d., the phrase "rationale for" is replaced with the phrase "purpose (or the lack thereof) of."

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. Paragraph .66 is replaced with:

.66 Evaluating whether the business purpose for significant unusual transactions indicates that the transactions may have been entered into to engage in fraud. 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.

Note: The auditor's identification of significant unusual transactions should take into account information obtained from: (a) the risk assessment procedures required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial



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reporting) and (b) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

Note: The auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. See paragraphs 14-16 of proposed auditing standard, *Related Parties*. Appendix A of proposed auditing standard, *Related Parties*, includes examples of such information and examples of sources of such information.

b. Paragraph .66A is added after paragraph .66:

.66A The auditor should design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. The procedures should include:

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;
fn 24A and

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- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

Note: Paragraph 11A of Auditing Standard No. 13 requires the auditor to take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures.

- c. Footnote 24A is added after subparagraph c. of paragraph.66A

^{fn 24A} Examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

- d. Paragraph .67 is replaced with:

.67 The auditor should evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. In making that evaluation, the auditor should evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);
- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor;^{fn 25A}
- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company;

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Number: 1 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/5/2013 9:18:02 AM

Dear PCAOB Folks:

Whenever such content and/or similar content is encountered within this "Re-proposed" draft document, please provide throughout this entire effort, help and/or assistance to the Auditor in the form of examples of and/or demonstrations of how best to satisfy meet each of these innocuous and vapid pronouncements.....which provide less than little....which is the equivalent of zip.....thereby making them useful as opposed to the opposite of useful.....

**Respectfully yours,
Pw Carey**



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- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);
- 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 other, more clearly independent, parties on an arm's-length basis;
- The transaction enables the company to achieve certain financial targets;
- 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); and
- Management has discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Note: Paragraphs 20-23 of Auditing Standard No. 14, *Evaluating Audit Results*, provide requirements regarding the auditor's evaluation of whether identified misstatements might be indicative of fraud.

- e. Footnote 25 is deleted and footnote 25A is added at the end of the third bullet in paragraph .67:

^{fn 25A}

Related parties or relationships or transactions with related parties previously undisclosed to the auditor includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties. Proposed auditing standard, *Related Parties*, requires the auditor to perform certain



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procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

f. Paragraph .67A is added after paragraph 67:

.67A 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 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.^{fn 25B}

Note: The auditor considers management's disclosure regarding significant unusual transactions in other parts of the company's Securities and Exchange Commission filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

g. Footnote 25B is added at the end of paragraph.67A:

^{fn 25B} See paragraph 31 of Auditing Standard No. 14.

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Number: 1 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Highlight Date: 7/8/2013 7:29:30 AM

Number: 2 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/8/2013 7:29:10 AM

Pw believes the following information can only assist and help the Auditor in their "evaluation" process, digging deeper whenever they encounter the 'bread crumbs' associated with 'significant unusual transactions':

In KPMG's 2011 *Who is the Typical Fraudster* report, we analyzed 348 actual [HYPERLINK "http://hotstartsearch.com/search/?q=fraud%20investigations"](http://hotstartsearch.com/search/?q=fraud%20investigations) [fraud investigations](#) conducted by KPMG member firm in 69 countries to narrow down the profile of a typical fraudster.

Who is the typical fraudster?

**Are there any:
defining traits,
features, or
behaviors**

that could help you to identify those individuals within your organization more likely to perpetrate fraud? In KPMG's 2011 Who is the Typical Fraudster report, we analyzed 348 actual fraud investigations conducted by KPMG member firm in 69 countries to narrow down the profile of a typical fraudster. Our findings indicate that a typical fraudster is:

- **Male**
- **36 – 45 years old**
- **Commits fraud against his own employer**
- **Works in the finance function or in a finance related role**
- **Holds a senior management position**
- **Employed by the company for more than 10 years**
- **Works in collusion with another perpetrator**

This report is intended to help you learn more about potential fraudsters, identifying fraud 'red flags,' and implementing more effective measures to manage the prevention and detection of fraud and your response to it.

In the analysis, you will also find that the overriding motivation for fraud is:

One: PERSONAL GREED, followed by

Two: PRESSURES ON INDIVIDUALS TO REACH TOUGH PROFIT and

Three: BUDGET TARGETS.

[HYPERLINK "http://www.kpmg.com/us/en/issuesandinsights/articlespublications/pages/typical-fraudster.aspx"](http://www.kpmg.com/us/en/issuesandinsights/articlespublications/pages/typical-fraudster.aspx) \o "Click to Continue > by Text-Enhance" [The survey](#) highlights, more importantly, how weakening control structures make the opportunity to commit fraud easier. By understanding these critical factors, organizations can better mitigate their financial and reputational risks.

Respectfully yours,

Pw



APPENDIX 3 – Other Proposed Amendments to PCAOB Auditing Standards

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

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

- a. The following sentence is added to the end of footnote 3 of paragraph 4:

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.

- b. In paragraph 10, the note following the final bullet is deleted.

- c. Paragraph 10A is added after paragraph 10:

10A. To assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's financial relationships and transactions with its **executive officers** (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the Securities and Exchange Commission and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.

- d. In paragraph 11:

- The third bullet is replaced with:

Obtaining an understanding of compensation arrangements with senior management other than executive officers referred to in paragraph 10A, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses;

- In the fourth bullet, delete the period (.) and add a semicolon (;) at the end of the bullet.

- Add a fifth bullet:

Inquiring of the  chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and

- Add a sixth bullet:

Obtaining an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

- e. In Appendix A, paragraph A3A is added after paragraph A3:

A3A. Executive officer – For issuers, the president; any vice president of a company in charge of a principal  business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company. Executive officers of subsidiaries may be  named executive officers of a company if they perform such policy-making functions for the company. (See Rule 3b-7 under the Exchange Act.) For brokers and dealers, the term "executive officer" includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions. (See Schedule A of Form BD.)

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Number: 1 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/8/2013 7:35:00 AM

Pw believes this inquiry can be conducted remotely by reviewing the widely accepted industry compensation annual reviews, white papers, studies including Compensation Conferences working papers and publications....

Also, the engagement of Compensation Consultants provides an open barn door for a nice sweet Conflict of Interest....on both sides of the table.....don't you agree.....or.....perhaps not.....?

Number: 2 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Highlight Date: 7/8/2013 7:30:50 AM

Number: 3 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/8/2013 7:55:17 AM

Pw believes we should introduce the Auditor with the implications of the FCPA in this regard, such as the following:

There are several standards for risk management. One such standard is ISO 31000.

Best Practice--When conducting WATCHLIST SEARCHES, it is a good idea to use a vendor who conducts searches on watchlists using multiple sources. Relying on one source might be dangerous. Comparing two competing watchlist sources is a good practice. Using, for example, a Dow Jones Risk & Compliance source check, along with another organisation's service as a back-up, is a recommended option. A product of the development of the money laundering compliance industry is that a number of watchlists are now produced by governments in various countries which list involved persons in potential illegal activity.

These lists were initially prepared to capture known or suspected money-launderers and used by banks to stop fraudulent transactions. In the wake of the September 11 bombings in the US and the passing of the Patriot Act, these lists have been significantly expanded to include various terrorist organisations and persons suspected of engaging in international crime. Following the lead of the U.S. Government, almost every country in the world has now developed their own lists. See appendix A for further information on country watchlists.

Number: 4 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/8/2013 8:13:22 AM

Pw believes that bringing to the attention of the Auditor that such tools as the following checklist can only help the Auditor meet their fiduciary duties, obligations and responsibilities:

Example of a Set of Cheat-Sheet Notes:

****** "NO GO" ZONES ******

There are some "No go" zones that may appear in a due diligence report where further review or approvals may be required to go forward:

The entity or a name appears on any of the various country government watchlists listing persons involved in potential illegal activity (i.e., as opposed to the PEP and SOE watchlists which might not be sufficiently significant to constitute a "No go" zone)

There is a media / internet article that discusses integrity issues, making an allegation regarding the integrity of the company or its key principles

There is a litigation that involves fraud, illegal conduct, corruption or integrity violations

******RED FLAGS******

There are a number of red flags that may appear in a due diligence report. Not all red flags suggest that there is an issue or that you cannot do business with the subject. It does mean, however, that the red flag needs to be reviewed more closely before taking any further steps.

Here are some typical red flags:

Company reports

The subject has a very small number of shares issued

The number of shareholders is not disclosed or not available

The company is registered in a location which is known for low transparency (e.g., Cayman Islands, Fiji, Vanuatu, British Virgin Islands, Canary Islands, Bahamas)

Watchlists

Any hit on a watchlist is certainly a red flag and perhaps a "No go" (depending on whether it raises potential illegality or other integrity issues)

PEP or SOE

Any hit on politically exposed persons (PEP) or state-owned entities (SOE) is a red flag. Extra precautions and review are required

Legal proceedings

Many companies are involved in legal proceedings. This is a typical business issue. However, any proceedings involving the following will raise a red flag:

Proceedings involving fraud, collusion, anti-trust violations, corruption, FCPA or UK Anti-Bribery Act allegations

Bankruptcy or significant repeated proceedings to recover outstanding money or satisfy contractual terms

A pattern of frequent and continual involvement in litigation

Media / Internet searches

Any media or Internet results indicating negative press, illegal activity, fraud, or collusion

**** Site visits ****

Any site visits that show the following is a red flag:

Offices in highly industrial areas

Offices in residential areas

Offices where the company's name is not indicated

Offices with significant levels of security or highly restricted access

Offices which are much smaller than expected for the company's size

**** Other red flags that may be found in due diligence investigations include:

Unusual payment requests

Unethical practices (e.g., preparing false documents, giving false answers to questions)

Press reports suggesting unethical behaviour

Comments that imply bribery

Apparent lack of commitment to, or refusal to comply with, the law or local policies and standards

Termination of agreements by other clients or partners

Requests to keep the agency or partnership relationship secret

Requests for unusual favourable payment terms

Lack of concern about the quality of products and services, or related training or warranty issues

"Promotional" funds or accounts

Requests to split payments (or other consideration) into small amounts

Close relationships with government officials in high-risk countries, or requests from a government official in a high-risk country that a specific agent be retained

Requests to be paid in a different currency or in a different location than appropriate, or at a different address than agreed for such payments

Work in a high-risk country with a reputation for corruption or bribery, or a previous charge or conviction for bribery or corruption

Negative reputation or character assessment

Payment issues

History of integrity issues

Best Practices in Conducting FCPA/Anti-Bribery Due Diligence Whitepaper, by Scott Lane, from The Red Flag Group

Number: 5 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/8/2013 8:39:22 AM

Pw believes the Auditor must be reminded of their fiduciary duties, responsibilities and obligations during the entire audit lifecycle....and should be periodically reminded throughout the course of their audit. Tools such as the following will help in this Continuous Ethical Monitoring (CEM) effort:

Appendix B:

Investigation conduct standards (example)

The Red Flag Group's Investigation and Due Diligence Conduct Standards

The Red Flag Group is committed to performing with the highest level of ethical conduct.

All our staff must pledge to act at all times with integrity and perform their work in a professional manner. We hold a professional responsibility to our clients, to the public interest, and to each other; a responsibility that requires subordinating self-interest to the interests of those we serve.

The responsibility to conduct professional investigations carries with it the obligation to act at all times with integrity and fairness. To meet this responsibility, all investigations and due diligence analyses ("Investigations") conducted by The Red Flag Group will adhere to the following standards. These standards apply to all Red Flag Group staff, contractors, agents and partner firms conducting due diligence or investigations on behalf of the firm.

All investigations shall be conducted in compliance with all relevant applicable laws.

No bribe or facilitation payment shall ever be paid to obtain information or speed up the delivery of information.

Also, we never subcontract work to parties that we cannot legally perform / undertake ourselves.

All investigators shall treat information with which they have been entrusted during the course of business with respect, and only access or disclose that information for the purposes intended.

All investigators shall conduct client work in a manner which is fair, transparent, accountable, honest, cautious, thorough, law abiding, mindful of the confidentiality of the material with which they have been entrusted, and with due respect and protection for the reputation of The Red Flag Group and our clients.

The investigative techniques employed must not unnecessarily interfere with the reasonable privacy interests of the subject.

Sensitive investigative techniques, including but not limited to physical and computer forensic searches or the use of covert or undercover strategies, shall only be employed after first obtaining the written authorisation of the client.

Investigators shall not employ artifice, deception or coercion to intrude upon legitimate privacy rights, or protected fiduciary relationships; nor shall they offer any form of inducement for another person to breach a legal duty of confidentiality.

All investigators shall, at all times, demonstrate a commitment to professionalism and diligence in the performance of his or her duties. Investigators shall never engage in any illegal or unethical conduct, or in any activity which would constitute a conflict of interest.

All investigators shall, when writing reports, obtain evidence or other documentation to establish a reasonable basis for any opinion rendered. No opinion shall be expressed regarding the guilt or innocence of any person or party.

Staff shall never reveal any confidential information obtained during a professional engagement without proper authorisation.

Best Practices in Conducting FCPA/Anti-Bribery Due Diligence Whitepaper, by Scott Lane, from The Red Flag Group.....

Please Note: If and/or when you encounter any instances of poor form, sloppy rationalizations, typos and/or dangling participles and/or metaphors....any and all such instances can only be traced to the actions of two entities; the first would be the NSA, an entity which we greatly LOVE, ADMIRE, RESPECT and WISH ONLY THE BEST for ever and ever and ever (well, you get the idea)....and the second entity, is the long rumored and theoretical actions of a herd of invisible rogue cows, who periodically and without asking, take over my keyboard and with their shiny, tiny, black little hooves, destroy the pearls of my thoughts.....with their inappropriate and stupid ideas.....honest, any such silliness is their doing (not mine), and therefore is not my fault.....(not to be confused with the MF Global Defense).....

In closing, thank you again for your courteous time and attention and best wishes with your on-going efforts.....to improve that which is currently in-place and not working.....

Respectfully yours,

**Pw Carey
GRC Application Security Analyst CISA, CISSP**



Auditing Standard No. 16, *Communications with Audit Committees*

Auditing Standard No. 16, *Communications with Audit Committees*, is amended as follows:

- a. The phrase "AU sec. 334, *Related Parties*" in footnote 25 is replaced with the phrase "proposed auditing standard, *Related Parties*."
- b. The following bullet is inserted after the third bullet in Appendix B:
 - Proposed auditing standard, *Related Parties*, paragraphs 7 and 19.

AU sec. 315, "Communications Between Predecessor and Successor Auditors" (Section III.B. of Appendix 4)

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows:

- a. The following bullet is added to the end of paragraph .09:
 - The predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions.^{fn 5A}
- b. Add the following footnote to the end of paragraph .09:

^{fn 5A} Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, describes significant unusual transactions.
- c. In paragraph .11, replace the fifth sentence with:

The predecessor auditor should ordinarily permit the successor auditor to review working papers, including documentation of planning, internal control, audit results, and other matters of continuing accounting and auditing significance, such as the working papers containing an analysis of balance sheet accounts, those relating to contingencies, related parties, and significant unusual transactions.



AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"
(Section III.C. of Appendix 4)

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. The heading before paragraph .79 is replaced with:

Communication about Possible Fraud to Management, the Audit Committee, the Securities and Exchange Commission, and Others^{fn 37}

- b. Paragraph .81A is added after paragraph .81:

.81A The auditor has a responsibility, under certain conditions, to disclose possible fraud to the Securities and Exchange Commission to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change and the fraud or related risk factors constitute a reportable event or are the source of a disagreement, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required pursuant to Section 10A(b) of the Securities Exchange Act of 1934 relating to an illegal act that the auditor concludes has a material effect on the financial statements.

- c. For paragraph .82:

- Footnotes 39 and 41 are deleted.
- The paragraph is replaced with:

.82 The auditor also may have a duty to disclose the existence of possible fraud to parties outside the entity in the following circumstances:

- a. To a successor auditor when the successor makes inquiries in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors*.^{fn 40}



- b. In response to a subpoena.
- c. To a funding agency or other specified agency in accordance with requirements for the audits of companies that receive governmental financial assistance.
- d. The following item is added to paragraph .85A.2, section b., under "Opportunities":
 - o The exertion of dominant influence by or over a related party

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), as amended, is amended as follows:

- a. Footnote 2 to paragraph .27 is replaced with:

Proposed auditing standard, *Related Parties*, establishes requirements regarding the auditor's evaluation of relationships and transactions between the company and its related parties.

AU sec. 333, "Management Representations" (Section III.D. of Appendix 4)

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

- a. The third sentence of paragraph .03 is replaced with:

For example, after the auditor performs the procedures described in proposed auditing standard, *Related Parties*, the auditor should obtain a written representation that management has no knowledge of any relationships or transactions with related parties that have not been properly accounted for and adequately disclosed. The auditor should obtain this written representation even if the results of those procedures indicate that relationships and transactions with related parties have been properly accounted for and adequately disclosed.

- b. In paragraph .06:
 - Subparagraph c. is replaced with:



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Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Subparagraph f. is replaced with:

Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.

- Subparagraph l. is replaced with:

Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.^{fn9}

- c. Footnote 9 to paragraph .06 is replaced with:

See paragraph 18 of proposed auditing standard, *Related Parties*.

- d. The second sentence in paragraph 4 of Appendix A is replaced with:

Examples are fraud, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in proposed auditing standard, *Related Parties*.

- e. In paragraph 6 of Appendix A:

- Item 2.a. is replaced with:

Financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Item 11.d. is added:

Side agreements or other arrangements (either written or oral) that have not been disclosed to you.



AU sec. 334, "Related Parties"

SAS No. 45, Omnibus Statement on Auditing Standards — 1983 (AU sec. 334, "Related Parties"), as amended, is superseded.

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," as amended, is superseded.

AU sec. 336, "Using the Work of a Specialist"

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336, "Using the Work of a Specialist"), as amended, is amended as follows:

- a. Footnote 6 of paragraph .10 is replaced with:

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.

AU sec. 560, "Subsequent Events" (Section III.E. of Appendix 4)

SAS No. 1, "Codification of Auditing Standards and Procedures," section 560, "Subsequent Events" (AU sec. 560, "Subsequent Events"), as amended, is amended as follows:

- a. In paragraph .12b.:

- Item (v) is added:

Whether there have been any changes in the company's related parties or whether there have been any significant new related party transactions.

- Item (vi) is added:

Whether the company has entered into any significant unusual transactions.



AU sec. 722, "Interim Financial Information" (Section III.F. of Appendix 4)

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

a. In paragraph .24:

- Subparagraph g. is replaced with:

Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Subparagraph j. is replaced with:

Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.

- Subparagraph m. is replaced with:

Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

b. The second sentence of paragraph C5 of paragraph .56 is replaced with:

Examples are fraud, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in proposed auditing standard, *Related Parties*.

c. Within paragraph C6 of paragraph .56, within the second illustrative representation letter (2.) for a review of interim financial information (statements):

- Item 2.a. is replaced with:

All financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Item 12.d. is added:



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Side agreements or other arrangements (either written or oral) that have not been disclosed to you.



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APPENDIX 4 – Additional Discussion of the Reproposed Standard and Amendments and Questions for Public Comment

The Board is reproposing a new auditing standard, *Related Parties* (the "reproposed standard"); amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "reproposed amendments regarding significant unusual transactions"); and other amendments to PCAOB auditing standards (the "other reproposed amendments").^{1/} This Appendix discusses the reproposed standard in Appendix 1, the reproposed amendments regarding significant unusual transactions in Appendix 2, and the other reproposed amendments in Appendix 3.

The Board previously issued a proposed auditing standard, *Related Parties* (the "proposed standard"), proposed amendments regarding significant unusual transactions (the "proposed amendments regarding significant unusual transactions") and the other proposed amendments (the "other proposed amendments").^{2/} The comment period ended on May 31, 2012. The Board received 37 comment letters. The Board also discussed the proposed standard and amendments with its Standing Advisory Group ("SAG") on May 17, 2012 ("the SAG discussion").^{3/}

^{1/} The reproposed amendments regarding significant unusual transactions and the other reproposed amendments are collectively referred to as the "reproposed amendments." The reproposed standard and reproposed amendments are collectively referred to as the "reproposed standard and amendments" or the "reproposal."

^{2/} See *Proposed Auditing Standard, Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2012-001 (Feb. 28, 2012) (the "proposing release"), available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>. The proposed amendments regarding significant unusual transactions and the other proposed amendments are collectively referred to as the "proposed amendments." The proposed standard and proposed amendments are collectively referred to as the "proposed standard and amendments" or the "proposal."

^{3/} The SAG transcript is available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>.



This Appendix provides additional background information regarding the reproposal and includes a discussion of the Board's consideration of significant comments received on its February 28, 2012 proposal.^{4/} Each section of this Appendix includes questions for commenters regarding the reproposal. The Board also is seeking input and comment on economic considerations, including audits of emerging growth companies ("EGCs"), audits of brokers and dealers as well as on the appropriate effective date for the repropose standard and amendments. This Appendix includes the following sections:

	<u>Page</u>
I. Reproposed Auditing Standard, <i>Related Parties</i>	A4-2
II. Reproposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions	A4-58
III. Other Reproposed Amendments to PCAOB Auditing Standards	A4-73
IV. Economic Considerations, Including Audits of Emerging Growth Companies	A4-96
V. Audits of Brokers and Dealers	A4-117
VI. Effective Date	A4-119

I. Reproposed Auditing Standard, *Related Parties*

Overall, commenters were generally supportive of the need to improve the existing auditing standard, AU sec. 334, *Related Parties*. However, some commenters suggested that the proposed standard could benefit from additional clarification and suggested changes. In response to comments received, the Board has made revisions to clarify and refine various aspects of the proposed standard. These comments and the

^{4/} See PCAOB Release No. 2012-001.



proposed revisions are discussed in the following topical areas that address specific paragraphs of the repropoed standard:

	<u>Page</u>
A. Introduction (Paragraph 1)	A4-4
B. Objective (Paragraph 2)	A4-6
C. Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 – 9)	A4-9
D. Identifying and Assessing Risks of Material Misstatement (Paragraph 10)	A4-23
E. Responding to the Risks of Material Misstatement (Paragraphs 11 – 13)	A4-26
F. Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14 – 16)	A4-37
G. Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17 – 18)	A4-46
H. Communications with the Audit Committee (Paragraph 19)	A4-52
I. Other Considerations	A4-56

Relevant information is provided for each topical area, including a description of the proposed standard and existing requirements, a description of the repropoed standard, and a discussion of significant comments received and Board responses. Following the "Other Considerations" discussion is a list of questions for commenters regarding the repropoed standard. Commenters are encouraged not only to respond to those questions but also to provide input on all aspects of the repropoed standard.



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A. Introduction (Paragraph 1 of the Reproposed Standard in Appendix 1)

The Proposed Standard and Existing Requirements

Paragraph 1 of the proposed standard stated that this standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. In contrast, the existing standard, AU sec. 334, indicates that the standard provides guidance on procedures that should be considered by the auditor to identify related party relationships and transactions, and to satisfy himself concerning the required financial statement accounting and disclosures.^{5/}

A footnote to paragraph 1 of the proposed standard stated that the auditor should look to the requirements of the U.S. Securities and Exchange Commission ("SEC") for the company under audit with respect to the accounting principles applicable to that company, including the definition of related parties and the financial statement disclosure requirements with respect to related parties (the "framework-neutral approach").^{6/} This approach reflects the fact that applicable financial reporting frameworks may contain different definitions of the term "related party." Likewise, applicable financial reporting frameworks also may contain different disclosure requirements regarding relationships and transactions with related party transactions. AU sec. 334 refers auditors to the U.S. generally accepted accounting principles ("U.S. GAAP") definition of a "related party" and to the disclosure requirements in U.S. GAAP.^{7/}

^{5/} See AU sec. 334.01.

^{6/} For SEC filings that include financial statements prepared in accordance with or reconciled to U.S. GAAP, see, e.g., Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") Topic 850, Related Party Disclosures. For SEC filings that include financial statements prepared in accordance with International Financial Reporting Standards ("IFRS"), see, e.g., International Accounting Standard No. 24, *Related Parties*.

^{7/} See footnote 1 of AU sec. 334.01 for the definition of the term "related party" and AU secs. 334.02-.03 for discussion of U.S. GAAP disclosure requirements.



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As more fully described below, after consideration of the comments received, the Board did not substantively revise the introduction to the proposed standard.

The Reproposed Standard

The introduction in the reproposed standard, like the introduction in the proposed standard, states that the standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. As reproposed, the introduction retains the footnote that refers the auditor to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties" and the financial statement disclosure requirements with respect to related parties.

Significant Comments and Board Responses

Several commenters supported the use of a framework-neutral approach. Some commenters provided suggestions on how to further clarify the standard. In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

Defining the Term "Related Party": Some commenters suggested replacing the reference to the SEC in footnote 1 with a direct reference to the applicable financial reporting framework. One of these commenters suggested that the footnote appears to imply that the SEC has its own definition of a related party. Another commenter suggested including a definition of a "related party" in an Appendix to the standard that would refer to the definition of a "related party" contained in the applicable financial reporting framework. The Board observed that the SEC determines the accounting principles applicable to issuers (for example, U.S. GAAP or IFRS) and other reporting requirements for SEC filings, as noted in footnote 1 of the proposed standard. The Board considered the comments received, noting that commenters generally agreed with the proposed framework-neutral approach. Accordingly, the Board is not proposing to revise the introduction for these comments.

Including Examples of Related Party Transactions: Another commenter recommended including examples of related party transactions. The Board considered this comment and noted that applicable financial reporting frameworks may contain different definitions and examples of related party transactions. Thus, including



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examples in the repropoed standard might create inconsistencies and confusion. Consequently, this suggestion has not been incorporated into the repropoed standard.

Providing Additional Context of the Risks Associated with Related Party Transactions: The Board received some comments requesting additional context regarding the risks associated with related party transactions. One commenter recommended including an introductory discussion to focus the auditor's attention on the risks associated with related party transactions and to emphasize the importance of the use of professional skepticism. In contrast, another commenter suggested including language similar to that contained in International Standard on Auditing ("ISA") 550, *Related Parties*, which states that many related party transactions are in the normal course of business and, in such circumstances, may carry no higher risk of material misstatement of the financial statements than with similar transactions with unrelated parties. The Board considered these comments and did not include such discussion in the repropoed standard. However, the Board notes that the revisions made to clarify the relationship with the risk assessment standards could assist in providing context regarding potential risks of material misstatement due to error or fraud.^{8/} The Board further noted that the proposing release included a discussion regarding the nature of the risks associated with related party transactions.

B. Objective (Paragraph 2 of the Repropoed Standard in Appendix 1)

An objective provides an overarching concept that can be especially helpful when an auditor is considering procedures and evaluating audit evidence during the course of an audit.^{9/}

^{8/} See e.g., *In the Matter of the Application of Wendy McNeeley, CPA*, SEC Accounting and Enforcement Release No. 3427, at 10-12 (Dec. 13, 2012), which states that related party transactions alert auditors that "heightened scrutiny" is warranted. See also the discussion entitled "Clarifying the Relationship with the Risk Assessment Standards" in Section I.C. of this Appendix.

^{9/} The proposing release described the Board's considerations of the use of an objective in the proposed standard. See PCAOB Release No. 2012-001 at A4-4, available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>.



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The Proposed Standard and Existing Requirements

The proposed standard stated that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements. In contrast, the existing standard, AU sec. 334, does not specifically describe an objective for the auditor's work regarding a company's relationships and transactions with its related parties.

As more fully described below, after consideration of the comments received, the Board did not substantively revise the objective.

The Reproposed Standard

Consistent with the proposed standard, the reproposed standard states that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

Like the proposed standard, a footnote refers the auditor to examples of other relevant standards and rules, including paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*, and paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

Significant Comments and Board Responses

Several commenters expressed support for the objective described in the proposed standard. Other commenters suggested expanding the objective, or expressed concern regarding the nature of the objective. In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

Expanding the Objective to Include Other Matters: One commenter suggested including the auditor's communication with the audit committee in the objective. Another commenter suggested including a statement in the objective that the auditor should take into account information obtained from the performance of risk assessment procedures. The Board considered these comments, noting that the intent of the objective of the proposed standard was to focus the auditor on the end result — obtaining sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and



disclosed in the financial statements. Therefore, the Board is not proposing to revise the objective for these comments.

Including the Consideration of "Fraud" as an Explicit Objective: Some commenters recommended that the objective should explicitly refer to the risk of fraud. In particular, one commenter noted that there were only two references to fraud in the proposed standard, and that the auditor's use of judgment would be more informed by reinforcing references to fraud in the objective. The Board believes that related party transactions deserve special attention by the auditor, in part, because of their historic association with fraudulent financial reporting.^{10/} However, because the proposed standard was designed to align with and build upon the risk assessment standards, and because those risk assessment standards emphasize that the auditor's responsibilities for assessing and responding to fraud risks are an integral part of the audit process rather than a separate, parallel process, the Board is not proposing to revise the objective.

Clarifying the Nature of the Objective: The Board received comments regarding the nature of the objective of the proposed standard and the usefulness of the release text in elucidating the Board's objectives and expectations. For example, one commenter recommended clarifying how the requirements of the proposed standard relate to and support the objective. That commenter suggested explaining how the requirements of the proposed standard provide a sufficient basis to achieve the objective and how the objective ensures that sufficient appropriate evidence is obtained in all circumstances. Another commenter noted that the release text suggested that the auditor must exercise judgment to meet the objective over and above complying with the requirements of the proposed standard. This commenter further observed that such a statement is misplaced in the text of a proposing release and stated that the release would require open, thorough, and transparent due process before being articulated as a policy as the notions articulated appear to open the door to enabling PCAOB inspections to generate deficiencies and to otherwise extend auditor liability.

The Board considered these comments and notes that the objective stated in the proposed standard provides that the auditor's work takes place within the context of the

^{10/} The proposing release contained a discussion of related party transactions that have resulted in material misstatements and fraud. See, e.g., PCAOB Release No. 2012-001 at 9-11, available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>.



Board's overall requirement that the auditor obtain sufficient appropriate evidence to support the auditor's opinion.^{11/} The Board, therefore, is not proposing to revise the objective to add specific statements regarding how the requirements in the standard relate to, or assure the achievements, of the objective.

C. Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 – 9 of the Reproposed Standard in Appendix 1)

In an audit performed in accordance with PCAOB standards, the identification and assessment of, and response to, risks of material misstatement in the financial statements underlie the entire audit process, including the procedures that the auditor performs to support the opinion expressed in the auditor's report. Performing risk assessment procedures to obtain an understanding of a company's relationships and transactions with its related parties is important because such relationships and transactions could pose increased risks of material misstatement.

The Proposed Standard and Existing Requirements

The requirements in paragraphs 3 and 4 of the proposed standard built upon the foundational risk assessment requirements contained in Auditing Standard No. 12, *Identifying and Assessing the Risks of Material Misstatement*. Specifically, paragraph 3 of the proposed standard would have required that the auditor perform procedures to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes (or the lack thereof) of the types of transactions involving related parties. Paragraph 4 of the proposed standard would have required that the auditor take into account information obtained from the performance of risk assessment procedures required by Auditing Standard No. 12 in identifying related parties and obtaining an understanding of relationships and transactions with related parties.

The existing standard, AU sec. 334, states that in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor

^{11/} See paragraph 33 of Auditing Standard No. 14.



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should obtain an understanding of management responsibilities and the relationship of each component of the entity to the total entity.^{12/}

As more fully described below, after consideration of the comments received, the Board substantially revised paragraphs 3 and 4. In particular, in response to comments received that requested clarification of the relationship between the proposed standard and the risk assessment standards, the Board made revisions to better integrate the proposed requirements with the risk assessment standards.

The Reproposed Standard

As reproposed, paragraph 3 of the reproposed standard would require 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 in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12. Paragraph 3 of the reproposed standard specifies that the procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include: obtaining an understanding of the company's process; performing inquiries; and communicating with the audit engagement team and other auditors.

A note to paragraph 3 of the reproposed standard states that 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.

A second note would clarify that performing the risk assessment procedures described in paragraphs 4-9 of the reproposed 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 related parties and relationships and transactions with related parties.

In clarifying the relationship to the risk assessment standards, the Board's reproposal would remove the second note to paragraph 10 of Auditing Standard No. 12.

^{12/} See AU sec. 334.05.



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That note states that the auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties in accordance with AU sec. 334. As described previously, the procedures in paragraphs 4-9 of the repropoed standard would be performed in conjunction with the risk assessment procedures in Auditing Standard No. 12.

The repropoed amendments would add a new sentence to footnote 3 of paragraph 4 of Auditing Standard No. 12 that states that 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.

Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comments:

Clarifying the Relationship with the Risk Assessment Standards: Some commenters suggested that the Board take steps to more closely align the proposed standard with the risk assessment standards. One commenter noted that the omission of clear linkage to the concept of auditor risk assessment in paragraph 3 may result in an overly burdensome requirement for the auditor to identify and assess risks of material misstatement, and then perform appropriate audit procedures. Another commenter suggested revising paragraph 3 to include a preface that would refer to Auditing Standard No. 12. This commenter also suggested clarifying the relationship of paragraph 3 to the procedures set out in paragraphs 4-11 by incorporating discussion in the proposing release into the standard. Other commenters were concerned that certain requirements in the proposed standard appeared overly prescriptive and were inconsistent with the approach described in the risk assessment standards.

After considering these comments, the Board included changes in the repropoed standard that clarify that the auditor would perform the risk assessment procedures required by the repropoed standard in conjunction with the risk assessment procedures required by Auditing Standard No. 12. This would provide opportunities for an auditor to integrate audit effort, where appropriate. The specific risk assessment procedures that would be required by the repropoed standard, which are necessary for the auditor's identification and assessment of the risks of material misstatement associated with a company's related party transactions, would build upon the procedures being performed under Auditing Standard No. 12.



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Also, as further described in Section I.F. of this Appendix, the Board revised its proposal to include a new section that would clarify the auditor's responsibilities for evaluating whether the company has properly identified its related parties and relationships and transactions with related parties.

Identifying Contradictory Information: At the SAG discussion, the point was raised that the auditor should search public information regarding a company's related parties and transactions and, in particular, to search for contradictory information to test representations provided by management. The point was also raised that such contradictory information would not come to the auditor's attention unless the auditor looked for it, and, without a requirement to do so, the auditor might place too much reliance on management for the identification of the company's related parties.

The Board considered these points and is not proposing to include requirements for the auditor to search public information indiscriminately as this could result in unnecessary costs. The Board anticipates however, that, in appropriate situations, the auditor might review public documents for information regarding a company's related parties and transactions, particularly when it is readily available. For example, a review of relevant available public information might be appropriate in situations in which information comes to the auditor's attention that suggests that related parties previously undisclosed to the auditor might exist. In addition, existing standards require that as part of obtaining an understanding of the company the auditor should consider reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements.^{13/}

Evaluating the Materiality of Related Party Transactions: One commenter recommended deleting the footnote to paragraph 3 of the proposed standard, which referenced paragraph 7 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*. That commenter expressed concern that this reference implied that all related party transactions represent transactions for which lesser amounts than the materiality level for the financial statements taken as a whole would influence the judgment of a reasonable investor.

The Board considered this comment and noted that applicable financial reporting frameworks require the disclosure of material related party transactions. The footnote to paragraph 3 of the proposed standard noted that lesser amounts of misstatements

^{13/} See paragraph 11 of Auditing Standard No. 12.



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could influence the judgment of a reasonable investor because of qualitative factors, such as conflicts of interest in related party transactions. While the Board continues to support the statement in this footnote, it has reconsidered the need for it in light of other revisions to the repropoed standard that clarify the relationship between the repropoed standard and the risk assessment standards. Accordingly, the repropoed standard does not include that footnote. The Board has also removed the other footnote to paragraph 3 of the propoed standard, which referred to paragraph 16 of Auditing Standard No. 9, *Audit Planning*.

Obtaining an Understanding of the Company's Process (Paragraph 4 of the Repropoed Standard in Appendix 1)

Obtaining an understanding of the company's process regarding identifying, authorizing, approving, accounting for, and disclosing transactions between the company and its related parties is an important procedure to assist the auditor in obtaining an understanding of the company's relationships and transactions with its related parties.

The Propoed Standard and Existing Requirements

Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatement, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.^{14/} AU sec. 334.05, issued before the adoption of the risk assessment standards, is similar, but not as specific. Among other things, AU sec. 334.05 states that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities. AU sec. 334.05 further states that the auditor should consider controls over management activities.

Paragraph 5 of the propoed standard was intended to align with and build upon the requirements in Auditing Standard No. 12. Specifically, paragraph 5 of the propoed standard would have required that the auditor obtain an understanding of the controls that management has established to: (a) identify related parties and relationships and transactions with related parties; (b) authorize and approve transactions with related

^{14/} See paragraph 18 of Auditing Standard No. 12.



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parties; and (c) account for and disclose relationships and transactions with related parties in the financial statements.

In response to comments, the Board made revisions to better integrate the proposed requirements with the risk assessment standards. In addition, the repropoed standard contains new references to relevant paragraphs in Auditing Standard No. 12.

The Repropoed Standard

Paragraph 4 of the repropoed standard would state that, in conjunction with obtaining an understanding of internal control over financial reporting, the auditor should obtain an understanding of the company's process for: (a) identifying related parties and relationships and transactions with related parties; (b) authorizing and approving transactions with related parties; and (c) accounting for and disclosing relationships and transactions with related parties in the financial statements.

A new footnote would refer the auditor to paragraphs 18 and 20 of Auditing Standard No. 12 to emphasize that the procedures required by paragraph 4 of the repropoed standard would be performed in conjunction with the auditor's risk assessment process.

Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comments:

Providing Additional Context Regarding Internal Control: Some commenters suggested that the Board provide additional context with respect to the auditor's understanding of internal control. For example, one commenter suggested explaining that, in certain situations controls over related party relationships and transactions may be deficient, may more readily be overridden by senior management, or may not exist, and, in those situations, the auditor may not be able to rely on internal controls in designing audit procedures to obtain sufficient audit evidence. Another commenter urged the Board to clarify that the quality of internal controls over the identification of related parties, transactions with related parties, and related disclosures is critical.

The Board considered these comments and is not proposing to include additional context regarding internal controls in the repropoed standard. However, the Board notes that the revisions to better integrate and clarify the relationship of the repropoed standard with existing requirements in the risk assessment standards regarding



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obtaining an understanding of internal control over financial reporting should address these concerns.

Performing Inquiries (Paragraphs 5-7 of the Reproposed Standard in Appendix 1)

Appropriately focused inquiries can inform the auditor's understanding of the nature of the relationships between the company and its related parties, and the terms and business purposes (or the lack thereof) of transactions involving related parties. In addition, inquiries can assist the auditor in determining the extent of audit procedures that should be performed to determine whether the company has identified its related parties and relationships and transactions with its related parties.

The Proposed Standard and Existing Requirements

Paragraphs 6-8 of the proposed standard would have required the auditor to make specific inquiries of company management, others within the company likely to have additional knowledge regarding the company's related parties or relationships or transactions with the company's related parties, and of the company's audit committee.

The existing standard, AU sec. 334, describes a variety of specific audit procedures for the auditor's consideration in determining the existence of related parties.^{15/} These specific procedures include requesting from appropriate management personnel the names of all related parties and inquiring whether there were any transactions with these parties during the period.

The Board has made revisions to the proposed standard in response to a number of comments regarding the use of additional auditor judgment, including to clarify whether inquiry of certain individuals is necessary in all instances and with respect to the nature and extent of inquiries of others.

The Reproposed Standard

Paragraph 5 of the reproposed standard is substantially similar to paragraph 6 of the proposed standard. As reproposed, paragraph 5 would require the auditor to inquire of management regarding: the names of the company's related parties during the period under audit, including changes from the prior period; background information concerning the related parties (for example, physical location, industry, size, and extent

^{15/} See AU sec. 334.07.



of operations); the nature of any relationships, including ownership structure, between the company and its related parties; the transactions entered into, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions; the business purpose for entering into a transaction with a related party versus an unrelated party; 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; and any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

A new footnote to paragraph 5 of the reposed standard would clarify that obtaining representations from management pursuant to AU sec. 333 complements the auditor's inquiries under paragraph 5 and is not a substitute for them.^{16/}

Paragraph 6 of the reposed standard would clarify the auditor's responsibilities when performing inquiries of others. As revised by the Board, paragraph 6 of the reposed standard would require the auditor to inquire of others within the company regarding their knowledge of the matters in paragraph 5 of the reposed standard. Pursuant to paragraph 6 of the reposed standard, the auditor would be required to identify others within the company to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding: (a) the company's related parties or relationships or transactions with related parties; (b) the company's controls over relationships or transactions with related parties; and (c) the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

As described in further detail below, the examples of "others" within the company are not included in the reposed standard. In addition, the Board added a footnote to paragraph 6 of the reposed standard, which states that for purposes of this standard the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties. As

^{16/} See Section III.D. of this Appendix for discussion of amendments the Board is proposing to AU sec. 333, *Management Representations*.



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reproposed, this footnote clarifies the meaning of the phrase previously described in the note to paragraph 3 of the proposed standard.

Paragraph 7 of the reproposed standard is substantially the same as paragraph 8 of the proposed standard and includes changes to a footnote to reflect the adoption of Auditing Standard No. 16, *Communications with Audit Committees*.

Specifically, paragraph 7 of the reproposed standard would require the auditor to inquire of the audit committee, or its chair, regarding: the audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns. As reproposed, a footnote to paragraph 7 of the reproposed standard would refer the auditor to Auditing Standard No. 16 for the definition of the term "audit committee."

The inquiries in paragraphs 5 through 7 of the reproposed standard could be performed at the same time as the inquiries about the risks of material misstatement, including fraud risks, that are required by paragraphs 54 through 58 of Auditing Standard No. 12.^{17/} These inquiries also would provide an opportunity for the auditor to discuss the company's financial relationships and transactions with its executive officers with the audit committee, or its chair, as part of the auditor's procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers.^{18/}

Significant Comments and Board Responses

Some commenters suggested making revisions to allow more room for the use of auditor judgment. Other commenters made suggestions pertaining to specific inquiries required by the proposed standard. In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

^{17/} Paragraph 8 of Auditing Standard No. 16, *Communications with Audit Committees*, also requires the auditor to make certain inquiries of the audit committee; see *Communications with Audit Committees* PCAOB Release No. 2012-004 (Aug. 15, 2012).

^{18/} See the reproposed amendments in Section III.A of this Appendix.



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Allowing Judgment When Performing Inquiries of Management: Some commenters suggested revising the proposed standard to allow for the exercise of auditor judgment in determining which inquiries should be made of management and noted that certain inquiries may not be relevant depending on the facts and circumstances. Another commenter suggested combining certain of the inquiries listed in the proposed standard to better allow for the use of auditor judgment in determining the nature and extent of information regarding the identity of the company's related parties, including changes from the prior period. The Board considered these comments and believes the matters identified in the list of inquiries of management consist of basic information that the auditor should obtain as part of obtaining an understanding of the company's financial relationships and transactions with its related parties. Accordingly, the Board is not proposing to make revisions for these comments.

Allowing Judgment When Performing Inquiries of Others within the Company: Several commenters suggested revising the paragraph of the proposed standard that addresses inquiries of others within the company to include the phrase "as appropriate" or "as applicable" to allow auditors judgment in both identifying appropriate individuals within the company to whom inquiries should be made and to determine the extent of the inquiries to be made. Another commenter suggested that the auditor should inquire of any individuals from whom relevant information may be obtained and noted that some individuals who would respond to inquiries of management under paragraph 6 of the proposed standard also were included in the list of examples of "others" in paragraph 7 of the proposed standard.

The Board considered these comments and is proposing a number of revisions to clarify the auditor's responsibilities when performing inquiries of others. The revisions clarify that the auditor's inquiries of others within the company relate to their knowledge of the same matters that are the subject of the auditor's inquiries of management. These matters are identified in paragraph 5 of the repropoed standard. In addition, it was not the Board's intent to require the auditor to inquire of others within the company regarding matters that the auditor did not believe were reasonably within their knowledge. To remove the notion that the auditor should make inquiries in each audit of all the individuals that were listed in paragraph 7 of the proposed standard and to address the observation that some individuals included in the list of examples of "others" might also be members of management, the Board has removed the list of individuals. Revisions have also been made to clarify that the auditor should inquire of others within the company likely to have knowledge regarding the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.



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Identifying Related Party Transactions Not Authorized or Approved: One commenter raised a concern regarding whether smaller issuers would have formalized policies and procedures pertaining to authorizing and approving transactions with related parties. While this comment was directed at the paragraph of the proposed standard related to the auditor's communications with the audit committee, the Board's consideration of this comment prompted a change to the paragraph of the repropoed standard related to inquiries of management. The commenter stated that, while the requirement to communicate significant related party transactions to the audit committee may be appropriate, such a communication requirement may imply a level of formality that does not exist for smaller issuers and, thus, may create uncertainty for auditors of those issuers as to their responsibility to assess the issuer's policies and procedures and the level of communication required.

The Board considered this comment, recognizing that material features of companies' procedures and policies for the review, approval or ratification of related party transactions will vary depending on both the size and complexity of the company and the types of transactions covered by such policies and procedures. The Board does not mean to imply that such policies and procedures should be in writing or adhere to any particular framework. The Board, however, believes that gaining an understanding of the policies and procedures, regardless of their formality or nature, is important to an auditor's consideration of the risks that relationships and transactions with related parties may pose for material misstatement of the company's financial statements.

The Board also revised the inquiry that had been in paragraph 6.f. of the proposed standard (which is now in paragraph 5.f. of the repropoed standard) to remove the word "significant" so that the auditor would inquire of management regarding any such related party transactions. Auditor communications with the audit committee of such matters, as would be required by paragraph 19.b.-c. of the repropoed standard, would maintain a focus on such significant transactions identified by the auditor. Accordingly, the repropoed standard would require the auditor, rather than management, to make the determination as to which transactions are significant.

Expanding the Inquiry of the Audit Committee: One commenter suggested requiring the auditor to inquire of the audit committee, or its chair, about the audit committee's understanding of the business purpose or business reasons of related party transactions to corroborate management's responses. The Board considered this comment and is not proposing to expand the list of required inquiries, given concerns expressed by other commenters who suggested that the Board allow the use of additional auditor judgment to avoid potentially unnecessary costs. In the Board's view, the required inquiries of the audit committee, or its chair, in concert with the auditor's



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communications with the audit committee in the repropoed standard would provide an opportunity for corroboration of management's responses.

In considering this comment, the Board noted that in the proposed standard it had used the terms "business purpose" and "business reasons" in the list of auditor inquiries of management. To avoid confusion, the repropoal would change the phrase "business reasons" to "business purpose."

Communicating with the Audit Engagement Team and Other Auditors (Paragraphs 8-9 of the Repropoed Standard in Appendix 1)

Communicating information to engagement team members regarding a company's related parties and relationships and transactions with related parties might increase the likelihood that the engagement team will identify related parties or relationships or transactions with related parties previously undisclosed to the auditor. Effective communication to engagement team members might also highlight evidence that corroborates or contradicts information provided by management about relationships and transactions with related parties. Additionally, effective communication to engagement team members could enhance the auditor's understanding of the company's relationships and transactions with its related parties.

In addition, under PCAOB standards, a principal auditor may use the work and reports of other auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the company's financial statements.^{19/} Exchanging relevant information about related parties with the other auditor can assist the principal auditor in understanding the overall nature of the company's relationships and transactions with related parties and in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor.

The Propoed Standard and Existing Requirements

Paragraphs 9 and 10 of the propoed standard would have required the auditor to communicate to engagement team members and, if applicable, other auditors relevant information about related parties, including the names of the related parties and

^{19/} See paragraph .01 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.



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the nature of the company's relationships and transactions with those related parties. Further, paragraph 10 of the proposed standard would have required the auditor to make certain inquiries of the other auditor regarding related parties.

The existing standard, AU sec. 334.08, contains audit procedures intended to provide guidance for identifying material transactions that may be indicative of the existence of previously unidentified related party relationships. One such procedure is to provide audit personnel performing segments of the audit, or auditing and reporting separately on the accounts of related components of the reporting entity, with the names of known related parties so that they may become aware of transactions with such parties during their audits. Further, AU sec. 334.07.g., suggests a number of audit procedures for determining the existence of related party relationships, including making inquiries of other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions. Finally, AU sec. 9334.13 states that the principal auditor and the other auditor should obtain from each other the names of known related parties and that, ordinarily, the exchange should be made at an early stage of the audit.

As more fully described below, after consideration of the comments received, the Board did not make substantive revisions to the communication requirements, other than to refer the auditor to relevant paragraphs of the risk assessment standards.

The Reproposed Standard

Paragraph 8 of the repropoed standard would require the auditor to communicate to engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.

The requirement in paragraph 8 of the repropoed standard would complement the existing requirement in paragraph 49 of Auditing Standard No. 12 that key engagement team members discuss the susceptibility to material misstatement due to error or fraud. Paragraph 52 of Auditing Standard No. 12 provides that the discussion, in part, includes the susceptibility of the financial statements to material misstatement through related party transactions.

A new footnote to paragraph 8 of the repropoed standard observes that the communication that would be required by the repropoed standard complements the discussion among engagement team members, required by Auditing Standard No. 12, regarding risks of material misstatement. In addition, the new footnote includes an



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expanded discussion of Auditing Standard No. 10, *Supervision of the Audit Engagement*, which establishes requirements regarding supervision of the engagement team members, including directing engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities.

Paragraph 9 of the repropoed standard states that, 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 9 would also require the auditor to inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.^{20/}

Like the proposed standard, a footnote to paragraph 9 of the repropoed standard refers the auditor to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements.

Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comments:

Clarifying the Responsibilities of "Other Auditors": One commenter stated that the Board should address the responsibility of other auditors to communicate with the principal auditor, particularly other auditors auditing equity method investees who are not subject to control by the reporting investor entity. Another commenter suggested that all audit engagement letters acknowledge a joint responsibility to inform investors of

^{20/} The Board has not proposed a similar inquiry of engagement team members because existing standards already require engagement team members to bring relevant matters to the attention of the audit engagement partner. See, e.g., paragraph 5 of Auditing Standard No. 10.



material related party transactions, to reinforce to the company and the auditor the significance of informing investors of the effects of related party activity. That commenter also suggested that the proposed standard represents an opportunity to clarify that all registered firms must appropriately address suspicious activities involving a public company and should not knowingly facilitate transactions with non-public entities that have no business purpose other than to conceal activity of a registrant. The Board considered these comments and noted that they generally raise important issues that may be considered in other projects that are outside the scope of this project.

D. Identifying and Assessing Risks of Material Misstatement (Paragraph 10 of the Reproposed Standard in Appendix 1)

Identifying and appropriately assessing the risks of material misstatement provide a basis for designing and implementing responses to the risks of material misstatement.

The Proposed Standard and Existing Requirements

Paragraph 12 of the proposed standard aligned with the risk assessment requirements contained in Auditing Standard No. 12 for the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level.^{21/} Paragraph 12 of the proposed standard stated that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties.

Under the risk assessment standards, the auditor is also required to determine whether any of the identified and assessed risks of material misstatement are fraud risks or other significant risks.^{22/} Depending on the facts and circumstances, risks of material misstatement associated with related parties and relationships and transactions with related parties might also represent fraud risks or other significant risks. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, provides examples of fraud risk factors, including some relating to related parties.^{23/}

^{21/} See paragraph 59 of Auditing Standard No. 12.

^{22/} See paragraphs 59.f. and 70-71 of Auditing Standard No. 12.

^{23/} See AU sec. 316.85.A.2, section a., under "Opportunities."



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AU sec. 334 does not provide specific guidance for the auditor regarding the identification and assessment of risks of material misstatement associated with related party transactions. AU sec. 334.06 provides that, in the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business.

As more fully described below, after consideration of the comments received, the Board made revisions to further clarify the auditor's responsibilities for identifying and assessing the risks of material misstatement.

The Reproposed Standard

Like the proposed standard, paragraph 10 of the repropoed standard would remind the auditor of the requirement in Auditing Standard No. 12 to identify and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 10 of the repropoed standard would expand on the proposed standard by stating that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties or relationships or transactions with related parties. The addition of the clause "including whether the company has properly identified, accounted for, and disclosed its related parties or relationships or transactions with related parties" would highlight, among other things, that the auditor's assessment of risk includes a focus on risks related to the company's less than complete identification of its related parties or relationships or transactions with related parties. Such a focus helps support the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties.^{24/}

A new note to paragraph 10 would state that in identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information

^{24/} See the footnote to paragraph 14 of the repropoed standard, which states that evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.



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obtained from performing the procedures in paragraphs 4-9 of the repropoed standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comments:

Presuming Significant Risks or Fraud Risks: Some commenters noted that the proposed standard creates the presumption that all related party transactions are significant risks. Moreover, some commenters stated that the proposed standard should not deem certain related party transactions as significant risks as that determination should be based upon facts and circumstances. Other commenters suggested expanding the examples of fraud risk factors regarding related party transactions. The Board considered these comments and agrees that not all related party transactions should be presumed to be significant risks. Like the proposed standard, the repropoed standard would not mandate that all related party transactions be presumed to be or deemed to be significant risks, or designated as a fraud risk. Under the risk assessment approach, the auditor's assessment is scalable and based on the facts and circumstances of the audit, including the facts and circumstances of a company's relationships and transactions with related parties.

Incorporating the Proposing Release Discussion Regarding Dominant Influence into the Standard: One commenter recommended that those factors identified as "factors that may signal dominant influence" in Appendix 4 of the proposing release be incorporated into the standard. The Board notes that the other proposed amendments would revise AU sec. 316.85.A.2 to include the exertion of dominant influence by or over a related party as an example of a fraud risk factor and would expand that concept to encompass all related parties outside of management of the company. Accordingly, the Board is not proposing to include a discussion regarding dominant influence in the related party standard.

Providing Additional Guidance on Identifying and Assessing Risks of Material Misstatement: One commenter recommended that the Board provide specific guidance as to how to relate risk, materiality, and other circumstantial considerations to the selection of appropriate procedures to be employed, rather than a "one-size-fits-all" approach in the proposed standard. That commenter also noted that smaller, closely-held issuers engage in frequent related party transactions, that are often less subject to controls but, because of their significance, can be detected by auditors with fewer



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procedures than would be required by the proposed standard. The Board considered this comment and, as described previously, has taken steps to further align the repropoed standard with the requirements in the risk assessment standards, which are scalable based on a company's size or complexity.

E. Responding to the Risks of Material Misstatement (Paragraphs 11-13 of the Proposed Standard in Appendix 1)

As noted in the release, relationships and transactions with related parties can pose increased risks of material misstatement in company financial statements and have been a contributing factor in prominent corporate scandals.^{25/} As discussed in more detail below, similar to the proposed standard, the repropoed standard would establish specific procedures for responding to risks of material misstatement associated with the company's related parties and relationships and transactions with related parties.

The Proposed Standard and Existing Requirements

Paragraph 13 of the proposed standard aligned with the foundational risk assessment requirements contained in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, which require the auditor to design and implement audit responses that address the identified and assessed risks of material misstatement.^{26/} Paragraph 13 of the proposed standard stated that 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.

A note to paragraph 13 of the proposed standard referred the auditor to AU secs. 316.66-.67A for related party transactions that are also significant unusual transactions. This note was intended to remind auditors that certain related party transactions also might be subject to the proposed amendments regarding significant unusual transactions.

^{25/} See also, *In the Matter of the Application of Wendy McNeeley, CPA, SEC Accounting and Auditing Enforcement Release ("AAER") No. 3427, at 10-12 (Dec. 13, 2012).*

^{26/} See paragraph 3 of Auditing Standard No. 13.



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As described more fully below, after consideration of the comments received, the Board made revisions to better clarify the relationship between the repropoed standard and the risk assessment standards. The Board also expanded the note to paragraph 13 of the proposed standard to further describe the auditor's work regarding related parties that are significant unusual transactions.^{27/}

The Repropoed Standard

Similar to paragraph 13 of the proposed standard, paragraph 11 of the repropoed standard would remind the auditor of the requirement in Auditing Standard No. 13 to design and implement audit responses that address the identified and assessed risks of material misstatement. Paragraph 11 of the repropoed standard states that this includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties. A new footnote refers the auditor to relevant paragraphs of the risk assessment standards, including paragraph 17 of Auditing Standard No. 15, *Audit Evidence*, which provides that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

The note to this paragraph has been expanded to further clarify the auditor's responsibilities for related party transactions that are also significant unusual transactions. As repropoed, the note states that the auditor also should look to the requirements in proposed paragraphs .66-.67A of AU sec. 316 for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). The revised note would clarify that, for such related party transactions, AU sec. 316.67 requires the auditor to evaluate whether the business purpose (or the lack thereof) of the transactions indicates that the transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

^{27/} See *also* the discussion in Section II.A. of this Appendix that describes the linkage between the repropoed standard and the repropoed amendments regarding significant unusual transactions.



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Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comment:

Clarifying the Reference to Significant Related Party Transactions Outside the Normal Course of Business: One commenter questioned whether a related party transaction that, although within the normal course of business, otherwise appears to be unusual due to its timing, size, or nature could be a related party transaction that is also a significant unusual transaction. That commenter based their question on an example of a related party transaction that is also a significant unusual transaction that was contained in a note to paragraph 13 of the proposed standard. The Board considered this comment and notes that the example of a significant related party transaction outside the normal course of business represents just one example of a related party transaction that is also a significant unusual transaction. Accordingly, the Board is not proposing revisions for this comment.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk (Paragraph 12 of the Repropoed Standard in Appendix 1)

Securities regulators expect that auditors will provide "heightened scrutiny" of a company's related party transactions.^{28/} Similar to the Board's proposal, the repropoed standard would require the auditor to perform certain basic procedures (supplemented by more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances) regarding related party transactions that are either required to be disclosed in the financial statements or determined to be a significant risk. In the Board's view, focusing the auditor's attention on these related party transactions is intended to enhance the effectiveness of the auditor's evaluation of whether the company's related party transactions are properly accounted for and disclosed.

^{28/} See, *In the Matter of the Application of Wendy McNeeley, CPA*, SEC AAER No. 3427, at 10-12 (Dec. 13, 2012), which states in part that the SEC and Courts have repeatedly held that related party transactions require heightened scrutiny by auditors, and notes the importance of the auditor understanding the business purpose of material related party transactions.



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The Proposed Standard and Existing Requirements

Paragraph 15 of the proposed standard would have required the auditor to perform specific procedures for each related party transaction, or type of related party transaction, that is either required to be disclosed in the financial statements or determined to be a significant risk.

The existing standard, AU sec. 334, contains procedures that the auditor should consider performing when responding to risks arising from related party relationships and transactions. For example, AU sec. 334.11 requires that, for each material related party transaction that requires disclosure, the auditor should consider whether he or she has obtained sufficient appropriate evidential matter to understand the related party relationship and the effects of the related party transactions on the financial statements. AU secs. 334.09-.10 describe procedures for examining identified related party transactions. Those paragraphs direct the auditor to apply the procedures the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of identified related party transactions and their effect on the financial statements, noting that those procedures should extend beyond inquiry of management. Footnote 6 of AU sec. 334.09 states that "[u]ntil the auditor understands the business sense of material transactions, he cannot complete his audit."

As described more fully below, after consideration of the comments received, the Board made several revisions intended to more clearly articulate the nature and extent of the required procedures, including changes intended to clarify the auditor's responsibility when related party transactions are aggregated for disclosure purposes.

The Reproposed Standard

Paragraph 12 of the repropoed standard would require the auditor to perform specified procedures for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk. For such transactions, the repropoed standard would require the auditor to:

- a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. 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;
- c. Determine whether any exceptions to the company's established policies or procedures were granted;
 - d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
 - e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

As reproposed, paragraph 12.a. would clarify that the auditor should read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction.

As reproposed, paragraph 12.d. would be expanded to require the auditor's evaluation of the financial capability of the related party to include significant loan commitments and supply arrangements.

Paragraph 12.e., was revised in response to comments to remove the reference to the objective of the standard and to clarify the auditor's responsibilities. Like the proposed standard, paragraph 12.e. of the reproposed standard would provide an opportunity for the auditor to scale the audit by requiring the auditor to supplement the basic required procedures with more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. Specifically, as revised, paragraph 12.e. would require the auditor to perform other procedures as necessary to address the identified and assessed risks of material misstatement.

In response to comments, a note to paragraph 12 of the reproposed standard has been added to clarify the auditor's responsibility for aggregated related party disclosures. Specifically, the note would state that 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 in paragraph 12 of the reproposed standard for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement. The Board notes that a "selection of



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transactions" could be the selection of one transaction from the aggregation in the appropriate circumstances.

A footnote to paragraph 12.c. of the repropoed standard states that information gathered while obtaining an understanding of the company also might assist the auditor in identifying agreements prohibiting or restricting related party transactions (for example, loans or advances to related parties).

A footnote to paragraph 12.d. of the repropoed standard states that examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.

Significant Comments and Board Responses

Although some commenters expressed general support for the procedures required by the proposed standard, others made specific suggestions regarding the nature and extent of the auditor's procedures.

Clarifying the Auditor's Responsibility for Aggregated Related Party Disclosures: Some commenters stated that the required procedures could be interpreted to suggest that all transactions comprising a "type" of related party transaction must be subject to the required procedures. One commenter suggested clarifying that testing transactions from each "type" of related party transaction is sufficient. Other commenters recommended clarifying the proposed standard by incorporating additional discussion from the proposing release into the standard. The Board considered these comments and, as previously discussed, added a note to paragraph 12 of the repropoed standard to clarify that testing each related party transaction that the company has aggregated for disclosure purposes is not required.

Allowing More Room for the Use of Auditor Judgment: Some commenters stated that the proposed audit procedures do not allow for sufficient application of auditor judgment when responding to the risks of material misstatement arising from a company's relationships and transactions with related parties required to be disclosed in the financial statements or determined to be a significant risk. The Board considered this comment and noted that the proposed standard established basic procedures that would be supplemented by more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. These facts and circumstances include the size and complexity of the transactions, the nature of a company's



relationships or transactions with its related parties, and the related risk of material misstatement in the financial statements. This approach permits auditor judgment, within a framework that assures that basic requirements are met and the interests of investors are protected.

Referencing the Objective of the Standard: Some commenters recommended clarifying the requirement in the proposed standard that the auditor "perform other procedures as appropriate, depending on the nature of the related party transaction and the related risks of material misstatement, to meet the objective of this standard."

The Board considered this comment, noting that the Board's auditing standards require the auditor to obtain sufficient appropriate audit evidence to support their audit opinion on the company's financial statements. Depending on the facts and circumstances of the audit, an auditor might determine that additional procedures beyond those required by paragraphs 12.a.-d. of the repropoed standard are necessary to obtain sufficient appropriate audit evidence regarding related party transactions that either are required to be disclosed in the financial statements or that are determined to be a significant risk. The Board made revisions to require the auditor to perform other procedures "as necessary to address the identified and assessed risks of material misstatement." The Board believes that this approach is more clearly linked to the auditor's responsibilities to obtain sufficient audit evidence to support his or her audit opinion.

Understanding the Business Purpose (or the Lack Thereof) of a Related Party Transaction: One commenter noted that more emphasis could be given to the importance of the auditor's understanding of the business purpose of related party transactions. At the SAG discussion, the point was raised that some auditors believe that as long as management has not asserted that the terms of the related party transaction are equivalent to those available on an arm's-length basis, the auditor has no obligation beyond determining whether management has disclosed the transaction.

Another commenter recommended deleting the phrase "(or the lack thereof)" from the proposed standard. That commenter agreed that auditors should be aware of the possibility that transactions with related parties may not have a business purpose but did not believe that the requirements in the proposed standard would provide the auditor with evidence about a lack of a business purpose.

In the Board's view, performing the procedures in paragraphs 3-9 of the repropoed standard in conjunction with the risk assessment procedures required by Auditing Standard No. 12 should inform the auditor's understanding of the company's



relationships and transactions with its related parties. That understanding would include the terms and business purposes (or the lack thereof) of the transactions involving related parties. Understanding the business purpose of related party transactions is an important consideration in assessing and responding to risks of material misstatement and requires the auditor to understand other factors underlying the transaction. For example, although a company may assert that it has utilized a related party transaction to achieve a particular goal, the company may, in fact, have used the transaction for some other purpose.^{29/} Obtaining an understanding of the terms and business purpose of a related party transaction includes understanding why the company entered into the transaction with a related party versus an unrelated party.

The inclusion of the phrase "(or the lack thereof)" is intended to promote a questioning and skeptical approach by the auditor when obtaining an understanding of the business purpose of related party transactions. Sharpening the auditor's focus on evaluating the business purpose of related party transactions is particularly appropriate in view of the risk of material misstatement involving related party transactions.^{30/} The importance of identifying transactions that appear to lack a business purpose is reinforced in other parts of the Board's proposal. For example, the repropoed standard, like the proposed standard, would require the auditor to communicate to the audit committee the identification of significant related party transactions that appear to the auditor to lack a business purpose. In addition, the other repropoed amendments to AU sec. 316.85 would add "contractual arrangements lacking a business purpose" as a new example of a fraud risk factor. Accordingly, the Board is not proposing to revise the

^{29/} For example, a broker or dealer might use related party transactions to make the size of their operations appear smaller to avoid regulatory requirements. See the discussion entitled "Related Party Transactions at Brokers and Dealers" in Section V. of this Appendix.

^{30/} See, e.g., paragraph 15 of FASB Statement No. 57, *Related Parties*, which states "[w]ithout disclosure to the contrary, there is a general presumption that transactions reflected in financial statements have been consummated on an arm's-length basis between independent parties. However, that presumption is not justified when related party transactions exist because the requisite conditions of competitive, free-market dealings may not exist. Because it is possible for related party transactions to be arranged to obtain certain results desired by the related parties, the resulting accounting measures may not represent what they usually would be expected to represent."



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proposal for these comments. However, as described above, the Board is proposing revisions in paragraph 12.a. of the repropoed standard to clarify the auditor's procedures.

Evaluating the Financial Capability of the Related Party: Some commenters expressed concern regarding the proposed requirement to evaluate the financial capability of the related party. One commenter noted that while evaluating the financial capability of the related party is an important consideration, sufficient information may not be available to do so. That commenter recommended that the Board acknowledge such circumstances and the related auditor response. Another commenter stated that evaluating financial capability may be difficult to perform when the related party is privately held and not controlled by the audit client and further stated that the assessment that the audit client has the ability to exercise significant influence over a related party (or vice versa) for accounting purposes does not necessarily equate to management of the audit client having sufficient influence over the related party to demand the receipt of non-public information.

The Board considered these comments, noting that the proposed requirement would have applied only to items that are individually or collectively significant. In the Board's view, obtaining evidence to evaluate the financial capability of a related party can inform the auditor's evaluation of the business purpose (or the lack thereof), including whether the substance of that transaction differs materially from its form.^{31/} The Board notes that auditors are currently performing procedures to evaluate the financial capability of counterparties in a variety of audit areas today, regardless of whether the counterparty is a related party. For example, auditors might examine the company's support regarding the financial capability of another party as part of evaluating the company's decision to recognize revenue on a particular transaction. Accordingly, the Board is not proposing to make revisions for this comment.

^{31/} See, e.g., *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005), noting "among transactions calling for close inspection are related-party transactions, including transactions between a company and its officers or directors. Such dealings are viewed with extreme skepticism in all areas of finance...The reason for this is apparent: Although in an ordinary arms-length transaction, one may assume that parties will act in their own economic self-interest, this assumption breaks down when the parties are related. A company that would perform a thorough credit-risk assessment before extending a loan might not do so if the loan were to one of its officers or directors."



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Performing Procedures at the Related Party: At the SAG discussion, the point was raised that the auditor should consider performing audit procedures at the premises of the related party. In considering this comment, the Board notes that its auditing standards require the auditor to obtain sufficient appropriate audit evidence to support his or her audit opinion. In certain circumstances, an auditor may decide that performing audit procedures at the related party is appropriate. The Board, however, is not proposing to require that procedures be performed at the related party's premises because the related party may not allow the auditor to perform such procedures. In some circumstances, such a requirement might place an unreasonable burden on the auditor and the company under audit.

Including Examples from the Proposing Release in the Standard: Several commenters recommended incorporating the additional discussion and examples of procedures that the auditor might perform pursuant to paragraph 15.d. of the proposed standard included in Appendix 4 of the proposing release into the standard. The Board considered these comments and determined, as it has done in other projects, to include performance requirements in the standard and to provide additional discussion and examples in an appendix to the release. This approach promotes a clear separation between the required procedures in the standard and the Board's discussion regarding the potential application of the standard. As such, the examples of procedures and other discussion in the proposing release have not been incorporated into the repropose standard.

Intercompany Transactions (Paragraph 13 of the Reproposed Standard in Appendix 1)

Applicable financial reporting frameworks require the elimination of intercompany transactions in the preparation of consolidated financial statements. Based on a company's facts and circumstances, intercompany transactions could result in risks of material misstatement.

The Proposed Standard and Existing Requirements

Paragraph 14 of the proposed standard would have required the auditor to perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ. As such, paragraph 14 incorporated an existing procedure contained in AU sec. 334. Specifically, AU sec. 334.09.e. states that the auditor should consider arranging for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.



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Other existing standards also reference the importance of the auditor's review of consolidating accounts, such as AU sec. 543, which states that, regardless of whether the principal auditor decides to make reference to the audit of the other auditor, the principal auditor should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.^{32/}

As more fully described below, after consideration of the comments received, the Board is not proposing revisions to this paragraph. However, the Board is seeking additional comment on the auditor's responsibility for performing procedures on intercompany account balances, and has included a specific question at the end of this section.

The Reproposed Standard

As repropoed, paragraph 13 would require the auditor to perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

Significant Comments and Board Responses

The Board considered all comments received, including the following significant comments:

Providing Expanded Guidance Regarding Intercompany Account Balances: Several commenters suggested that the Board clarify the auditor's responsibility regarding intercompany account balances. For example, some commenters suggested including examples of the risks associated with intercompany balances and guidance regarding the nature, timing, and extent of risk assessment procedures and related responses. Another commenter indicated that, when fiscal years differ, testing of intercompany transactions could be performed at a concurrent interim date and noted

^{32/} See AU sec. 543.10, which provides that those measures may include ascertaining through communication with the other auditor that a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.



that, in their view, the requirement in the proposed standard might be read to imply that testing is required as of period end.

The Board considered these comments, noting that the preparation of consolidated financial statements could involve complex matters regarding intercompany transactions. For example, a company could consolidate a subsidiary that has a different year-end. Further, some intercompany transactions that are eliminated in consolidation could include related party transactions that may not require disclosure under the applicable financial reporting framework, yet might give rise to significant risks of material misstatement.^{33/} Such related party transactions would be subject to the procedures described in paragraph 12 of the repropoed standard. The Board is not proposing to revise the proposal for these comments, but has included a question at the end of Section I. of this Appendix seeking additional input from commenters in this area.

F. Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14-16 of the Repropoed Standard in Appendix 1)

While management has the primary responsibility for preparing the company's financial statements, the auditor should be sensitive throughout the audit to the possibility that management may not have informed the auditor of all related parties or relationships or transactions with related parties.

The Proposed Standard and Existing Requirements

The proposed standard would have addressed the auditor's responsibility to identify a company's related party transactions in paragraph 3 (duty to perform procedures), paragraph 11 (evaluating whether information that comes to the auditor's attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist), paragraph 16 (determining whether related parties or relationships or transactions with related parties previously undisclosed to the auditor, in fact, exist), and paragraph 17 (performing audit procedures on related parties or relationships or transactions with related parties previously undisclosed).

^{33/} See paragraphs 59.f. and 70-71 of Auditing Standard No. 12.



AU sec. 334.07 describes a number of procedures for determining the existence of related parties, while AU sec. 334.08 provides examples of procedures for identifying material transactions with known related parties and for identifying material transactions that may be indicative of the existence of previously undetermined related party relationships. AU sec. 334.04 also states that during the course of his audit, the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and of common ownership or management control relationships that require disclosure even though there are no related party transactions. AU sec. 334.03 describes transactions that because of their nature may be indicative of the existence of related parties.

As more fully described below, after consideration of the comments received, the Board substantially revised paragraphs 3, 11, 16, and 17 of the proposed standard. As part of these revisions, the Board consolidated the auditor's responsibilities for evaluating whether the company has properly identified its related parties and relationships and transactions with related parties into a single section of the repropoed standard. In addition, as discussed in more detail below, the Board made revisions in response to commenters who suggested that the Board clarify the auditor's responsibility to identify the company's related parties and to allow more room for auditor judgment by removing the requirement that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk.

The Reproposed Standard

Paragraph 14 of the repropoed standard would focus the auditor more directly on a key aspect of the auditor's objective by requiring the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties.^{34/} Paragraph 14 of the repropoed standard anticipates that, while the auditor would start its work regarding related parties with the names of related parties and relationships and transactions with related parties identified by the company, the auditor may not merely rely on management's representations as to the

^{34/} Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.



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accuracy and completeness of the information provided to the auditor.^{35/} A new footnote to paragraph 14 of the reposed standard would state that evaluating whether a company has properly identified its related parties involves more than assessing the process used by the company to identify its related parties. It is the role of the auditor to go beyond management's representations and perform audit procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

Paragraph 14 of the reposed standard would require the auditor to take into account the information gathered during the audit in evaluating whether the company has properly identified its related parties and relationships and transactions with related parties. Paragraph 14 would also require that as part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. A new footnote to paragraph 14 of the reposed standard would state that information obtained from identifying and evaluating a company's significant unusual transactions and obtaining an understanding of a company's financial relationships and transactions with its executive officers could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Like the proposed standard, a note refers the auditor to Appendix A which describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Many of the examples contained in Appendix A of the reposed standard are contained in AU secs. 334.07-.08.

The reposed standard would not require an auditor to perform procedures with respect to each source of information referenced in Appendix A. However,

^{35/} The auditor's procedures to evaluate whether the company has properly identified its related parties should extend beyond the inquiries pursuant to paragraphs 5-7 of the reposed standard. Paragraph 10 of Auditing Standard No. 15 requires that when using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to: test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and evaluate whether the information is sufficiently precise and detailed for purposes of the audit.



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evaluating whether a company has properly identified its related parties and relationships and transactions with related parties requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company. Further, an auditor may be required to perform auditing procedures with respect to certain of those sources (for example, reading confirmation responses and responses to inquiries of the company's lawyers) by other auditing standards or through the performance of auditing procedures in other areas.^{36/} Appendix A also states that the examples contained in that Appendix are not intended to represent a comprehensive listing.

The auditor's efforts to identify and evaluate a company's significant unusual transactions might also assist the auditor in identifying information that might indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Among other things, Appendix A states that contracts and other agreements representing significant unusual transactions are an example of a source of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

According to paragraph 15 of the reproposed standard, if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor would be required to perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Like the proposed standard, the reproposed standard also would require that these procedures extend beyond inquiry of management.

A footnote to paragraph 15 would refer the auditor to paragraph 29 of Auditing Standard No. 15, which states that if audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

^{36/} See, e.g., AU sec. 330, *The Confirmation Process*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

Paragraph 16 of the repropoed standard would require that if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify additional relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of the repropoed standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;
- f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
- g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
- h. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor determines that it is likely that an illegal act has or may have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

The requirements of paragraph 16 of the repropoed standard would, in large part, mirror those required by the proposed standard. Notably however, in response to

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What tools, strategies and techniques are available for this evaluation process....

Number: 2 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/4/2013 9:16:40 AM

Within 5 business days....tell the Auditor what are the expectations....how will they know....?

Number: 3 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/4/2013 9:18:58 AM

Provide best practices, tools, techniques, strategies for conducting the Assessment Process....aka: guidance...what are the expectations....?

Number: 4 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/4/2013 9:20:12 AM

Provide best practices, tools, techniques, strategies for Performing this Procedure....aka: guidance...what are the expectations....?

Number: 5 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/4/2013 9:20:44 AM

Provide best practices, tools, techniques, strategies for Performing this Evaluation of the implications....aka: guidance...what are the expectations....?

Number: 6 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/4/2013 9:21:11 AM

Provide best practices, tools, techniques, strategies for Performing this Reassessment Procedure....aka: guidance...what are the expectations....?

Number: 7 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/4/2013 9:22:35 AM

Provide best practices, tools, techniques, strategies for Performing this Evaluation of the implications for the Audit if management's nondisclosure indicates fraud et cetera....Procedure....aka: guidance...what are the expectations....?



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comments, revisions have been made to allow more room for auditor judgment. As repropoed, paragraph 16 would not require that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk.

Like the proposed standard, a footnote to paragraph 16 of the repropoed standard would refer the auditor to AU sec. 333.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.

Significant Comments and Board Responses

The Board received several comments regarding the auditor's responsibility for evaluating information and performing procedures regarding related parties or relationships or transactions with related parties previously undisclosed to the auditor. In developing the repropoed standard the Board considered all comments received, including the following significant comments:

Clarifying the Auditor's Responsibility for Evaluating the Company's Identification of Its Related Parties: Some commenters suggested that the Board clarify the auditor's responsibility to perform procedures to identify the company's related parties. In response, the repropoed standard has been revised to focus more directly on a key aspect of its objective, that is, whether related parties and relationships and transactions with related parties have been properly identified by the company under audit.

As repropoed, the standard would include a new requirement for the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties, as well as more focused audit steps intended to support the auditor's required evaluation. Such steps, which closely mirror the auditor's risk assessment process, include: (i) performing risk assessment 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; (ii) identifying and assessing risks associated with a company's relationships and transactions with its related parties, including whether the company has properly identified its related parties and relationships and transactions with related parties; (iii) designing and performing audit procedures that address and respond to the risks of material misstatement associated with the company's related parties and transactions; and (iv) performing specific procedures that



address related party relationships or transactions identified by the auditor that were previously undisclosed by company management.

In the Board's view, the clarifications in the repropoed standard represent a more effective audit approach that recognizes that the company is responsible for the preparation of its financial statements, including, in the first instance, the identification of the company's related parties and relationships and transactions with related parties, and that the auditor begins the audit with information obtained from the company.^{37/}

Allowing More Room for the Use of Auditor Judgment: Several commenters stated that the proposed standard should allow more room for the use of auditor judgment when the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Some of these commenters expressed concern over the proposed requirement that all previously undisclosed related party transactions identified by the auditor be treated as a significant risk. Some of these commenters noted that an undisclosed related party transaction could be inconsequential in nature, and, in such circumstances, treating the transaction as a significant risk, and performing all of the procedures set forth in the proposed standard would be unnecessary. Other commenters suggested it might be appropriate to perform some, but not all, of the related procedures in the proposed standard.

In the Board's view, certain basic procedures should be performed by the auditor when an undisclosed related party transaction comes to the auditor's attention. For example, because of the potential for fraud, paragraph 16.b. of the repropoed standard would require the auditor to evaluate why the related party or relationship or transactions with a related party was previously undisclosed to the auditor. However, in response to the concerns expressed by some commenters, the Board has removed the requirement that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk. As repropoed, the auditor would only be required to perform the more extensive procedures required by paragraph 12 of the

^{37/} To further assist the auditor's efforts in identifying related parties, the repropoed other amendments include a complementary provision that would expand existing management representations contained in AU sec. 333, *Management Representations*, to state that the company has provided the names of all related parties and all relationships and transactions with its related parties to the auditor. However, the auditor may not solely rely on management's representations.



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reproposed standard when the undisclosed related party transaction is either required to be disclosed in the financial statements or determined to be a significant risk.

Evaluating Information That Comes to the Auditor's Attention: Paragraph 11 of the proposed standard would have required the auditor to evaluate whether information that comes to the auditor's attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. One commenter indicated that this may infer a separate evaluation of all information obtained by the auditor. The commenter suggested that, alternatively, the auditor should be required to "remain alert" for information or other conditions that indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. The Board considered this comment, noting that it had considered the "remain-alert" approach contained in International Auditing and Assurance Standards Board ("IAASB") and AICPA Auditing Standards Board ("ASB") standards in developing the proposed standard. The Board believes, however, that "remain alert" may be too passive given the need for the heightened level of scrutiny associated with related party transactions. Accordingly, the Board is not proposing to replace the "evaluate-whether" language with a requirement to "remain alert."

Clarifying the Auditor's Responsibility Regarding Appendix A: Several commenters suggested that the Board clarify the auditor's responsibility regarding the examples of information and sources of information included in Appendix A of the proposed standard. For example, some commenters thought the auditor's responsibility with respect to Appendix A was not clear, others thought that Appendix A appeared too prescriptive, and one commenter expressed concern that PCAOB inspectors may interpret Appendix A to require the auditor to perform specific procedures. The Board considered these and similar comments and noted that many commenters generally requested that the Board provide additional guidance regarding the information, and sources of information that could indicate relationships or transactions with related parties. Appendix A to the proposed standard was included to assist the auditor's identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor. The information and sources relevant to a particular audit would depend on the facts and circumstances of the audit and, thus, not all of the information or sources of information in Appendix A would need to be considered in every audit. Other auditing standards, however, might require the auditor to examine certain items listed in Appendix A. The Board is proposing to retain Appendix A but seeks commenters' views on whether the addition of Appendix A is helpful to auditors or whether it should be removed.



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Further, one commenter recommended requiring the auditor to read the minutes of the board of directors and its compensation committee, if any. While this comment was directed at the requirement to obtain an understanding of the company's financial relationships and transactions with its executive officers, the Board's consideration of this comment prompted a change to the paragraph of the repropoed standard related to evaluating whether the company has properly identified its related parties and relationships and transactions with related parties.

In the Board's view, reading minutes of meetings of the board of directors is an important procedure for identifying information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. The Board also noted that existing standards already require the auditor to read minutes of meetings of the board of directors and appropriate committees for other purposes^{38/} and AU sec. 334 includes reading minutes as an example of a procedure for identifying transactions with related parties.^{39/}

Consequently, the Board made revisions that would require that, as part of the auditor's evaluation whether the company has properly identified its related parties and relationships and transactions with related parties, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. Performing this procedure may also inform the auditor's understanding of the company's financial relationships and transactions with its executive officers.

Determining Whether Previously Undisclosed Related Parties Exist: One commenter noted that the proposed standard would have required the auditor to perform procedures that extend beyond inquiry of management in order to determine whether undisclosed relationships or transactions with related parties that might exist do, in fact exist, but that the Board provided no examples of such procedures. That commenter noted that if the Board has specific procedures in mind, then examples of such procedures should be provided. The Board considered these comments and noted that the risk assessment standards require the auditor to perform audit procedures to

^{38/} See, e.g., AU sec. 560, *Subsequent Events*, AU sec. 722, *Interim Financial Information*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

^{39/} See AU sec. 334.08b.



resolve inconsistencies in, or doubts about the reliability of, audit evidence.^{40/} If the auditor identifies information that creates a doubt about the completeness of the company's identification of its related parties, the auditor should perform the audit procedures necessary to resolve the matter. For example, in resolving the matter, the auditor might review relevant available public information about the party in question, or inquire of other parties with knowledge about the party in question (e.g., banks, guarantors, agents, or attorneys). Because the nature of those procedures would depend upon the facts and circumstances of the audit, the Board is not proposing to make revisions for these comments.

Including the Discussion Contained in AU sec. 334.04: Some commenters expressed concern that the proposed standard could create an expectation that the auditor will always identify all of the company's related party transactions. One commenter recommended that the Board include language in the standard that is similar to that in AU sec. 334.04, which states that an audit cannot be expected to provide assurance that all related party transactions will be discovered.

In the Board's view, an audit performed in accordance with PCAOB auditing standards should provide reasonable assurance that the financial statements are free of material misstatements whether caused by fraud or error.^{41/} This includes reasonable assurance regarding accounting for and disclosure of related party transactions. The auditor should perform such specific procedures to obtain sufficient appropriate evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the company's financial statements.

G. Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17-18 of the Reproposed Standard in Appendix 1)

The auditor's evaluation of a company's accounting and disclosure of relationships and transactions with related parties is important to the protection of investor interests because the substance of related party transactions might differ materially from their form. Furthermore, related party transactions not only may involve

^{40/} See paragraph 29 of Auditing Standard No. 15.

^{41/} See paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

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Number: 1 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Highlight Date: 7/7/2013 10:13:36 AM

Pw believes that all instances of the following must be changed from:

".....In the Board's view, an audit performed in accordance with PCAOB auditing standards SHOULD PROVIDE REASONABLE ASSURANCE that the financial statements are free of material misstatements whether caused by fraud or error..."

to: ".....SHOULD PROVIDE AN INDEPENDENT, CORRECT, CLEAR, ACCURATE, NOT SUBJECT AND/OR OPEN TO INTERPRATION, AN EVALUATION that the financial statements are free of material misstatements REGARDLESS OF ORIGIN AND/OR CAUSE OF SAME...."

Number: 2 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/7/2013 10:14:45 AM

Pw believes we should always include a follow along guidance with the following phrase...."SUCH AS" (aka: to be inserted whenever we encounter the following dangling phrase:....

" DEPENDING ON MATERIALITY"is too loose and open ended....to-to....open to interpretation....these Standards should reduce all opportunities for faulty interpretation....

Respectfully yours,

**Pw Carey
GRC Application Security Analyst CISA, CISSP**



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difficult measurement and recognition issues, but may also be used to engage in financial statement fraud and conceal misappropriation of assets.

The Proposed Standard and Existing Requirements

Paragraph 18 of the proposed standard would have required the auditor to evaluate whether the financial statements contain the information regarding related party transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

AU sec. 334.02 states that the auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure. AU sec. 334.02 also states that "the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form." Auditing Standard No. 14 describes the auditor's responsibility for evaluating the presentation of financial statements, including disclosures, more generally. Auditing Standard No. 14 requires the auditor to evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.^{42/} Furthermore, AU sec. 411.06 requires the auditor to consider whether the substance of transactions or events differs materially from their form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. Like the proposed standard, the repropoed standard aligns with, and builds upon, the requirements in Auditing Standard No. 14 and AU sec. 411.

As more fully discussed below, after consideration of the comments received, the Board made revisions to clarify the auditor's responsibility for evaluating whether related party transactions have been properly accounted for and disclosed in the financial statements.

The Reproposed Standard

Paragraph 17 of the repropoed standard would require the auditor to evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. This would include evaluating whether the financial statements

^{42/} See paragraph 30 of Auditing Standard No. 14.



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contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework. A new footnote to paragraph 17 would direct the auditor to paragraph 31 of Auditing Standard No. 14.

As repropoed, paragraph 17 is intended to align the auditor's evaluation with the objective of the standard and to focus the auditor on both the accounting and disclosure of the company's relationships and transactions with related parties.

Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comment:

Evaluating Financial Statement Accounting and Disclosure: One commenter expressed concern that the substance-over-form issue discussed on page A4-20 of Appendix 4 of the proposing release could require auditors to challenge the appropriateness of the accounting standards and recommended changes to the proposed standard to focus the auditor's requirements only on the disclosure of related party transactions.

The Board considered this comment. The Board, however, does not agree that the proposed standard would have required the auditor to challenge accounting standards. Footnote 1 to paragraph 1 of the proposed standard stated that the auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company. The discussion in Appendix 4 of the proposing release is consistent with AU sec. 334.02, which notes that the auditor should be aware that the substance of a related party transaction could be significantly different from its form. This concept was not included in the proposed standard as it is already contained in AU sec. 411.06.

The Board further notes that financial statements may not be presented fairly if they do not include information about the matters that affect their use, understanding and interpretation.^{43/} For example, to improve the appearance of its financial condition, a company and a related party could attempt to "dress up" the appearance of the company's balance sheet at period-end. Some period-end "window-dressing"

^{43/} See AU sec. 411.04.



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transactions might involve side agreements undisclosed to the auditor, while others might represent transactions, that the auditor is aware of, in which management placed more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction. As repropoed, paragraph 12.e. would require the auditor to obtain the audit evidence necessary to address risks of material misstatement identified and assessed by the auditor, including risks of material misstatement associated with these matters.

To further clarify the auditor's responsibility for evaluating whether related party transactions (including related party transactions that pose difficult substance-over-form considerations or that appear to lack a business purpose) have been properly accounted for and disclosed in the financial statements, the Board is also proposing revisions in paragraph 17 of the repropoed standard. Those revisions would require the auditor to evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements.

This commenter also expressed concern that the proposed standard implied that the auditor's evaluation of the fair presentation of financial statements occurs in a piecemeal fashion and that auditors evaluate individual disclosures in isolation. The Board considered this comment, noting that, like the proposed standard, the repropoed standard would require that the auditor perform procedures for each related party transaction that requires disclosure in the financial statements. Similarly, the auditor's evaluation pursuant to paragraph 17 of the repropoed standard would encompass each related party transaction that requires disclosure.^{44/} The Board is not proposing to revise the requirement in this paragraph for this suggestion.

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (Paragraph 18 of the Repropoed Standard in Appendix 1)

Financial reporting frameworks allow management to assert that a related party transaction was consummated on terms equivalent to those prevailing in arm's-length

^{44/} Like the proposed standard, footnote 2 of the repropoed standard refers the auditor to examples of other relevant standards and rules, including paragraph 31 of Auditing Standard No. 14 and paragraph .04 of AU sec. 411.



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transactions only when management can substantiate that assertion.^{45/} However, those financial reporting frameworks do not discuss what information is required to substantiate such an assertion or how management is to determine the terms and conditions that would prevail in an arm's-length exchange, including, for example, whether there would be a guarantee or an extension of credit.

The Proposed Standard and Existing Requirements

Paragraph 19 of the proposed standard would have required that if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. AU sec. 334 includes requirements regarding the auditor's evaluation of assertions that related party transactions occurred on terms equivalent to those occurring on an arm's length basis. For example, AU sec. 334.12 states that, except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been.

As more fully discussed below, after consideration of the comments received, the Board is reproposing paragraph 19 without revision.

The Reproposed Standard

Paragraph 18 of the reproposed standard would require that, if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. The reproposed standard also would state that if the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's

^{45/} See FASB ASC paragraph 850-10-50-5. Paragraph 23 of International Accounting Standard ("IAS") 24 also states that disclosures "that related party transactions were made on terms equivalent to those that prevail in arm's length transactions are made only if such terms can be substantiated."



assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.^{46/}

Like the proposed standard, a note to paragraph 18 would state that transactions with related parties might not be conducted on terms equivalent to those prevailing in arm's-length transactions. Except for routine transactions, it may not be possible for management to determine whether a particular transaction would have taken place, or what the terms and manner of settlement would have been, if the parties had not been related. Accordingly, it may be difficult for the auditor to obtain sufficient appropriate audit evidence to substantiate management's assertion that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. The note retains the discussion contained in AU secs. 9334.22-.23 that a preface to an assertion such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

Significant Comments and Board Responses

In developing the repropoed standard, the Board considered all comments received, including the following significant comments:

Assessing the Implications of Management's Inability to Provide Support for Its Arm's-Length Assertion: One commenter recommended that footnote 35 in the proposing release should be included in the repropoed standard. That footnote provided that a decision by management to remove, at the auditor's request, an arm's-length assertion regarding a related party transaction from the financial statements due to management's inability to provide the auditor with sufficient appropriate audit evidence, might impact the auditor's assessment of internal control over financial reporting. The Board considered this recommendation and agrees that such circumstances might impact the auditor's assessment of internal control over financial reporting or understanding of the control environment. However, such a determination would be based on the facts and circumstances of the situation. In the Board's view, including the discussion in footnote 35 of the proposing release in the repropoed standard might inappropriately create an impression that further procedures regarding

^{46/} A decision by management to remove, at the auditor's request, such an assertion from the financial statements due to management's inability to provide the auditor with sufficient appropriate audit evidence might affect the auditor's assessment of internal control over financial reporting.



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the control environment are always necessary. As a result, the Board is not proposing to make revisions for this comment.

Describing the Effect of the Auditor's Report on SEC Filings: Some commenters recommended that the standard should note that a qualified or adverse opinion will result in an inability to make appropriate SEC filings. The Board considered this comment, noting that the auditor's responsibility is to obtain sufficient appropriate audit evidence to support the auditor's opinion and issue the appropriate audit report. It is the responsibility of management to determine the impact of any modification to the auditor's standard report on the company's ability to make appropriate filings with the SEC. As such, the Board is not proposing to make revisions for this comment.

Allowing More Room for the Use of Auditor Judgment: Some commenters stated that the requirements in the proposed standard do not permit the auditor to exercise auditor judgment when responding to the significance of management's refusal to modify a disclosure that asserts that a related party transaction was conducted at arm's-length. Those commenters noted that the existing standard states that the evaluation is "based on the materiality" of the transaction and that this phrase has not been included in the repropoed standard. The Board considered these comments and noted that financial reporting frameworks permit management to assert that a related party transaction occurred on an arm's-length basis only when support for such an assertion exists. A statement by management in the financial statements that a related party transaction occurred on an arm's-length basis when support for that statement does not exist represents a departure from U.S. GAAP and IFRS. Such a misstatement would require the auditor to express either a qualified or adverse opinion on the financial statements. As such, the Board is not proposing to make revisions for this comment.

H. Communications with the Audit Committee (Paragraph 19 of the Proposed Standard in Appendix 1)

Both the auditor and the audit committee benefit from a meaningful exchange of information regarding significant risks of material misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports, including matters arising from a company's relationships and transactions with related parties.^{47/}

^{47/} Higher quality financial reporting (as a result of better informed auditors, better informed audit committees, or both) improves the quality of information available



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The Proposed Standard and Existing Requirements

Paragraph 20 of the proposed standard would have required the auditor to communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, as well as other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

In contrast, the existing standard, AU sec. 334, does not include requirements regarding the auditor's communication with the audit committee. Other, existing auditing standards, however, require that the auditor communicate significant matters to the audit committee, including those encountered during a review of interim financial information.^{48/}

As more fully discussed below, the Board is reproposing the auditor's communication requirements substantially as proposed, with revisions to further align and work in concert with, the requirements in Auditing Standard No. 16, *Communications with Audit Committees*.^{49/}

The Reproposed Standard

Paragraph 19 of the reproposed standard would require the auditor to communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with its related parties. The reproposed standard also would require that the auditor communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;

to the markets and reduces the information asymmetry that exists about the company among investors as well as between investors and the company's management.

^{48/} See Auditing Standard No. 16 and AU sec. 722.34.

^{49/} See PCAOB Release No. 2012-004 (Aug. 15, 2012).



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- b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and
- e. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

Paragraph 19 of the repropoed standard is intended to work in tandem with paragraph 7 of the repropoed standard, which would require the auditor to make inquiries of the audit committee, or its chair, at an earlier point in the audit. The communication required by paragraph 19 of the repropoed standard would provide an opportunity for the auditor to communicate information obtained during the audit relevant to those earlier inquiries.

Subsequent to the close of the comment period for the Board's proposal, the Board adopted Auditing Standard No. 16, *Communications with Audit Committees*.^{50/} The Board made changes to align the requirements in the repropoed standard with Auditing Standard No. 16. For example, a new footnote has been added to paragraph 19 of the repropoed standard that would refer the auditor to Auditing Standard No. 16 regarding the timing of communications to the audit committee. This footnote in the repropoed standard replaces a note that was included in the proposed standard that indicated the auditor should communicate with the audit committee "in a timely manner" and "prior to the issuance of the auditor's report." That note is no longer necessary because Auditing Standard No. 16 includes specific requirements on the nature and timing of auditor communications with the audit committee. In addition, the phrase, "in a timely manner and prior to the issuance of the auditor's report" in paragraph 20 of the proposed standard has not been included in the repropoed standard to avoid confusion because Auditing Standard No. 16 includes specific guidance on the timing of communications.

^{50/} See PCAOB Release No. 2012-004 (Aug. 15, 2012).



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The repropoed amendments include conforming amendments to Auditing Standard No. 16 that would:

- Replace the reference in footnote 25 to AU sec. 334 with a reference to the repropoed standard; and
- Add a reference in Appendix B, *Communications with Audit Committees Required by Other PCAOB Rules and Standards* of Auditing Standard No. 16 to the audit committee inquiries and communications required by paragraphs 7 and 19 of the repropoed standard.

Significant Comments and Board Responses

Commenters generally requested clarification regarding the alignment of the proposed standard with the requirements in the proposed auditing standard regarding auditor communications with audit committees. As described above, the Board has made revisions to the communication requirements to align with, and be incremental to, communications with the audit committee under Auditing Standard No. 16.

In developing the repropoed standard, the Board also considered all other comments received, including the following significant comments:

Reporting Matters on an Exception Basis: At the SAG discussion, the point was raised that the auditor's communications to audit committees should emphasize exceptions identified by the auditor. Another commenter recommended that the paragraph in the proposed standard requiring communication to the audit committee that the financial statements include a statement that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction be removed from the standard because, in the commenter's opinion, it would be more appropriate for the auditor to respond to questions in this area only if asked by the audit committee. Another commenter recommended waiving the communication to the audit committee when related party transactions are already well known, not unusual, or not material. This commenter questioned the benefit of communication in those instances. The Board considered these comments and is not proposing revisions to provide for communication of these matters on an exception basis. Doing so would not provide for the proactive communication that the Board believes should occur with the audit committee regarding a company's relationships and transactions with its related parties.

Making the Auditor's Communications Incremental to Management's: One commenter stated that the auditor's communication with the audit committee should be



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focused on matters not previously communicated by management and any other areas requiring significant auditor judgment. The Board considered this comment and noted that the proposed communication requirements would involve communication of the auditor's evaluation of certain matters and that management is not in a position to communicate the auditor's views. As such, the Board is not proposing to make revisions for this comment.

Timing of the Auditor's Communications: One commenter stated that the language in the proposed standard is "too soft" and is an argument for letting the information linger until "all the facts are in," up to the point when the audit report is released. That commenter recommended requiring early audit committee communication requirements regarding related party transactions. The Board considered this comment and noted that paragraph 7 of the repropoed standard would require the auditor to inquire of the audit committee as part of the auditor's risk assessment procedures. In addition, Auditing Standard No.16 anticipates timely and robust communications between the auditor and the audit committee throughout the audit. The Board, therefore, is not proposing to make revisions for this comment.

Clarifying Significant Matters: One commenter stated that it is unclear what the Board expects the auditor to communicate beyond the significant matters that are specifically identified in the proposed standard. That commenter recommended combining the requirements in the proposed standard into a single paragraph and including a requirement that the auditor communicate "other significant matters, if any, related to the auditor's evaluation of the company's identification of, accounting for, and disclosures of its relationships and transactions with related parties." Because the Board does not intend to limit audit committee communications to only those significant matters included in the repropoed standard, no revisions have been made in response to this comment. For example, in evaluating the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, the auditor might identify other significant matters that might be of interest to the audit committee, such as concerns over the company's process for identifying related parties and relationships and transactions with related parties.

I. Other Considerations

The Board did not propose any changes to the auditor's report in connection with the proposed standard and amendments, but sought input on whether the proposed standard should change the auditor's responsibilities for the auditor's report regarding related party transactions. The Board notes that any changes to the auditor's report in this area would be considered in conjunction with the Board's project on improvements



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to the Auditor's Reporting Model. The Board encourages commenters to send comments on such issues in response to future Board proposals on the Auditor's Reporting Model.^{51/}

Questions:

1. Are the requirements of the repropoed standard appropriate? Why or why not?
2. Do the changes in the repropoal clarify the relationship of the repropoed standard with the risk assessment standards? Why or why not?
3. Does the alignment of the repropoed standard with the risk assessment standards enable the auditor to introduce efficiencies in the audit approach? Why or why not?
4. Would the procedures required by the repropoed standard improve the auditor's understanding of a company's relationships and transactions with its related parties? Why or why not?
5. Is the requirement in the repropoed standard to evaluate whether the company has properly identified the company's related parties and relationships and transactions with its related parties appropriate? Why or why not?
6. Does the repropoed standard appropriately allow for the use of auditor judgment? Why or why not?
7. Are the auditor's responsibilities for the examples of information and sources of information contained in Appendix A to the repropoed standard clear? Are there other examples that should be included in the repropoed standard?
8. Is the objective of the repropoed standard appropriate? Why or why not? Does the repropoing release clearly articulate that the objective of the repropoed standard works similarly to objectives contained in other PCAOB auditing standards?

^{51/} See <http://pcaobus.org/Rules/Rulemaking/Pages/Docket034.aspx>.



9. Does the requirement in the reposed standard to perform specific procedures for each related party transaction required to be disclosed in the financial statements or determined to be a significant risk provide for a scaled approach? Why or why not?
10. Does the approach in the reposed standard for the auditor to perform specific procedures for related party transactions that are required to be disclosed in the financial statements or that are determined to be a significant risk represent a cost-sensitive, yet effective, approach? Why or why not?
11. What additional guidance, if any, regarding the auditor's responsibility for performing procedures on intercompany account balances pursuant to paragraph 13 of the reposed standard is necessary?

II. Reposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

Overall, commenters were generally supportive of the need to improve the existing requirements regarding significant unusual transactions. However, some commenters suggested changes to the proposed requirements. In response, the Board has made certain revisions to clarify and refine the proposed amendments regarding significant unusual transactions. These comments and the proposed revisions are organized by the following topical areas:

	<u>Page</u>
A. Identifying Significant Unusual Transactions	A4-59
B. Evaluating Significant Unusual Transactions	A4-66

Relevant information is provided for each topical area, including a description of the proposed amendments regarding significant unusual transactions and existing requirements, a description of the reposed amendments regarding significant unusual transactions, and a discussion of significant comments received and Board responses. Specific questions for commenters follow the discussion of Evaluating Significant Unusual Transactions, however, commenters are encouraged to comment on all aspects of the reposed amendments.



A. Identifying Significant Unusual Transactions (Section A. of the Reproposed Amendments in Appendix 2)

Financial reporting frauds have demonstrated that companies may use significant unusual transactions, such as transactions in which management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction, to materially misstate their financial statements. Significant unusual transactions can also result in material misstatement of financial statements due to error. Improving the auditor's identification of significant unusual transactions can promote audit quality.

Improving the auditor's identification of significant unusual transactions also can inform the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties, as a related party transaction previously undisclosed to the auditor might also be a significant unusual transaction.

The Proposed Amendments and Existing Requirements

The proposed amendments regarding identifying significant unusual transactions aligned the description of significant unusual transactions in the Board's auditing standards, enhanced the requirements for identifying a company's significant unusual transactions, and revised and added to the examples of fraud risk factors described in AU sec. 316.

The existing standard relating to the auditor's consideration of fraud in a financial statement audit, AU sec. 316, recognizes that during an audit the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment.^{52/} The risk assessment standards also anticipate that the auditor might come across significant transactions that are outside the normal course of business for the company or that are otherwise appear to be unusual due to their timing, size, or nature.^{53/}

^{52/} See AU sec. 316.66.

^{53/} For example, paragraph 71.g. of Auditing Standard No. 12 states that one factor that should be evaluated for the auditor's determination of which risks are



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As more fully described below, after consideration of the comments received, the Board is reproposing the amendments regarding identifying significant unusual transactions substantially as proposed, except for certain changes that are intended to enhance the linkage between the reproposed amendments regarding significant unusual transactions and the reproposed standard.

The Reproposed Amendments

Description of Significant Unusual Transactions

Like the proposed amendments, the reproposed amendments regarding significant unusual transactions would amend AU sec. 316.66 to describe significant unusual transactions as 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. This description is consistent with the existing description in paragraph 71.g. of Auditing Standard No. 12. The reproposed amendments to AU sec. 316.66 also would state that significant unusual transactions may be used to engage in fraudulent financial reporting or conceal misappropriation of assets.

The reproposed amendments regarding significant unusual transactions also would make conforming changes to introduce a uniform description of "significant unusual transaction" throughout the Board's standards. Specifically, the reproposed amendments would align the terminology in paragraph 14 of Auditing Standard No. 5, *An Audit of Internal Control over Financial Reporting That Is Integrated with An Audit of Financial Statements*, paragraph 12 of Auditing Standard No. 9, paragraph 13 of Auditing Standard No. 12, paragraph 15.c. of Auditing Standard No. 13, paragraph .85.A.2 of AU sec. 316, and paragraph .55.B1. of AU sec. 722, *Interim Financial Information*. As compared to the proposed amendments, these conforming changes would reflect a number of minor revisions that are intended to further clarify the description of a significant unusual transaction throughout the Board's standards.

significant risks is whether the risk involves significant transactions outside the normal course of business or that otherwise appear to be unusual due to their timing, size, or nature.



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Enhancing Requirements for Identifying Significant Unusual Transactions

The repropoed amendments would include amendments to the Board's existing standards that would require the performance of procedures as part of the auditor's risk assessment process to identify significant unusual transactions. As discussed below, these procedures would include: (1) inquiring of management and others, (2) understanding controls relating to significant unusual transactions, and (3) taking into account other information obtained during the audit. The repropoed amendments in this area remain substantively the same, except for certain changes that serve to enhance the linkage between the repropoed amendments regarding significant unusual transactions and the repropoed standard.

Inquiring of Management and Others (Paragraphs 56-57 of Auditing Standard No. 12)

The repropoed amendments would build on existing requirements in Auditing Standard No. 12 that require the auditor to make inquiries of management and others within the company about the risks of material misstatement.^{54/} Specifically, the repropoed amendments regarding significant unusual transactions would revise paragraph 56.a. of Auditing Standard No. 12 to require the auditor to inquire of company management regarding whether the company has entered into any significant unusual transactions, and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties. The proposed amendments regarding significant unusual transactions would also revise paragraphs 56.b. and 56.c. of Auditing Standard No. 12 to require the auditor to inquire of the audit committee and internal audit personnel (if applicable), respectively, regarding whether the company has entered into any significant unusual transactions.

Paragraph 57 of Auditing Standard No. 12 requires that the auditor inquire of others within the company about their views regarding fraud risks and includes the example of employees involved in initiating, recording, or processing complex or unusual transactions. The repropoed amendments would add significant unusual transactions as an example of a complex or unusual transaction to paragraph 57 of Auditing Standard No. 12.

^{54/} See paragraphs 56-57 of Auditing Standard No. 12.



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Understanding Controls Relating to Significant Unusual Transactions (Paragraph 73A of Auditing Standard No. 12)

Auditing Standard No. 12 requires that the auditor obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.^{55/}

The repropoed amendments regarding significant unusual transactions would build on the risk assessment standards by adding paragraph 73A to Auditing Standard No. 12. That paragraph would require the auditor to obtain an understanding of the controls management has established to identify, authorize and approve, and account for and disclose significant unusual transactions in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18-40 and 72-73 of Auditing Standard No. 12.

Taking into Account Other Information Obtained During the Audit (AU sec. 316.66)

The repropoed amendments regarding significant unusual transactions would add a note to AU sec. 316.66 stating that the auditor's identification of significant unusual transactions should take into account information obtained from: (a) the risk assessment procedures required by Auditing Standard No. 12 (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial reporting), and (b) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

As discussed above, revisions have been made in the repropoal to clarify the linkage between the repropoed standard and the repropoed amendments regarding significant unusual transactions. Specifically, unlike the propoal, the repropoed amendments would add a second note to AU sec. 316.66 that would state that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. In addition, a new note would also be included after paragraph 11 in the repropoed standard that would state

^{55/} See paragraph 18 of Auditing Standard No. 12.



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that, for a related party transaction that is also a significant unusual transaction pursuant to AU secs. 316.66-.67A, the auditor is required to evaluate whether the business purpose (or the lack thereof) of the transaction indicates that the transaction was entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. Further, a new footnote to the repropoed standard would state that information obtained from identifying and evaluating a company's significant unusual transactions (as well as from obtaining an understanding of a company's financial relationships and transactions with its executive officers) could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Fraud Risk Factors

Like the proposed amendments, the repropoed amendments regarding significant unusual transactions also would revise certain examples of fraud risk factors contained in AU sec. 316. For example, AU sec. 316.85A.2 notes that significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm can provide opportunities to engage in fraudulent financial reporting. The repropoed amendments regarding significant unusual transactions would bifurcate that discussion into two separate examples, namely: (1) related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business) and (2) significant transactions with related parties whose financial statements are not audited or are audited by another firm. The repropoed amendments also would add contractual arrangements lacking a business purpose as an example of a fraud risk factor.

Significant Comments and Board Responses

The Board considered all comments received, including significant comments in the following areas:

Defining Significant Unusual Transactions and Including Examples: Some commenters recommended defining the term "significant unusual transaction." Another commenter recommended including examples of significant unusual transactions. After considering these comments, the Board has not revised the proposed amendments. In the Board's view, the description of a significant unusual transaction included in the proposed amendments permits auditor flexibility in applying the description to different companies of different sizes and in different industries. Likewise, the Board has not included examples of significant unusual transactions in its repropoal. In the Board's



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view, whether a specific transaction constitutes a significant unusual transaction should be based upon the specific facts and circumstances.

Clarifying the Complementary Nature of Significant Unusual Transactions and Identifying Related Parties Previously Undisclosed to the Auditor. Some comments received by the Board appeared to indicate that commenters might not have fully appreciated the Board's intended emphasis on the complementary nature of the auditor's efforts regarding significant unusual transactions and identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor. The Board believes that emphasizing the complementary nature of the auditor's efforts in identifying significant unusual transactions can also inform the auditors evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties. To further emphasize the complementary nature of the auditor's efforts regarding a company's relationships and transactions with its related parties and significant unusual transactions, as discussed above, the Board is proposing revisions to further emphasize the linkage between these topics. These revisions include adding a new note to AU sec. 316.66, a new note to paragraph 11 of the repropoed standard, and a new footnote to paragraph 14 of the repropoed standard.

Determining Whether a Transaction is a Significant Unusual Transaction: One commenter noted that eliminating from AU sec. 316.66 the phrase "or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment," while also stating in the proposing release that significant unusual transactions need not be infrequent but could occur quarterly or more frequently, appears counterintuitive. That commenter was concerned that this could create ambiguity. Another commenter suggested providing examples of transactions that would not occur infrequently and nonetheless be considered significant unusual transactions. The Board considered these comments, noting that the description of a significant unusual transaction is designed so that the auditor determines whether a transaction is a significant unusual transaction based on the specific facts and circumstances. In the Board's view, removing the phrase contained in AU sec. 316 does not change the need for the auditor to make this determination based on the facts and circumstances, which would include the auditor's understanding of the company and its environment. Specifically, a new note to AU sec. 316.66 would state that the auditor's identification of significant unusual transactions should take into account information obtained from the risk assessment procedures required by Auditing Standard No. 12. Auditing Standard No. 12 requires the auditor to obtain an understanding of the



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company and its environment.^{56/} The proposing release stated that a significant unusual transaction need not occur infrequently to clarify that the timing or frequency of transactions is only one element to be considered in determining whether a transaction is a significant unusual transaction. The Board, therefore, is not proposing to change the amendments regarding significant unusual transactions in response to these comments.

Using Management's Terminology: One commenter noted that management does not have an equivalent term for "significant unusual transaction" in its literature (that is, the applicable accounting framework, Committee of Sponsoring Organizations of the Treadway Commission ("COSO") or SEC management guidance). In that commenter's view, the transactions that the auditor determines are "significant unusual transactions" will likely be transactions that management views as the result of its non-routine or estimation processes. That commenter noted that management's processes and related controls may not be different for "significant unusual transactions" than for other similar transactions. The Board considered this comment, noting that inquiring of management and others within the company regarding the existence of significant unusual transactions as part of its risk assessment procedures is an important step – but not the only step - in the auditor's identification of significant unusual transactions. The auditor might determine that there are significant unusual transactions despite management's assertions (for example, through other procedures performed during the audit, such as reading minutes of the board of directors meetings and performing journal entry testing). Consequently, the Board is not proposing to revise the amendments regarding significant unusual transactions in response to this comment.

Incorporating Examples of Procedures That May Identify Significant Unusual Transactions from the Proposing Release: One commenter recommended including examples of procedures from the proposing release that may help identify significant unusual transactions in the proposed amendments. The Board considered this comment but is proposing to include the performance requirements in the proposed amendments, while providing the additional discussion of the amendments and related examples in an appendix to the release, as it has done in the past. This approach promotes a clear separation between the required procedures in the standard and the Board's discussion regarding the potential application of the repropoed amendments. As such, the examples of procedures and other discussion in the proposing release have not been incorporated into the repropoed amendments. However, as described above, the Board is proposing to add a second note to AU sec. 316.66 that would state

^{56/} See paragraph 7 of Auditing Standard No. 12.



that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. This note also refers the auditor to Appendix A of proposed auditing standard, *Related Parties*, which includes examples of information and examples of sources of such information.

B. Evaluating Significant Unusual Transactions (Section B. of the Reproposed Amendments in Appendix 2)

Because a company might use a significant unusual transaction to engage in fraudulent financial reporting or to obscure the company's financial position or operating results, existing standards require the auditor to perform procedures to evaluate significant unusual transactions identified by the auditor and discuss the auditor's evaluation of such transactions with the audit committee.^{57/} The amendments in this area are designed to improve the auditor's evaluation of significant unusual transactions, including the auditor's evaluation of the business purpose (or the lack thereof), and whether the transactions have been appropriately accounted for and adequately disclosed in the company's financial statements. Improving the auditor's evaluation of significant unusual transactions should also result in a more meaningful exchange of information between the auditor and the audit committee.^{58/}

The Proposed Amendments and Existing Requirements

The proposed amendments regarding significant unusual transactions were intended to strengthen the auditor's evaluation of significant unusual transactions. The proposed amendments, which would have built on existing requirements in AU secs. 316.66-.67, included specific procedures intended to focus the auditor's attention on critically evaluating whether the business purpose (or the lack thereof) for significant unusual transactions indicates that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.

^{57/} See AU secs. 316.66-.67 and paragraph 13.d. of Auditing Standard No. 16.

^{58/} Higher quality financial reporting (as a result of better informed auditors, better informed audit committees, or both) improves the quality of information available to the markets and reduces the information asymmetry that exists about the company among investors as well as between investors and the company's management.



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The proposed amendments also would have included an evaluation of whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

Existing AU sec. 316.66 currently requires that once an auditor becomes aware of significant unusual transactions, the auditor should gain an understanding of the business rationale for such transactions and whether that rationale (or the lack thereof) suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. Existing AU sec. 316.67 identifies several matters that the auditor should consider in understanding the business rationale for those transactions.

As more fully described below, after consideration of the comments received, the Board made revisions to the proposed amendments regarding evaluating significant unusual transactions.

The Reproposed Amendments

Evaluating the Business Purpose of Significant Unusual Transactions

The repropose amendments regarding evaluating significant unusual transactions would add a new paragraph to AU sec. 316, AU sec. 316.66A, to require that the auditor design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. The repropose procedures would include:

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.



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As repropoed, item a. of the proposed amendments to AU sec. 316.66A would clarify that the auditor should read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction.

As repropoed, item c. of the proposed amendments to AU sec. 316.66A would be expanded to require the auditor's evaluation of the financial capability of the other party to include other significant matters, specifically, significant loan commitments and supply arrangements.

Item d. of the proposed amendments to AU sec. 316.66A would be revised to better clarify the auditor's responsibilities. Like the proposed amendments, item d. would provide an opportunity for the auditor to scale the audit by requiring the auditor to supplement the basic required procedures with more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. Specifically, as revised, item d. would require the auditor to perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Like the proposed amendments, a footnote to item c. of the repropoed amendments to AU sec. 316.66A also would state that examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

The repropoed amendments also would require the auditor to evaluate certain matters when evaluating whether the business purpose (or the lack thereof) of a significant unusual transaction suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. Like the proposed amendments, the repropoed amendments would largely incorporate the list of matters currently in AU sec. 316.67 and would add additional matters. Those additional matters would include:

- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end).



- 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 other, more clearly independent, parties on an arm's-length basis.
- The transaction enables the company to achieve certain financial targets.

These additional matters are intended to strengthen the auditor's evaluation of the business purpose (or the lack thereof) for significant unusual transactions, including whether they may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.

In addition, the reproposal would align the proposed footnote to AU sec. 316.67 with the description of "related parties or relationships or transactions with related parties previously undisclosed to the auditor." The revised footnote also would reference the requirement in the repropoed standard that the auditor perform certain procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

Evaluating the Accounting and Disclosure of Significant Unusual Transactions

The repropoed amendments would emphasize the auditor's responsibility to evaluate the accounting and disclosure of significant unusual transactions by adding a new paragraph to AU sec. 316, paragraph .67A. That new paragraph would require the auditor to evaluate whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements. AU sec. 316.67A would further state that this includes evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework. A new footnote would direct the auditor to paragraph 31 of Auditing Standard No. 14.

Like the proposed amendments, the repropoed amendments would add a new note to AU sec. 316.67A that would state that, in evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in accordance with the financial reporting framework, the auditor considers management's disclosure regarding significant unusual transactions in other parts of the company's SEC filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.



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Other Matters Regarding Significant Unusual Transactions

Like the proposed amendments, the repropoed amendments regarding significant unusual transactions also would include new paragraph 11A to Auditing Standard No. 13. That paragraph would remind auditors that significant unusual transactions can affect the risks of material misstatement due to error or fraud, and that the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to the repropoed amendments to AU secs. 316.66-.67A regarding significant unusual transactions.

The repropoed amendments regarding significant unusual transactions would complement the auditor communication requirements in Auditing Standard No. 16. Specifically, improving the auditor's identification and evaluation of significant unusual transactions could improve the quality of auditor communications with audit committees. The repropoed amendments also would revise paragraph 13.d. of Auditing Standard No. 16 to refer to the "business purpose (or the lack thereof)" instead of the "business rationale" of a significant unusual transaction.

Significant Comments and Board Responses

In developing the repropoed amendments regarding evaluating significant unusual transactions the Board considered all comments received, including the following significant comments:

Providing Additional Guidance for Identifying and Assessing Risks of Material Misstatement: One commenter recommended providing guidance as to how to relate risk, materiality, and other considerations to the selection of procedures for significant unusual transactions rather than a "one-size-fits-all" approach, which that commenter asserted was inherent in the proposed amendments regarding significant unusual transactions. The Board notes that the proposed amendments regarding significant unusual transactions were designed to establish basic procedures for the auditor to identify and evaluate significant unusual transactions, and allow the auditor to assess risks and respond to risks based on the facts and circumstances, including the size and complexity of the company and the assessed significance of the identified risks of material misstatement in the financial statements. The Board, therefore, did not change the amendments in response to this comment.

Evaluating the Financial Capability of the Other Party: Some commenters expressed concern that information pertinent to an unrelated third party may not be



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available to the auditor, hindering the auditor's ability to evaluate the financial capability of the other party. After considering these comments, the Board is not proposing to make revisions for this comment. See the discussion "Evaluating the Financial Capability of the Related Party" under the heading "Transactions with Related Parties Required to Be Disclosed in the Financial Statements or That are a Significant Risk" in Section I.E. of this Appendix.

Incorporating Examples of "Other Procedures" from the Proposing Release: Some commenters suggested incorporating the examples of procedures that might be appropriate for the auditor to perform that were contained in the proposing release into the proposed amendments regarding significant unusual transactions. The Board considered these comments and determined, as it has done in other projects, to include the performance requirements in the Board's standards and to provide the additional discussion of the amendments and related examples in an appendix to the release. This approach promotes a clear separation between the required procedures in the standard and the Board's discussion regarding the potential application of the standard. As such, the examples of procedures and other discussion in the proposing release have not been incorporated into the repropoed amendments regarding significant unusual transactions.

Evaluating the Implications of the Lack of a Business Purpose: One commenter stated that older versions of the auditing standards suggested that if the auditor is unable to understand the business purpose of a transaction, the auditor may not be able to express an unqualified opinion. That commenter suggested that this provision be included, along with reporting guidance. Further, at the SAG discussion, the point was raised that the standard should include a statement similar to footnote 6 of AU sec. 334.09, which states that "[u]ntil the auditor understands the business sense of material transactions, he cannot complete his audit. If he lacks sufficient specialized knowledge to understand a particular transaction, he should consult with persons who do have the requisite knowledge."

The Board considered these comments and noted that significant unusual transactions, like all transactions, are subject to the requirements contained in AU sec. 411.06, which requires that the auditor consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. That evaluation would encompass an understanding of the "business sense" of material transactions. As a result, these comments are not reflected in the reproposal.



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Evaluating Whether a Significant Unusual Transaction Enables the Company to Achieve Financial Targets: One commenter noted that the expanded list of factors (in AU sec. 316.67) was problematic. Specifically, that commenter noted that requiring the auditor to consider whether the accounting for a transaction enables the company to achieve certain financial targets could be a "catch-all" that covers a variety of unintended transactions. Another commenter suggested that this factor should be deleted, noting that the factor could result in an auditor unnecessarily evaluating transactions for fraud that clearly have not been entered into to engage in fraudulent financial reporting or the misappropriation of assets. That commenter stated that this factor is redundant as other factors, for example, whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transactions (e.g., accounting-motivated structured transaction) are sufficient.

The Board considered these comments, noting that considering whether a transaction enables the company to achieve certain financial targets is an important consideration when evaluating whether that transaction has been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. The Board is proposing to revise this factor to focus the auditor on whether the transaction enables the company to achieve financial targets.

Questions:

12. Are the repropoed amendments regarding the auditor's identification of significant unusual transactions appropriate? Why or why not?
13. Are the repropoed amendments regarding the auditor's evaluation of significant unusual transactions appropriate? Why or why not?
14. Would the procedures required by the repropoed amendments regarding significant unusual transactions improve the auditor's identification and evaluation of a company's significant unusual transactions? Why or why not?
15. Are the repropoed amendments regarding significant unusual transactions appropriately aligned with the risk assessment standards? Why or why not?
16. Do the repropoed amendments regarding significant unusual transactions appropriately allow for the use of auditor judgment? Why or



why not? Does the requirement that the auditor perform specific procedures for each significant unusual transaction identified by the auditor provide for a scaled approach? Why or why not?

17. Is the complementary relationship between the amendments regarding significant unusual transactions and the repropoed standard clear? Why or why not?

III. Other Repropoed Amendments to PCAOB Auditing Standards

The Board also proposed amendments regarding a company's financial relationships and transactions with executive officers, other new requirements that complement the proposed standard and amendments, and amendments that would have conformed other auditing standards to the proposed standard and amendments. Overall, while the proposed changes regarding a company's financial relationships and transactions with executive officers drew support from a range of commenters, some commenters raised concerns that performing such procedures could have unintended consequences, including impacting the design of compensation arrangements. In response to the comments received the Board made revisions to clarify and refine various aspects of the other proposed amendments. The discussion of the comments and proposed revisions pertains to the following PCAOB auditing standards:

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A. Auditing Standard No. 12, <i>Identifying and Assessing Risks of Material Misstatement</i>	A4-74
B. AU sec. 315, <i>Communications Between Predecessor and Successor Auditors</i>	A4-87
C. AU sec. 316, <i>Consideration of Fraud in a Financial Statement Audit</i>	A4-89
D. AU sec. 333, <i>Management Representations</i>	A4-90
E. AU sec. 560, <i>Subsequent Events</i>	A4-91
F. AU sec. 722, <i>Interim Financial Information</i>	A4-93
G. AU sec. 9543, <i>Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543</i>	A4-94



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Relevant information is provided regarding the repropoed amendments to each standard, including a description of the proposed amendments and existing requirements, a description of the repropoed amendments, and a discussion of significant comments received and Board responses. Following the discussion of the repropoed amendments to AU sec. 722 are specific questions for commenters, although the Board encourages comments on all aspects of the repropoed amendments. In particular, the Board seeks comment regarding the repropoed amendments to Auditing Standard No. 12 that would require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment.

A. Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Appendix 3)

A company's financial relationships and transactions with its executive officers might create incentives and pressures that could create risks of material misstatement of the financial statements. Performing procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers can benefit the auditor's identification of fraud risks and other significant risks. Further, performing procedures to obtain such an understanding can result in the identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor, which in turn can contribute to the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties.

The Proposed Amendments and Existing Requirements

The Board's proposal included amendments to Auditing Standard No. 12 that would have required the auditor to perform specific procedures to obtain an understanding of relationships and transactions with the company's executive officers as part of the auditor's risk assessment. The proposed amendments also would have included procedures that the auditor *should consider* performing, namely: (i) obtaining an understanding of the company's policies and procedures regarding executive officer expense reimbursements and (ii) inquiring of the chair of the company's compensation committee (or its equivalent) and any company compensation consultants regarding the structuring of the company's compensation for its executive officers. The proposed amendments were intended to assist the auditor in identifying and assessing risks associated with a company's financial relationships and transactions with its executive officers.



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The other proposed amendments were designed to build on the existing risk assessment standards. Specifically, paragraph 11 of Auditing Standard No. 12 already requires that, as part of obtaining an understanding of the company, the auditor should consider obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses. The proposal anticipated that the additional procedures to be performed would contribute to the auditor's consideration of fraud in a financial statement audit pursuant to AU sec. 316, which recognizes certain incentives and pressures on management to commit fraud as examples of fraud risk factors.

As more fully described below, after consideration of the comments received, the Board is proposing revisions to the other proposed amendments to Auditing Standard No. 12 to clarify that the auditor's procedures in this area would be performed as part of the auditor's risk assessment process and would not require the auditor to make any determination regarding the reasonableness of the company's compensation arrangement with its executive officers or recommendations regarding such compensation arrangements.

The Reproposed Amendments

As repropoed, the Board's amendments relating to financial relationships and transactions with a company's executive officers would add paragraph 10A to Auditing Standard No. 12. The proposed change would require the auditor, as part of the auditor's risk assessment process, to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers (for example, executive compensation, including perquisites, and any other arrangements). As stated in the proposing release, the Board intends that the procedures should be sufficient to identify whether these financial relationships and transactions could create conditions (for example, incentives and pressures) that could result in risks of material misstatement, including fraud risks.^{59/}

The repropoed amendments, like the proposed amendments, would require the auditor to perform procedures that include, but are not limited to:

^{59/} See page A4-41 of the proposing release.

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Pw believes such "REASONABLENESS" must be based upon widely accepted industry compensation standards and baselines.....drawing attention to those which are 25% greater than the norm....

Respectfully yours,

**Pw Carey
GRC Application Security Analyst CISA, CISSP**



- Reading the employment and compensation contracts between the company and its executive officers; and
- Reading proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.^{60/}

The focus of the repropoed procedures is the company's "executive officers." As noted above, the Board's repropoed amendments would build on the existing focus in paragraph 11 of Auditing Standard No. 12 on the company's compensation arrangements with "senior management." Like the proposed amendments, the repropoed amendments would include a definition of the term "executive officer" that links to the SEC's definition of an executive officer in Rule 3b-7 under the Exchange Act, for issuers, and a list contained in Schedule A of Form BD, for broker-dealers.^{61/}

The repropoed amendments would not change the existing requirement to consider obtaining an understanding of compensation arrangements with senior management. The population for the procedures required by paragraph 10A of the other repropoed amendments is the list of "executive officers," as defined in the SEC rules or

^{60/} The auditor also might read the company's proxy statements and other relevant SEC company filings in meeting the requirements of paragraph 11 of Auditing Standard No. 12, which states that the auditor should consider reading public information regarding the company as part of the process for obtaining an understanding of the company.

^{61/} Specifically, the repropoed amendments to Auditing Standard No. 12 would include the following definition of an "executive officer": For issuers, the president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policy-making functions for the company. (See Rule 3b-7 under the Exchange Act.) For brokers and dealers, the term "executive officer" includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions. (See Schedule A of Form BD.)

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Pw believes that all instances relating to "executive compensation" questions should include widely accepted comparative industry compensation baselines, guidelines and related public records for all respective job titles and related duties

Respectfully yours,

Pw Carey
GRC Application Security Analyst CISA, CISSP



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included on Schedule A of Form BD,^{62/} while the existing requirement in paragraph 11 of Auditing Standard No. 12 continues to apply to what may be a larger population of a company's management.

Like the Board's proposed amendments, the repropoed amendments also would include a number of other changes designed to strengthen the auditor's consideration of the risk of material misstatement associated with financial relationships and transactions with its executive officers. As repropoed, the revisions to paragraph 11 of Auditing Standard No. 12 would require the auditor to consider performing procedures to:

- Inquire of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers, and
- Obtain an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

In the Board's view, understanding a company's financial relationships and transactions with its executive officers can assist the auditor in understanding whether those relationships and transactions affect the risks of material misstatement.^{63/} For example, the auditor could consider whether the company's internal control over

^{62/} See Exchange Act Rule 3b-7, 17 C.F.R. §240.3b-7, and Schedule A of Form BD. See *generally* Item 401(b) of Regulation S-K, 17 C.F.R. §229.4-01(b).

^{63/} For example, according to a May 2010 academic study that examined in detail SEC accounting and auditing enforcement releases from 1998 to 2007, the chief executive officer or chief financial officer was named in 89 percent of the enforcement actions involving fraudulent financial reporting. That study also noted that the SEC's most commonly cited motivations for fraud included the need to meet internal or external earnings expectations, an attempt to conceal the company's deteriorating financial condition, the need to increase the stock price, the need to bolster financial performance for pending equity or debt financing, or the desire to increase management compensation based on financial results. See, M. Beasley, J. Carcello, D. Hermanson, and T. Neal, "*Fraudulent Financial Reporting 1998-2007 An Analysis of U.S. Public Companies*," at 3, available at http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.

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Pw believes the purpose of this Re-Proposed Standard MUST NOT BE".....designed to strengthen the auditor's consideration of the risk of material misstatement...".....

Rather it is to close the "open to interpretation loop" that permeates previous versions.....and this is accomplished by reducing and limiting the opportunities for ".....interpretation....." and replace interpretation with, drum roll here: intuitive guidance and tools....

Respectfully yours,

**Pw Carey
GRC Application Security Analyst CISA, CISSP**



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financial reporting is designed and operating to address risks that management might seek accounting results solely to boost certain executive officers' compensation. This understanding could also assist the auditor in determining areas where management bias might occur (for example, certain accounting estimates, including fair value measurements).

Similarly, obtaining an understanding of how the company has structured its compensation for its executive officers can assist the auditor in identifying fraud risks. Existing standards identify a company's financial relationships and transactions with its executive officers as examples of fraud risk factors.^{64/} The information obtained from this risk assessment procedure, therefore, could complement the requirement in paragraph 52 of Auditing Standard No. 12 that key engagement team members discuss the potential for material misstatement due to fraud, including consideration of the known external and internal factors affecting the company that might create incentives or pressures for management and others to commit fraud.

As described above, the repropoed amendments are not intended to call into question the compensation policies and procedures of the company, but rather, to assist the auditor in identifying and assessing risks of material misstatement in the financial statements that may be a consequence of a company's financial relationships and transactions with its executive officers.^{65/}

Significant Comments and Board Responses

Many commenters generally supported the proposed amendments to Auditing Standard No. 12 relating to executive compensation. One commenter stated that requiring the auditor to perform additional procedures to obtain an understanding of this aspect of company governance should result in higher quality audits that better assist investors in making informed investment decisions and improve public confidence in the financial markets. Other commenters however, did not support the proposed amendments and expressed concerns, including concerns that the proposed amendments might influence the design and appropriateness of company compensation arrangements with its executive officers and that the proposed amendments might impair auditor independence. Other commenters provided

^{64/} See AU sec. 316.85.

^{65/} See page A4-44 of the proposing release.



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recommendations to further strengthen the proposed amendments. In developing its reproposal, the Board considered all comments received, including the following significant comments:

Clarifying That the Proposed Procedures are Performed As Part of the Auditor's Risk Assessment: Some commenters expressed a concern that the proposal might result in auditors influencing the design and appropriateness of compensation arrangements with executive officers. One commenter suggested that the proposed amendments could potentially transform the traditional auditor's role from providing assurance on the reliability of financial statements to evaluating the design or appropriateness of executive compensation, including the business purpose and impact of executive compensation arrangements on the company.

Another commenter stated that the amendments would require the auditor to substantively judge executive compensation and that this could fundamentally change the relationship between the board and the auditor. That commenter also noted that the proposed amendments would appear to place the auditor in the role of advising the board on substantive business decisions. That commenter stated that this seems inconsistent with the non-audit service prohibitions in Section 201 of the Sarbanes-Oxley Act and, in fact, not suited to the auditor's areas of expertise. That commenter stated that this expanded role would entail analyzing executive compensation risk, without the need to connect the risk with the rewards and that the auditor's advice may be skewed in favor of limiting compensation in a manner that may not be in the best interest of the shareholders. That commenter further stated that the proposed amendments could result in certain companies having uncompetitive compensation arrangements, thereby, putting those companies at risk of losing talented executives.

Other commenters supported the proposed amendments but noted that there was confusion surrounding the proposal and suggested that the Board clarify the purpose of the proposed amendments. In addition, during the SAG discussion it was suggested that the Board clarify that there is no expectation that auditors will be engaged in the compensation committee process or in an audit of that process.

The Board considered all comments received and made revisions to emphasize that the purpose of the procedures is to further the auditor's risk assessment rather than to require the auditor to determine the appropriateness of a company's compensation agreements with its executive officers. The Board notes that the repropoed amendments would not require the auditor to assess the appropriateness of the compensation of executive officers. As repropoed, the first sentence of paragraph 10A of Auditing Standard No. 12 would read as follows:



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To assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers.

The revisions are intended to clarify that the procedures performed are intended to occur in the context of the auditor's process for assessing the risks of material misstatement of the company's financial statements.

Performing the Proposed Procedures Could Impair Auditor Independence: Some commenters expressed concern that the proposed amendments might affect an auditor's independence. Those commenters noted that, while the PCAOB recognized in the proposing release that it is not suggesting that auditors become involved in or influence executive compensation decisions, they are concerned that auditor independence could in fact be compromised in this manner. As support, those commenters noted their belief that it would be unreasonable to assume that auditors would not express opinions or have discussions with board members or management that could influence, wittingly or not, decisions regarding performance-based compensation plans.

The Board considered these comments and noted that auditors already have an existing responsibility to assess the risk of material misstatement of the financial statements. The Board further noted that obtaining an understanding of compensation arrangements with a company's senior management is already part of procedures that are considered in the context of the auditor's risk assessment activities. As proposed, the amendments relating to a company's financial relationships and transactions with its executive officers extend the auditor's existing work in this area, with a focused set of required procedures to address a critical area that could pose substantial risk to the integrity of companies' financial statements and reporting processes. Thus, the Board did not make changes in response to these comments. **In the Board's view, performing procedures to understand a company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment represents an extension of the auditor's existing responsibilities. The performance of such audit procedures should not impair auditor independence.**

Performing the Proposed Procedures Might Require Specialists: Several commenters suggested that auditors might need to engage specialists to understand

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company employment contracts, noting that the time to obtain and understand these contracts might be significant.

The Board considered these comments and noted that Auditing Standard No. 12 already requires the auditor to consider performing procedures with respect to employment arrangements with a company's senior management. The Board did not receive comments from auditing firms that suggested that they would have difficulty performing the procedures that would have been required by the proposed amendments. Accordingly, the Board is not proposing revisions to the proposed amendments, but is soliciting comment regarding potential costs of its reproposal.

Generating Documentation That Complicates Litigation: One commenter stated that the proposed amendments would generate documentation and other records that could complicate any litigation or claims relating to executive compensation discussions. That commenter further stated that these records would not be subject to attorney-client privilege or similar protections and could result in increased liability on the part of companies and their shareholders.

In the Board's view, the auditor's responsibilities to conduct the audit and prepare related documentation generally should not be limited by the threat of potential litigation against the company. Obtaining an understanding of the company, including by performing procedures relating to a company's financial arrangements with its executive officers, is an important part of the auditor's risk assessment activities. This understanding may lead to the discovery of incentives and pressures that could foster fraudulent financial reporting or conceal the misappropriation of assets. After consideration, the Board is not proposing to make revisions in response to this comment.

Determining the Company's Executive Officers: Some commenters recommended that the amendments clarify the auditor's role in determining who is considered an "executive officer." In particular, commenters questioned whether the auditor is expected to determine whether the list of executive officers, as set out in Rule 3b-7 under the Exchange Act or Schedule A of Form BD for brokers and dealers, is complete. Other commenters suggested that the Board incorporate portions of the discussion in the proposing release into the text of the amendments to clarify that it is management's responsibility to designate the company's executive officers.

The Board considered these comments, noting that the proposed amendments would not have required the auditor to evaluate management's identification of its "executive officers," for other regulatory and SEC filing purposes. In the Board's view,



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the SEC rules cited in the amendments provide an objective definition of the term "executive officers."^{66/} The Board did not make revisions in response to these comments.

Defining the Term "Senior Management": Some commenters stated that the amendments should clarify the interaction between the terms "executive officer" and "senior management." Several commenters recommended that the Board define senior management. One commenter recommended that the amendments recognize that, for certain entities, it may be possible for executive officers and senior management to be the same individuals (for example, at non-issuer brokers and dealers). That commenter further suggested discussing how the definition of executive officer would be applied to other types of non-issuer entities, for example, subsidiaries of issuers.

The Board notes that the term "senior management" is not a defined term in Auditing Standard No. 12 or SEC rules. The Board also recognizes that, for certain companies or brokers or dealers, senior management might be the same population as its executive officers. Further, the individuals the company considers to be its "senior management" may differ among issuers and among broker-dealers. The existing standard anticipates that a company's or broker's or dealer's facts and circumstances may affect the composition of its "senior management." The Board does not wish to foreclose the possibility that an auditor would (1) gain an understanding of the compensation arrangements with a larger group of "senior management" under Auditing Standard No. 12 in order to obtain an understanding of the company and then (2) perform the procedures under the other repropoed amendments regarding the financial arrangements with a smaller group of "executive officers." As such, the Board is not proposing revisions for these comments.

Using the "Named Executive Officers" ("NEOs") Contained in the Company's Proxy Statement: One commenter stated that the proposed amendments cast a wide net that places unnecessary requirements on auditors and unnecessary costs and burdens on issuers, management, and board members of companies. That commenter suggested narrowing the scope of the auditor's inquiries to NEOs, which consist of five executive officers that are specified in the SEC's rules, and that requiring auditors to perform procedures relating to the more broadly defined universe of "executive officers"

^{66/} See Item 401(b) of Regulation S-K, 17 C.F.R. §229.4-01(b).



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is unnecessary.^{67/} That commenter noted that, in their case, using the executive officers listed in their Form 10-K (pursuant to Rule 3b-7) would triple the amount of work as compared to using the NEOs contained in the company's proxy statement.

The Board considered this comment and observed that the term "senior management" is used in the risk assessment standards and that a review of the compensation arrangements for those "executive officers," as defined in the reproposed amendments, would represent a targeted expansion of work the auditor already considers performing under the existing standards.

The Board considered the commenter's suggestion that the auditor's work be limited to performing procedures for NEOs. However, using the universe of "NEOs," which includes the CEO, CFO, and the three other most highly compensated individuals at an issuer, might not include individuals with direct oversight of the financial reporting process, for example, the chief accounting officer. Additionally, the Board notes that, according to a recent study, the median number of "executive officers" for the S&P 500 is 8 (the mean is 8.71), and the median number of executive officers for the Russell 2000 is 5 (the mean is 6.12).^{68/} Accordingly, the Board is not proposing to incorporate this suggestion into the reproposed amendments. The Board, however, welcomes additional empirical data and other input on this matter.

Performing Procedures after Identifying a Significant Risk: Some commenters were concerned that the proposed amendments could be interpreted by auditors to require that performance-based compensation arrangements with executive officers would need to be substantively audited, rather than assessed for risk of material misstatement. Those commenters noted that the auditor should first determine that a significant risk to the financial statements exists prior to performing extended substantive procedures related to executive compensation arrangements.

The Board considered these comments and noted that the reproposed amendments would better position the auditor to identify and assess risks of material

^{67/} See Item 402(a)(3) of SEC Regulation S-K; 17 C.F.R. §229.4-02(a)(3) and SEC Securities Release Act No. 8732A, *Executive Compensation and Related Person Disclosure* (Aug. 29, 2006).

^{68/} See Study: Benchmarking the Number of "Executive Officers" The Corporate Counsel.net and LogixData (March 2, 2011).



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misstatement, including significant risks, that may be a consequence of the company's financial relationships and transactions with its executive officers. The repropoed amendments would not alter the auditor's responsibility under existing standards for performing substantive auditing procedures.^{69/} The Board is not proposing to make revisions in response to these comments.

Reading Proxy Statements and Other Company Documents: One commenter objected to the proposed requirement that the auditor read the proxy statement as part of the auditor's risk assessment procedures. That commenter questioned the availability of, and relevancy of the information in, the company's proxy statement. The Board considered this comment and, in the Board's view, reading proxy statements that are available to the auditor can provide the auditor with relevant information regarding a company's financial relationships and transactions with its executive officers that may be helpful to informing the auditor's understanding of the company. In addition, the risk assessment standards require that the auditor should consider reading public information about the company, for example, SEC filings.^{70/} Accordingly, the Board is not proposing any revisions in response to these comments.

Addressing Transactions Outside of Executive Compensation: One commenter noted that there are greater areas of exposure related to relationships with executive officers, such as supplier or customer relationships, that outweigh the risk of executive compensation. The Board considered this comment and notes that the repropoed amendments, like the proposed amendments, address all of a company's financial relationships and transactions with its executive officers, which would include supplier and customer relationships.

Inquiring of the Compensation Committee and Consultants: The proposed amendments would require that the auditor should consider inquiring of the compensation committee and its chair and any compensation consultants. One commenter noted that the Board should not require such inquiries, because any required inquiry by the auditors of the compensation committee chairperson would be unnecessarily intrusive and burdensome on the chairperson's time. That commenter further noted that any discussion with consultants seems to be a duplication of efforts. In contrast, other commenters recommended that the standard include a requirement

^{69/} See paragraphs 36-47 of Auditing Standard No. 13.

^{70/} See paragraph 11 of Auditing Standard No. 12.

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What a joke.....too intrusive and burdensome on the Chairpersons time.....what a joke....

Without Any Respect What So Ever.....

Pw



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for the auditor to 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. Further, other commenters stated that the proposed standard may be too imprecise and recommended that the Board clarify the information auditors should seek from compensation committees and compensation consultants regarding executive compensation arrangements.

The Board considered these comments, noting that the proposed standard was designed to permit the auditor to decide whether to inquire of the compensation committee or any compensation consultants and, if so, the nature and extent of inquiries to make based on the company's facts and circumstances. This flexibility would allow the auditor to avoid potentially unnecessary efforts, while focusing on matters that are important to the audit. Accordingly, the reproposal maintains the same approach taken in the proposal.

Obtaining an Understanding of Policies and Procedures Regarding Executive Officer Expense Reimbursements: Commenters expressed differing opinions regarding the proposed requirement that the auditor consider obtaining an understanding of established policies and procedures regarding executive officer expense reimbursements in paragraph 11 of Auditing Standard No. 12. One commenter recommended that the amendments establish a requirement for the auditor to review the expense reports of executive officers, whether or not it demonstrated a possible risk. Another commenter noted that, while there have been many recent headlines regarding executive officer expense reimbursements, those instances were generally immaterial to the financial statements. That commenter stated that, for this reason, because examining expense reimbursements for executive officers is likely to be time consuming, any expense reimbursement reviews should focus on detecting material misstatement.

The Board considered these comments and determined that the proposed amendments, which would have required that the auditor consider obtaining an understanding of the company's established policies and procedures for executive officer expense reimbursements, would have permitted the auditor to determine whether to perform this risk assessment procedure. Further, obtaining an understanding of the company's policies and procedures would not require the auditor to examine all of a company's executive officer reimbursements. Accordingly, the Board is not proposing to make revisions in this area, but is soliciting comments regarding potential costs relating to its reproposal.

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Pw believes this area represents one of the key red flag/triggers for fraud and bad behavior (aka: lying, cheating and stealing) from the Investment Community (which includes dollars, sweat, time and trust on the part of employees, shareholders and prospective investors) and must be included within the confines of this Re-Proposal; as such we should insert the regulatory obligations directly associated with the FCPA (Foreign Corrupt Practices Act)....and include the public records associated with the fines and penalties of non-compliance.....as an example:

Insert FCPA Court Case here:



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Coordinating with Other Regulators: One commenter stated, that while the proposed amendments were based upon existing audit standards, it had concerns regarding the possible encroachment of the PCAOB into areas of corporate governance that are within the purview of state corporate law, or under federal legislation, such as the Sarbanes-Oxley Act, or within the jurisdiction of the SEC. That commenter noted that under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the SEC is involved in or expected to propose a series of regulations on executive compensation, including incentive-based compensation in the financial services industry, pay-for-performance disclosures, pay ratio disclosures, and independent compensation committees. That commenter further noted that the proposed incentive-based compensation regulation is a joint rulemaking of several financial regulators and recommended that the PCAOB act within the bounds of its jurisdiction and also coordinate with these regulators to understand how the proposal interacts with expected regulatory changes.

The Board considered this comment and notes that the Board's existing standards already require that the auditor consider performing procedures to obtain an understanding of compensation arrangements with a company's senior management. The repropoed amendments would be an incremental expansion of the auditor's existing requirements and, thus, in the Board's view, represents an appropriate matter for Board standard setting. In addition, before any standard adopted by the Board becomes effective, it is subject to approval by the SEC.

Retaining Existing Requirements: One commenter recommended that the Board reconsider the need for the requirement in paragraph 11 of the proposed amendment to Auditing Standard No. 12 to consider obtaining an understanding of compensation arrangements for senior management other than executive officers. That commenter noted that, should the Board decide to retain the proposed requirement in the final amendment, it would be helpful to understand the reasons why the additional requirement is considered necessary. That commenter also recommended that the Board provide guidance as to the procedures the auditor should perform with respect to senior management other than executive officers, similar to paragraph 10A of the proposed amendments. Further, during the SAG discussion, the point was made that financial arrangements with employees other than executive officers could also result in risks of material misstatement.

The Board considered these comments, noting that the intent of these amendments is to better inform the auditor's risk assessment about possible risks of material misstatement arising from an "executive officer" population that is generally smaller than the senior management population. The intent is not to restrict the



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performance of existing risk assessment procedures that might provide the auditor with additional information regarding possible risks of material misstatement, including fraud risks or other significant risks. As such, the Board is not proposing to revise the existing requirements in Auditing Standard No. 12 for this comment.

Existing Requirements Are Sufficient: One commenter stated that the requirement in existing paragraph 11 of Auditing Standard No. 12 is more appropriate than the proposed amendment because other auditing standards state that the auditor's identification of fraud risks should include the risk of management override of controls.^{71/} Some commenters expressed the view that high-profile audit failures, such as Enron and Worldcom, did not occur because of a failure to understand the incentive compensation arrangements of these companies and recommended that the focus of the amendments should instead be on the control environment of the company.

The Board considered these comments, noting that obtaining an understanding of the company's financial relationships and transactions with its executive officers can assist the auditor in identifying incentives and pressures that might cause management to override controls. This understanding could also inform the auditor how and where management override might be likely to occur. Thus, no revisions have been made for these comments.

B. AU sec. 315, *Communications Between Predecessor and Successor Auditors* (Appendix 3)

Inquiring of a predecessor auditor regarding the company's relationships and transactions with its related parties and its significant unusual transactions can assist the successor auditor in determining whether to accept the engagement. Such inquiries also can benefit the successor auditor in obtaining an understanding of the company's relationships and transactions with its related parties and in identifying significant unusual transactions.

The Proposed Amendments and Existing Requirements

Existing AU sec. 315, *Communications Between Predecessor and Successor Auditors*, provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place but does not

^{71/} See paragraph 69 of Auditing Standard No. 12.



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specifically address a company's relationships or transactions with its related parties or its significant unusual transactions. AU sec. 334 notes that determining the existence of relationships with related parties requires the application of audit procedures that may include inquiring of predecessor auditors concerning their knowledge of existing relationships and the extent of management involvement in material transactions.^{72/}

The proposed amendments to AU sec. 315 would have required the auditor to make inquiry of the predecessor auditor's understanding of the company's relationships and transactions with related parties and significant unusual transactions. The proposed amendments also would have included within the successor auditor's review of the predecessor auditor's working papers any documentation regarding relationships and transactions with related parties and significant unusual transactions.

As more fully described in the following section, after consideration of the comments received, the Board did not substantively revise the other proposed amendments to AU sec. 315.

The Reproposed Amendments

The reproposed amendments would revise AU sec. 315.09 to require that the successor auditor make specific and reasonable inquiries of the predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions. The reproposed amendments also would revise AU sec. 315.11 to include in the successor auditor's review of the predecessor auditor's working papers any documentation regarding related parties and significant unusual transactions.

Significant Comments and Board Responses

The Board received general comments concerning communications between predecessor and successor auditors, but not comments specific to a company's relationships and transactions with related parties or its significant unusual transactions. The Board acknowledges those comments, but believes that the issues raised fall outside the scope of this standard-setting project.

^{72/} See AU sec. 334.07.g. and AU secs. 9334.12-.13.



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C. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (Appendix 3)

Emphasizing the auditor's identification and evaluation of significant unusual transactions could lead to more instances of auditors becoming aware of indications that fraud or another illegal act has or may have occurred.

The Proposed Amendments and Existing Requirements

The proposed amendments would have amended AU sec. 316 by expanding the discussion in the standard regarding certain audit requirements contained in Section 10A of the Exchange Act. The proposed amendments would have emphasized the auditor's responsibility to investigate and disclose possible fraud to management, the audit committee and, upon the satisfaction of certain conditions, the SEC, consistent with the auditor's responsibility under Section 10A of the Exchange Act.

As more fully described in the following section, the Board did not substantively revise the other proposed amendments to **AU sec. 316**.

The Reproposed Amendments

The other repropoed amendments to AU sec. 316 would add paragraph AU sec. 316.81A, which would state that the auditor has a responsibility, under certain conditions, to disclose possible fraud to the SEC to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change and the fraud or related risk factors constitute a reportable event or are the source of a disagreement, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required pursuant to Section 10A(b) of the Exchange Act of 1934 relating to an illegal act that the auditor concludes, among other things, has a material effect on the financial statements.

The other repropoed amendments would amend AU sec. 316.82 to state that the auditor also may have a duty to disclose the existence of possible fraud to parties outside the entity in the following circumstances: (a) to a successor auditor when the successor makes inquiries in accordance with AU sec. 315, (b) in response to a subpoena, and (c) to a funding agency or other specified agency in accordance with requirements for the audits of companies that receive governmental financial assistance.

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Significant Comments and Board Responses

The Board did not receive comments in this area.

D. AU sec. 333, *Management Representations* (Appendix 3)

Obtaining written management representations regarding the information that management has provided to the auditor can inform the auditor's efforts regarding a company's relationships and transactions with its related parties and a company's significant unusual transactions.

The Proposed Amendments and Existing Requirements

Existing AU sec. 333 requires auditors to obtain written representations from management for the periods covered by the auditor's report. That standard addresses representations covering financial statements; completeness of information; recognition, measurement, and disclosure; and subsequent events. AU sec. 333 currently requires the auditor to obtain a representation regarding the recognition, measurement, and disclosure of related party transactions.

The proposed amendments to AU sec. 333 would have required the auditor to obtain written representations regarding the company's related parties and the absence of side agreements or other arrangements.

As more fully described below, after consideration of the comments received, the Board did not substantively revise the other proposed amendments to AU sec. 333, except to remove a proposed amendment that was considered duplicative.

The Reproposed Amendments

The reproposed amendments to AU sec. 333 would revise AU sec. 333.06 to require that the auditor obtain written representations that management has disclosed to the auditor: (i) the names of all related parties and all relationships and transactions with related parties; (ii) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor; and (iii) that management has made available support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

The reproposed amendments also would revise the illustrative management representation letter in Appendix A of AU sec. 333, consistent with the amendments described above.



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Significant Comments and Board Responses

In developing the repropoed amendments to AU sec. 333, the Board considered all comments received, including the following significant comments:

Necessity for the Proposed Amendments: One commenter stated that the proposed amendments to AU sec. 333: (1) were unnecessary, (2) imply that related party transactions are more important than other information that the auditor must obtain from management, and (3) could result in voluminous management representation letters. The Board considered this comment, noting that obtaining the names of all of the company's related parties and relationships and transactions with related parties is important to the auditor's evaluation of whether a company has properly identified its related parties and relationships and transactions with related parties. Obtaining this information also is important to evaluating whether the company's relationships and transactions with its related parties have been appropriately accounted for and disclosed. Consequently, the Board has maintained the same approach in the reproposal as it did in the proposal.

Duplicative Requirements Regarding Arm's-Length Assertions: Some commenters noted that the proposed amendments to paragraph .06.I. and the addition of paragraph .11A to AU sec. 333 regarding assertions that a related party transaction was conducted on terms equivalent to those prevailing in an arm's-length transaction appeared to be duplicative. These commenters recommended either combining these proposed requirements into a single amendment or eliminating one of the proposed amendments. The Board considered these comments and agreed that the proposed amendments to AU sec. 333.06.I. are sufficient to explain the auditor's responsibilities to obtain a written representation from management regarding an arm's-length assertion included in the financial statements. Accordingly, the representation that would have been required by paragraph .11A has not been included in the reproposal.

E. AU sec. 560, Subsequent Events (Appendix 3)

Events or transactions that occur subsequent to the balance sheet date, but prior to the issuance of the financial statements, may have a material effect on the financial statements. Making specific inquiries during the "subsequent period" regarding a company's relationships and transactions with its related parties and its significant unusual transactions can benefit the auditor's identification of matters that might require disclosure in the financial statements.



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The Proposed Amendments and Existing Requirements

The proposal did not include amendments to AU sec. 560, *Subsequent Events*. That standard requires the auditor to perform auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles.^{73/} Existing AU sec. 560 does not require the auditor to inquire regarding the company's relationships and transactions with its related parties and its significant unusual transactions.

As more fully described below, after consideration of the comment received in this area, the Board is proposing amendments to require inquiries regarding related parties and significant unusual transactions during the "subsequent period."

The Reproposed Amendments

The reproposed amendments would amend AU sec. 560.12 to require that during the "subsequent period" the auditor inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to whether: (1) there have been any changes in the company's related parties or significant new related party transactions and (2) the company has entered into any significant unusual transactions.

Significant Comments and Board Responses

One commenter recommended including a requirement that the auditor inquire of management during the period after the balance-sheet date to assess whether any related party transactions have occurred that may require adjustment or disclosure essential to the fair presentation of the financial statements. The commenter recommended amending AU sec. 560.12.b. to specifically address related party transactions. The Board agrees with this recommendation and, as discussed above, is proposing an amendment because performing this inquiry might benefit investors by improving the auditor's identification of matters that might require disclosure in the financial statements.

^{73/} See AU sec. 560.12.



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F. AU sec. 722, *Interim Financial Information* (Appendix 3)

Obtaining written management representations during a review of interim financial information regarding the information that management has provided to the auditor can inform the auditor's efforts regarding a company's relationships and transactions with its related parties and a company's significant unusual transactions.

The Proposed Amendments and Existing Requirements

Existing AU sec. 722 requires the auditor to inquire of management that has responsibility for financial and accounting matters concerning unusual or complex matters that might have an effect on the interim financial information. The other proposed amendments would have revised AU sec. 722 to be consistent with the proposed amendments to AU sec. 333 and would have required the auditor to obtain written representations each interim period regarding the company's related parties and the absence of side agreements or other arrangements.

As more fully described below, after consideration of the comments received, the Board is reproposing the amendments to AU sec. 722 substantively as proposed.

The Reproposed Amendments

The reproposed amendments to AU sec. 722 would require that the auditor obtain written representations each interim period that management has disclosed to the auditor: (i) the names of all related parties and all relationships and transactions with related parties; (ii) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor; and (iii) that management has made available support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

The Board also is reproposing amendments to the illustrative management representation letter contained in Appendix C of AU sec. 722, consistent with the amendments described above.

Significant Comments and Board Responses

In developing the reproposed amendments to AU sec. 722, the Board considered all comments received, including the following significant comment:

Obtaining the Names of The Company's Related Parties During an Interim Review: One commenter stated that the proposed amendment to AU sec. 722.24.g.



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indirectly may imply that the auditor should obtain the names of all related parties and all relationships and transactions with related parties on a quarterly basis. However, that commenter stated that AU sec. 722 contains no corresponding required auditor inquiry of management to obtain such information. That commenter suggested amending AU sec. 722.18.c. to require inquiries of management regarding changes in related parties or significant new related party transactions, noting that the representation in AU sec. 722.24.g. then may focus on management's communication of such changes to the auditor.

The Board considered this comment and noted that the second bullet of AU sec. 722.18.c. states that the auditor ordinarily inquires of members of management who have responsibility for financial and accounting matters concerning unusual or complex situations that may have an effect on interim financial information. Appendix B to AU sec. 722 states that changes in related parties or significant new related party transactions is an example of a situation about which the auditor ordinarily would inquire of management pursuant to AU sec. 722.18.c. Consequently, the Board is not proposing to make revisions for this comment.

G. *AU sec. 9543, Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543*

Existing standards note that determining the existence of relationships with related parties requires the application of audit procedures, which may include inquiring of principal or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions.^{74/}

The Proposed Amendments and Existing Requirements

The proposed amendments to AU sec. 9543 would have revised AU sec. 9543.05 to remove the reference to AU sec. 334 and state that, before issuing his or her report, the other auditor should inquire of the principal auditor as to matters significant to the audit. Those matters would have included relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties. Accordingly, the proposed amendment aligned AU sec. 9543 with the requirements for a principal auditor included in paragraph 10 of the proposed standard.

^{74/} See AU sec. 334.07.g. and AU secs. 9334.12-.13.



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The Reproposed Amendments

The Board is not proposing revisions to AU sec. 9543. After consideration of the comments received, the Board has decided that any substantial revision to AU sec. 9543 should be considered as part of the Board's standard-setting project on AU sec. 543.

Significant Comments and Board Responses

In developing the revisions to the proposed amendment, the Board considered all comments received, including the following significant comments:

Clarifying the Other Auditor's Inquiries: One commenter noted that the Board did not propose amendments to AU secs. 9543.06-.07 and that those paragraphs infer that the inquiry of the principal auditor is based on the other auditor's judgment. Another commenter stated that the Board should clarify that other communications anticipated by AU sec. 9543 with respect to "matters significant to the audit" are those transactions, adjustments, or other matters that have come to the auditor's attention that may require adjustment to or disclosure in the financial statements. As discussed above, any substantive revision to AU sec. 9543 will be done as part of the Board's standard-setting project on AU sec. 543.

Questions:

18. Are the other repropoed amendments appropriate to address risks of material misstatement of the financial statements? Why or why not?
19. Is it sufficiently clear that the auditor (a) should obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment and (b) should not assess the appropriateness of executive officer compensation? Why or why not?
20. Are "executive officers" the appropriate population for the audit procedures designed to provide the auditor with an understanding of the company's financial relationships and transactions as part of its risk assessment process? Why or why not?



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IV. Economic Considerations, Including Audits of Emerging Growth Companies

The Board is considering the repropoed standard and amendments pursuant to its mandate to protect the interest of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The Board designed the repropoed standard and amendments to reduce the risk of material misstatements of financial statements not being detected by the auditor in three critical areas that have been contributing factors in prominent financial reporting frauds over the last few decades, which have resulted in investor losses and lost jobs. The auditor, serving in the role as a gatekeeper in the financial reporting system, should be alert to the possibility that transactions in these areas require heightened scrutiny during the audit process.^{75/} As such, the repropoed standard and amendments are intended to enhance audit quality.

As more fully described in the release and in Sections I. through III. of this Appendix, the Board believes that the repropoed standard and amendments regarding relationships and transactions with related parties, significant unusual transactions, and relationships and transactions with executive officers can improve the auditor's identification of, assessment of and response to the risks of material misstatement of financial statements, which may lead to higher quality accounting and disclosures for investors. Further, the Board's approach anticipates a more meaningful exchange of information between the auditor and a company's audit committee. These improvements have the potential to reduce information asymmetry in these critical areas.^{76/}

Throughout the development of its proposals, the Board has been sensitive to economic considerations, with the goal of adopting new requirements that make its

^{75/} See, e.g., *In the Matter of the Application of Wendy McNeeley, CPA*, SEC AAER No. 3427 at 10-12 (Dec. 13, 2012).

^{76/} Information asymmetry refers to situations involving separate parties in which one party has more, or better, information than the other party. For example, the separation of ownership and control in companies results in information asymmetry between managers and stakeholders. See Jensen, M.C. and Meckling, W.H. 1976. Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics* 3 (4): 305-360.



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auditing standards in these critical areas more effective, while avoiding unnecessary costs. The Board's approach to promoting audit quality features a scaled approach, requiring the auditor to perform basic procedures and then to determine, based on the risks posed by the company's facts and circumstances, whether additional procedures would be necessary.

Underlying the scaled approach is the concept that the procedures performed, and therefore the associated costs, are commensurate with the risks of material misstatement of the financial statements. Under such a scaled approach, the Board would not expect there to be a significant change in costs for the audit of a company that does not have: (1) extensive relationships or transactions with related parties; (2) significant unusual transactions or (3) financial relationships and transactions with the company's executive officers that give rise to risks of material misstatement.

In contrast, a company that has extensive relationships and transactions with related parties or significant unusual transactions, or that has financial relationships and transactions with executive officers that give rise to risks of material misstatement, could anticipate an increase in audit costs. Further, if the auditor identifies related parties or relationships or transactions with related parties that were previously undisclosed to the auditor, there would be incremental costs associated with the auditor's response to the increased risks of material misstatement.

The release and Sections I.-III. of this Appendix discuss how the repropoed standard and amendments will result in improved audit quality. This section provides a further discussion of economic considerations, including the need for improvements to existing standards, the Board's approach for promoting audit quality, and how the Board's approach reflects economic considerations. This section also discusses considerations for audits of emerging growth companies ("EGCs"). Following each discussion are lists of specific questions for commenters. Commenters are encouraged not only to respond to those questions but also to provide input on all aspects of the repropoed standard and amendments.

A. The Need for Improvements to Existing Standards

As described more fully in the proposing release, several factors collectively indicate a need for improvement to the existing standards.¹⁷⁷ Specifically, the Board

¹⁷⁷ The Board also recognizes that the interim auditing standard for auditing related party relationships and transactions adopted by the Board in 2003 had not been



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developed the proposed standard and amendments in light of the magnitude and number of financial reporting frauds involving companies' relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers.^{78/} The Board's proposal also was informed by observations from the PCAOB's oversight activities, discussions with the SAG, and international developments.

The Board's inspection program has identified deficiencies relating to the auditing of related party transactions, many of which relate to audits of financial statements of smaller public companies that were conducted by smaller audit firms.^{79/} In addition, the

revised since its issuance. The Board's interim standard, AU sec. 334, replaced AU sec. 335, *Related Party Transactions*, which was issued in July 1975. In 1983, AU sec. 334 was amended to remove guidance relating to accounting considerations and disclosure standards for related parties provided in Financial Accounting Standard Board ("FASB") Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, and by making other related technical changes. However, the nature and extent of the auditor's responsibilities and procedures pertaining to related parties in AU sec. 335 was carried over into AU sec. 334. Thus, audit procedures relating to related parties have remained largely unchanged since the issuance of AU sec. 335 in July 1975.

^{78/} The proposing release contains a discussion of prominent cases involving fraudulent financial reporting. In addition, a recent SEC case has supported the need for heightened scrutiny of related party transactions. In a case involving company transactions with its executive officers, the SEC, quoting the D.C. Circuit, stated: "although in an ordinary arms-length transaction, one may assume that parties will act in their own economic interest, this assumption breaks down when the parties are related. A company that would perform a thorough credit-risk assessment before extending a loan might not do so if the loan were to one of its officers or directors." See, *In the Matter of the Application of Wendy McNeeley, CPA*, AAER No. 3427 (Dec. 13, 2012).

^{79/} See *Report On 2007-2010 Inspections Of Domestic Firms That Audit 100 Or Fewer Public Companies*, PCAOB Release No. 2013-001 (Feb. 25, 2013) at 29, available at: http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf, which states, in part:

Inspections staff have observed deficiencies related to firms' failures to test for undisclosed related parties or transactions with undisclosed



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Board took note of the fact that a significant number of the Board's settled disciplinary actions to date have involved auditors' failures to perform sufficient procedures regarding related party transactions, many of which also involved audits of smaller public companies.

As part of its standard-setting process, the Board initially considered whether sufficient improvements could be made through its inspection and enforcement programs, without amending its standards and requirements but concluded that new requirements were appropriate as these critical areas could pose significant risks of material misstatement.^{80/} The Board also concluded that it was appropriate to propose a new standard regarding related parties, rather than amend the existing standard, because of, among other things, the nature and extent of changes necessary to align the existing standard with the risk assessment standards. In contrast, the Board concluded that appropriate improvements in audit quality with respect to a company's significant unusual transactions and financial relationships and transactions with its executive officers could be achieved by amendments to existing standards in those areas.

The Board further noted that in July 2008, the IAASB revised its auditing standard on related parties with the issuance of International Standard on Auditing No.

related parties. Some of those firms failed to identify and address the lack of disclosure of related party transactions in the financial statements. Inspections staff have also identified deficiencies relating to the firms' failure to obtain an understanding of the nature and business purpose of transactions with related parties and to evaluate whether the accounting for those transactions reflects their economic substance.

See also, *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms*, PCAOB Release No. 2007-010 (Oct. 22, 2007) at 7, available at: http://pcaobus.org/Inspections/Documents/2007_10-22_4010_Report.pdf.

^{80/} For example, before deciding to issue its initial proposal, the Board issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010), which discusses a range of auditor practice issues identified by PCAOB staff pertaining to significant unusual transactions.



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550, *Related Parties*.^{81/} The ASB also has revised its auditing standard on related parties with the issuance of AU-C Section 550, *Related Parties*, contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification*, in October 2011.

As described previously, commenters were generally supportive of the Board's efforts to enhance the auditor's identification and evaluation of related party and significant unusual transactions and agreed that improvements to the auditing standards were appropriate. While the proposed changes regarding a company's financial relationships and transactions with its executive officers drew support from a range of commenters, some commenters raised concerns that performing such procedures could have unintended consequences, including impacting the design of compensation arrangements.

As discussed in Section III.A, the Board is proposing revisions to the proposed amendments to Auditing Standard No. 12 to clarify that the auditor's procedures in this area would be performed as part of the auditor's risk assessment process and would not require the auditor to make any determination regarding the reasonableness of the company's compensation arrangements with its executive officers or recommendations regarding such compensation arrangements.

B. The Board's Approach for Promoting Audit Quality

The following discussion contains a general overview of how the improvements in the repropoed standard and amendments are designed to improve the auditor's assessment of and response to the risks of material misstatement, and promote the exercise of professional skepticism and audit quality. These improvements are more fully discussed in the release and Sections I.-III. of this Appendix.

Related Parties

The repropoed standard is designed to address specific risks associated with a company's relationships and transactions with its related parties, including whether the

^{81/} The IAASB emphasized that a new standard was warranted given the public focus on the accounting and auditing of related party relationships and transactions after recent major corporate scandals. See IAASB Exposure Draft, *Related Parties* (Dec. 2005).



company has (1) properly identified its related parties and relationships and transactions with its related parties and (2) properly accounted for and disclosed its relationships and transactions with its related parties in the financial statements. The repropoed standard also includes new requirements regarding the auditor's communications with the audit committee.

The repropoed standard includes specific procedures that would require the auditor, in order to identify and assess the risks of material misstatement, to obtain an understanding of the company's relationships and transactions with its related parties and then evaluate whether the company has properly identified its related parties and relationships and transactions with its related parties.

The repropoed standard has been developed to permit the auditor flexibility in determining the nature, timing, and extent of audit procedures to perform when evaluating whether the company has properly identified its related parties and relationships and transactions with related parties. In addition, this approach contemplates that the auditor's efforts regarding significant unusual transactions can assist in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor.

The repropoed standard also includes basic procedures that would require the auditor to evaluate whether the company has properly accounted for and disclosed its relationships and transactions with its related parties in the financial statements. Those procedures are designed to assist the auditor in identifying potential "red flags" that might indicate a risk of material misstatement.

Notably, research indicates that where fraud does exist, the presence of related parties is one of the top reasons cited for audit failures.^{82/} Research also indicates that 67% of alleged audit deficiencies with respect to related party transactions involved inadequate examination of the transaction.^{83/} Additional research indicates if auditors

^{82/} See Gordon, E.A., Henry, E., Louwers, T.J., and Reed, B.J. 2007. Auditing Related Party Transactions: A Literature Overview and Research Synthesis. *Accounting Horizons* 21 (1): 81-102.

^{83/} See Louwers, T.J., Henry, E., Reed, B.J., and Gordon, E.A. 2008. Deficiencies in Auditing Related-Party Transactions: Insights from AAERs. *Current Issues in Auditing* 2 (2): A10-A16.



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increase their sensitivity to fraud risk, they will likely exert more effort.^{84/} Consistent with this research, the repropoed standard is designed to assist auditors in evaluating whether the company's relationships and transactions have been properly accounted for and disclosed in the financial statements.

The repropoed standard also would require the auditor to communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties and other significant matters arising from the audit regarding the company's relationships and transactions with related parties. Improving the auditor's evaluation of a company's accounting and disclosure of its related parties should result in a more meaningful exchange of information between the auditor and the audit committee.

Significant Unusual Transactions

The repropoed amendments would require the auditor to perform specific procedures to identify a company's significant unusual transactions. In contrast, the existing standards only anticipate that the auditor may become aware of such transactions while performing other audit procedures. Once a significant unusual transaction is identified, the repropoed amendments should improve the effectiveness of the auditor's evaluation of that transaction, including whether the business purpose (or the lack thereof) indicates that the transaction was entered into to engage in financial statement fraud or conceal misappropriation of assets.

In addition to assisting in the auditor's evaluation of possible misstatements in a company's financial statements, improving the auditor's evaluation of significant unusual transactions should result in a more meaningful exchange of information between the auditor and the audit committee.

The identification and evaluation of a company's significant unusual transactions also may inform the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with its related parties.

^{84/} See, e.g., Zimbelman, M.F. 1997. The Effects of SAS No. 82 on Auditors' Attention to Fraud Risk Factors and Audit Planning Decisions. *Journal of Accounting Research* 35 (Supplement): 75-97.



Financial Relationships and Transactions with a Company's Executive Officers

The other repropoed amendments would require the auditor to perform procedures to obtain an understanding of the company's relationships and transactions with its executive officers. This understanding could assist the auditor in determining whether there are incentives or pressures for the company's executive officers that might give rise to a fraud risk or other significant risk. The auditor's efforts in obtaining an understanding of the company's financial relationships and transactions with its executive officers also has the potential to identify related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Other Repropoed Amendments to PCAOB Auditing Standards

The requirements in the other repropoed amendments are designed to complement the efforts in the repropoed standard and amendments to improve the auditor's: (1) efforts to address the risks associated with a company's relationships and transactions with its related parties and (2) identification and evaluation of significant unusual transactions. For example, the other repropoed amendments are designed to improve the auditor's identification of significant unusual transactions through improvements to the auditor's: (1) communications with a predecessor auditor, (2) procedures during the "subsequent period," and (3) procedures during interim reviews.

The Board's repropoal provides complementary audit procedures that consider the links and relationships between a company's relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with its executive officers. Clarifying the linkages between these areas can increase the probability of the auditor's uncovering the potential for fraud or error in a company's financial statements – as the auditor is more likely to "connect the dots."

C. How the Board's Approach Reflects Economic Considerations

As discussed above, the Board believes that the repropoed standard and amendments should enhance audit quality in ways that could also enhance the quality of a company's financial reporting. Enhancing the quality of a company's financial reporting could serve to reduce information asymmetry, foster increased public confidence in the financial markets, and potentially enhance capital formation and the efficiency of capital allocation decisions.

The repropoed standard and amendments are intended to raise the minimum threshold across audit firms for audit procedures. Improving consistency across audit



firms could level the playing field in terms of the probability of uncovering events that could impact investors, such as misstatements due to fraud or errors arising from non-arm's length transactions or significant unusual transactions. Similarly, raising the minimum threshold for audit procedures could lead to an increase in the perceived value of the auditor's assurances regarding a company's disclosures and accounting, which could have a positive impact on the efficient allocation of capital.

The auditor's increased focus on these critical areas could lead companies to improve their disclosures of such transactions. Incrementally increasing the transparency of relevant disclosures could reduce information asymmetry.^{85/} To the extent that the repropoed standard and amendments are viewed by the market as a step towards increasing the transparency of these areas and/or lowering the probability of fraudulent financial reporting, this could reduce the cost of capital for issuers.^{86/}

Enhancements to audit committee communications anticipated by the repropoed standard and amendments also may reduce information asymmetry and potentially enhance corporate governance mechanisms to improve company financial reporting and the quality of information available to the markets. Research has indicated that improving the quality of financial reporting can reduce investors' uncertainty about the information being provided in companies' financial reports, and thus increase efficiency in capital allocation and foster capital formation.^{87/}

^{85/} See Lambert, R.A., Leuz, C., and Verrecchia, R.E. 2012. Information asymmetry, information precision, and the cost of capital. *Review of Finance* 16 (1): 1-29.

^{86/} If the repropoed standard and amendments are successful at "shedding light" on these disclosures, it could reduce the level of information asymmetry. Information asymmetry has been linked to increased costs of capital (See e.g., Easley, D., and O'hara, M. 2004. Information and the Cost of Capital. *The Journal of Finance* 59 (4): 1553-1583.

^{87/} An increased level and/or quality of financial disclosures has been found to decrease the cost of equity (See Botosan, C., and M. Plumlee. 2002. A Re-examination of Disclosure Level and the Expected Cost of Equity Capital. *Journal of Accounting Research* 40 (1): 21-40.), decrease the cost of debt (See Sengupta, P. 1998. Corporate Disclosure Quality and the Cost of Debt. *The Accounting Review* 73 (4): 459-474.) and decrease bid-ask spreads (See Welker, M. 1995. Disclosure Policy,



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While the repropoed standard and amendments are designed to improve audit quality in critical areas that could pose significant risks of material misstatement, the Board recognizes that transactions with related parties are also used for legitimate purposes, including the efficient procurement of necessary resources.^{88/} To the extent that potential costs stemming from the repropoed standard and amendments increase audit costs related to transactions with related parties, this could conceivably serve as a deterrent against their use. This unintended consequence could adversely affect the competitiveness of companies that rely on transactions with related parties during their normal course of operations.

The Board recognizes that its proposals to enhance and update its existing auditing procedures involve new requirements that will impose costs. Being sensitive to the potential burden imposed by such costs, the Board developed an approach for improving audit quality in these three critical areas that encourages the efficient and effective implementation of its standards.

To the extent that the Board received comments on issues relating to costs in the context of its proposal, such comments were not uniform. For example, while one commenter criticized the Board for the lack of a specific economic analysis that could help commenters ascertain what additional burdens would be placed upon businesses and auditors as a result of the proposed standard and amendments, another commenter stated that they did not expect that the more specific requirements of the Board's proposed amendments regarding a company's financial relationships and transactions with its executive officers would result in a meaningful increase in audit costs.

As described above, the Board has attempted to be responsive in its repropoal to comments regarding audit effort (and resulting costs) by seeking to further align its repropoal with its existing risk assessment framework, by describing the differences between existing requirements and its proposals, and by considering revisions that would provide the auditor with more flexibility in appropriate situations.

Information Asymmetry and Liquidity in Equity Markets. *Contemporary Accounting Research* 11 (2): 801 – 827.).

^{88/} See Gordon, E.A., Henry, E., and Palia, D. 2004. Related party transactions and corporate governance. *Advances in Financial Economics* 9: 1-27.

The Board received a number of comments regarding the potential costs that could arise from the proposed amendments regarding a company's financial relationships and transactions with its executive officers. As discussed in Section III.A. of this Appendix, in response to comments, the Board has revised its proposal to clarify its expectations that these new audit procedures are performed as part of the auditor's risk assessment process.

The following paragraphs describe the Board's considerations to date, including how the application of the Board's approach was revised, based on the comments received:

 *Alignment with the Risk Assessment Standards:* The foundational requirements in the risk assessment standards cover the entire audit process, and focus the auditor's attention on considering the risks of material misstatement, whether due to error or fraud. Aligning the proposal with these requirements could promote audit quality by maintaining the auditor's focus, in connection with the audit procedures required by the repropoed standard, on risks of material misstatement. In the Board's view, this approach also should provide for the integration of audit effort, where appropriate, to achieve a more effective and cohesive audit. In response to comments received, the Board made revisions to clarify the relationship of the repropoed standard to the risk assessment standards.

 *Linkages with Other Standards:* The auditor's efforts regarding a company's relationships and transactions with its related parties, its significant unusual transactions, and its financial relationships and transactions with its executive officers are complementary to one another and offer opportunities for the proposed standard and amendments to be implemented in an efficient manner. For example, the auditor's work on identifying and evaluating significant unusual transactions might assist the auditor in identifying related party transactions that management had not previously disclosed to the auditor.

 *Use of Existing Concepts and Procedures:* Retaining existing auditing concepts and procedures in the proposed standard and amendments, to the extent appropriate, permits audit firms to build on their existing methodologies. This could minimize the incremental costs of implementing the repropoed standard and amendments. For example, Appendix A of the repropoed standard includes examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Many of the examples contained in Appendix A are in the existing standard, AU sec. 334.

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Number: 1 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/4/2013 9:33:56 AM

Provide guidance, examples of and best practices for the following: Alignment with the Risk Assessment Standards.....

Number: 2 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/4/2013 9:34:43 AM

Provide guidance, examples of and best practices for the following: Linkages with Other Standards.....

Number: 3 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/4/2013 9:35:26 AM

Provide guidance, examples of and best practices for the following: Use of Existing Concepts and Procedures.....

Opportunity for Scalability: The proposals employ a scaled approach, requiring basic procedures that are supplemented, as needed, by more in-depth procedures commensurate with the risks posed by the company's facts and circumstances. Such facts and circumstances may include the size or complexity of the transaction, the nature of the company's relationships or transactions with its related parties, and the related risk of material misstatements in the financial statements. For example, the improvements in the repropoed standard are designed for the auditor to perform specific procedures regarding related party transactions that require disclosure in the financial statements, rather than requiring the auditor to presume related party transactions are fraud risks in all cases, an approach that could result in unnecessary audit effort and costs.

Further, the Board revised its proposal in response to comments requesting the additional use of auditor judgment to avoid unnecessary costs. For example, the Board removed the proposed requirement that the auditor always treat each related party transaction previously undisclosed by management to the auditor as a significant risk, which would have triggered additional audit work in all cases.

Focus on Executive Officers:  As proposed, the auditor's consideration of a company's financial relationships and transactions with its executive officers does not require the auditor to perform procedures relating to all members of a company's senior management, but, rather, generally focuses the auditor's attention on a smaller group who are more likely to be in a position to influence the company's accounting and financial statements or conceal misappropriation of assets.

As repropoed, the amendments regarding the auditor's consideration of a company's financial relationships and transactions with its executive officers has been clarified to explicitly provide that the procedures regarding a company's financial relationships and transactions with its executive officers are performed as part of the auditor's risk assessment process. The repropoed amendments would not require the auditor to make any determination regarding the appropriateness or reasonableness of the company's compensation arrangements with its executive officers or recommendations regarding such compensation arrangements.

Notwithstanding the efforts the Board has made to tailor the repropoed standard and amendments to achieve audit efficiencies and provide for a more cohesive and effective audit effort, the Board recognizes that its proposals to enhance and update its existing auditing procedures involve new requirements that will impose costs.

Number: 1 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/4/2013 9:36:27 AM

Provide guidance, examples of and best practices for the following: Opportunity for Scalability.....

Number: 2 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/4/2013 9:38:25 AM

Provide guidance, examples of and best practices for the following: Focus on Executive Officers....as in

Q: "...why do you rob banks....?"

A: ".....cause I can....."WRONG!



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To further inform its considerations, the Board is seeking comment regarding economic considerations that should be taken into account when considering its reproposal, including seeking comment and empirical data regarding costs. As noted above, the Board anticipates that there will be some costs imposed by the reproposed standard and amendments, and that anticipated costs could include costs to audit firms, audit costs, and costs to companies. For example, audit firms will need to incur costs to update their audit methodologies to reflect the new requirements and conduct initial training of their personnel on the new requirements.

Audit fees also may increase due to the new auditor performance requirements in the Board's reproposal. Likewise, companies may need to incur additional expenses as, for example, audit committees may incur additional time and expense resulting from the new audit committee communication requirements for related party transactions, and management and others within the company might spend more time responding to inquiries by the auditor. Although the Board's reproposal builds on, and works in concert with, the approach taken in Auditing Standard No. 16, companies may need additional time or resources to conduct the new audit committee communications regarding related parties.

In addition to information and data involving costs, generally, the Board also is interested in receiving comments focusing on issues related to smaller companies and smaller audit firms. The benefits to audit quality that should result from the strengthening of auditor performance requirements for related party transactions, significant unusual transactions, and relationships and transactions with a company's executive officers, should accrue to companies of various types and natures, but they may have a differential impact on smaller companies and smaller audit firms.

For example, the Board notes that smaller companies may engage in more related party transactions, as was generally asserted by one commenter. In addition, as noted above, the Board's oversight activities in inspections and enforcement have revealed auditor failures to perform sufficient procedures regarding related party transactions, with most of these deficiencies involving smaller audit firms. Thus, smaller audit firms and their clients may incur costs to improve their existing audit approach regarding a company's relationships and transactions with its related parties. On the other hand, those firms and their clients may benefit from greater improvements in audit quality through the requirements contained in the reproposed standard and amendments. Smaller audit firms also may pass on additional costs to smaller companies in the form of increased audit fees.



The Board specifically requests commenters' views regarding the various economic considerations discussed above and is particularly interested in obtaining empirical data regarding both benefits and costs and other effects that may be related to the repropose standard and amendments. The Board also requests comments on the questions outlined below.

Questions:

21. Would improving the auditor's understanding of a company's relationships and transactions with its related parties assist the auditor in obtaining sufficient appropriate evidence necessary to support the audit opinion? Would improving the auditor's understanding promote the exercise of professional skepticism? Would improving the auditor's understanding increase the likelihood of the auditor identifying material misstatements? Are there additional benefits that the Board should consider?
22. Could the required communications with audit committees in the repropose standard result in improvements to audit committees' abilities to fulfill their duties?
23. Could the improved communications between the audit committee and the auditor lead to an improvement in the company's financial statement disclosures about its relationships and transactions with its related parties?
24. Would improving the auditor's identification and evaluation of significant unusual transactions increase the likelihood of the auditor identifying potential misstatements, including misstatements due to fraud? Would improving the auditor's identification and evaluation of significant unusual transactions promote the exercise of professional skepticism by the auditor? Are there additional benefits that the Board should consider?
25. Could the repropose amendments regarding significant unusual transactions lead to an improvement in the company's disclosures about its significant unusual transactions?
26. What benefits are associated with auditors obtaining an understanding of a company's financial relationships and transactions with its executive officers as part of its risk assessment? Are there additional benefits that the Board should consider?

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Number: 1 Author: Pw Carey, GRC App Security Analyst CISA, CISSP Compliance Partners, LLC, Barrington, IL 60010 USA
(pwc.pwcarey@gmail.com) Subject: Sticky Note Date: 7/4/2013 9:41:38 AM

Provide guidance, examples of and best practices for the following: Psychology of Fraud and the psychology of risk as they affect the Auditor....

Also, include the "Rule of Bread Crumbs"always....when conducting an audit.....



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27. What benefits are associated with the other repropoed amendments?
28. What costs will audit firms incur when implementing the repropoed standard and amendments? Please discuss both initial costs and recurring costs.
29. What costs will companies incur as a result of the implementation of the repropoed standard and amendments?
30. Could the repropoed standard and amendments lead to other changes in behavior by the auditor, the company, or the audit committee that the Board should consider?
31. Are there considerations relating to smaller companies that the Board should be aware of in considering its repropoal? Do smaller companies share the same risks of material misstatement of the financial statements regarding related party transactions and significant unusual transactions as the broader issuer population? Are related party transactions more common in smaller companies than the broader issuer population? Would the repropoed standard and amendments result in smaller companies experiencing unnecessarily greater or disproportionate costs compared to those experienced by larger companies? If so, how could such costs be controlled while improving audit quality?
32. Are there any unique considerations regarding costs for audits of brokers and dealers?
33. Are there unique considerations regarding costs for specific types of companies based on characteristics other than size of the transaction (e.g., industry)?
34. Are there additional considerations relating to competition, efficiency, and capital formation that the Board should take into account with respect to the repropoed standard and amendments? Specifically, are there benefits in lowered cost of capital from confidence in audits of issuers with related party disclosures?

D. Considerations For Audits of Emerging Growth Companies

Pursuant to Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act"), any rules adopted by the Board subsequent to April 5, 2012, do not apply to the



audits of EGCs (as defined in Section 3(a)(80) of the Exchange Act) unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."^{89/}

The Board's proposal was issued for comment prior to the enactment of the JOBS Act. The Board is reproposing the standard and amendments, in part, to obtain commenters' views regarding the applicability of its reproposal to audits of EGCs. As a result of the JOBS Act, the Board expects to provide information to assist the SEC in its determination regarding whether to apply the reproposed standard and amendments to audits of EGCs.

The Board is thus requesting that commenters provide any views or empirical data that will assist the PCAOB in providing information to the SEC regarding whether the reproposed standard and amendments should be applicable to audits of EGCs. The Board specifically requests comments, including empirical data, regarding the impact of the reproposed standard and amendments on investor protection, and whether the application of the reproposed standard and amendments would promote efficiency, competition, and capital formation. The Board also specifically requests comments that include empirical data regarding costs that are specific to the application of the reproposed standard and amendments to audits of EGCs. Specific questions are also set forth below.

The PCAOB has begun to monitor implementation of the JOBS Act in order to understand the characteristics of EGCs^{90/} and inform the Board's considerations

^{89/} Pub. L. No. 112-106 (April 5, 2012). See Section 103(a)(3)(C) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. §7213(a)(3)), as added by Section 104 of the JOBS Act.

^{90/} Pursuant to the JOBS Act, an "emerging growth company" is defined in Section 3(a)(80) of the Exchange Act. In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than \$1 billion during its most recently completed fiscal year (and its first sale of common equity securities pursuant to an effective Securities Act registration statement did not occur on or before December 8, 2011). See JOBS Act Section 101(a), (b), and (d). Once an issuer is an EGC, the entity retains its EGC status until the earliest of: (i) the first year after it has total annual gross revenue of \$1 billion or more (as indexed for inflation every five years by the SEC); (ii) the end of the fiscal year after the fifth anniversary of its first sale of common equity



regarding whether it should request that the SEC apply the standard and amendments to audits of EGCs. To assist commenters, the Board is providing the following information regarding EGCs that it has compiled from public sources.^{91/}

Characteristics of Self-Identified EGCs

As of November 15, 2012, based on the PCAOB's research, 579 SEC registrants have identified themselves as EGCs in SEC filings.

These entities operate in diverse industries. The five most common Standard Industrial Classification (SIC) codes applicable to these entities are: blank check companies; pharmaceutical preparations; prepackaged software services; real estate investment trusts; and computer processing/data preparations services.

A majority of the entities that have identified themselves as EGCs have begun reporting information under the securities laws, whether under the Securities Act or Exchange Act, since 2012. Of these entities, approximately:

- 36% identified themselves in registration statements and were not previously reporting under the Exchange Act.
- 47% of entities that have identified themselves as EGCs began reporting under the Exchange Act in 2012.

securities under an effective Securities Act registration statement; (iii) the date on which the company issues more than \$1 billion in non-convertible debt during the prior three year period; or (iv) the date on which it is deemed to be a "large accelerated filer" under the Exchange Act (generally, an entity that has been public for at least one year and has an equity float of at least \$700 million).

^{91/} To obtain data regarding EGCs, the PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and November 15, 2012, for disclosures by entities related to their EGC status. Only those entities that have voluntarily disclosed their EGC status have been identified. The PCAOB has not validated these entities' self-identification as EGCs. The information presented also does not include data for entities that have filed confidential registration statements and have not subsequently made a public filing. The PCAOB intends to update this information semi-annually.



- 17% of these entities have been reporting under the Exchange Act since 2011 or earlier.

Approximately 20% of these entities have securities listed on a U.S. national securities exchange as of November 15, 2012.

Audited financial statements were available for nearly all of the entities that have identified themselves as EGCs. For those entities for which audited financial statements were available, based on information included in the most recent audited financial statements filed as of November 15, 2012:

- The reported assets for those entities ranged from zero to approximately \$13 billion. The average and median reported assets of the entities were approximately \$122.1 million and approximately \$0.2 million, respectively.^{92/}
- The reported revenue for these entities, ranged from zero to approximately \$973.7 million. The average and median reported revenue of these entities was approximately \$53.7 million and zero, respectively.
- The average and median reported assets among these entities that reported revenue greater than zero was approximately \$257.3 million and \$42.9 million. The average and median reported revenue among these entities that reported revenue greater than zero was approximately \$109.1 million and \$16.5 million.

^{92/} For purposes of comparison, the PCAOB compared the data compiled with respect to the 579 entities with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The Russell 3000 was chosen for comparative purposes because it is intended to measure the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market (as marketed on the Russell website). The average and median reported assets of issuers in the Russell 3000 was approximately \$11.4 billion and approximately \$1.4 billion, respectively. The average and median reported revenue from the most recent audited financial statements filed as of November 15, 2012 of issuers in the Russell 3000 was approximately \$4.6 billion and \$705.5 million, respectively.



- Approximately 52% of the entities that filed audited financial statements identified themselves as "development stage entities" in their financial statements.^{93/}
- Approximately 31% were audited by firms that are annually inspected by the PCAOB (i.e., firms that have issued audit reports for more than 100 public company audit clients in a given year). Approximately 69% were audited by triennially inspected firms (i.e., firms that have issued audit reports for 100 or fewer public company audit clients in a given year).

Special Considerations Relating to Smaller Companies that are EGCs. Based on the data outlined above, EGCs generally appear to be smaller public companies. As noted above, based on the PCAOB's oversight findings, enhanced auditor consideration of related party transactions may be of particular benefit to smaller audit firms. As previously discussed, the Board's inspection program has identified deficiencies relating to the auditing of related party transactions, particularly with respect to smaller audit firms. Further, a significant number of the Board's settled disciplinary actions to date, many of which involved audits of smaller public companies, have involved auditors' failures to perform sufficient procedures regarding identified related party transactions and transactions with related parties previously undisclosed to the auditor.

Under the scaled approach of the repropoed standard and amendments, required audit procedures would vary based on each EGC's facts and circumstances. For EGCs without extensive related party relationships or transactions, the repropoed standard and amendments should not result in a significant change in audit costs. But, EGCs with extensive related party relationships or transactions would see a cost increase. The Board is sensitive to the disproportionate effects additional audit costs may have on smaller companies.

The Board also has taken note of the potential for a differential effect of its repropoal on small companies, including EGCs. Based on the Board's ongoing, but

^{93/} According to FASB guidance, development stage entities are entities devoting substantially all of their efforts to establishing a new business and for which either of the following conditions exists: (a) planned principal operations have not commenced or (b) planned principal operations have commenced, but there has been no significant revenue from operations. See FASB Accounting Standards Codification, Subtopic 915-10, Development Stage Entities – Overall.



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preliminary, analysis of EGC data, EGCs generally appear to be companies that are relatively new to the SEC reporting process. There is likely less information available to investors regarding such companies (e.g., they may have fewer audited results, fewer analysts follow them, and less press coverage).

The staff has reviewed the financial statements of certain companies that have identified themselves as EGCs and noted a significant percentage of EGCs disclose related party transactions.^{94/}

To the extent that the repropoed standard and amendments result in increased disclosure of relationships or transactions with related parties or significant unusual transactions, this information may be incrementally more valuable to both EGCs and investors in EGCs because the decrease in information asymmetry for such companies would be incrementally larger relative to other operating companies.

Further, improved disclosure of an EGC's relationships and transactions with its related parties, when entering public capital markets, could increase investor confidence in the reliability of the financial statements and, therefore, the supply of capital. Conversely, the additional audit related costs may deter certain EGCs from entering public markets, if those costs weigh heavily on their potential profitability.

To the extent that the market perceives adoption of the standard and amendments as a step towards lowering the probability of fraudulent financial reporting, exempting EGCs from the repropoed standard and amendments may put them at a competitive disadvantage as they would not derive this and the other benefits outlined above.

The Board specifically requests commenters' views regarding the various economic considerations discussed above, and is particularly interested in obtaining empirical data regarding benefits and costs and other effects that may result from the

^{94/} As previously noted, the PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012 and November 15, 2012 for disclosures by entities related to their EGC status. An analysis of 450 audited financial statements from the self-identified sample of EGCs indicates that 54 percent of the EGCs disclosed at least one related party transaction.



reproposed standard and amendments. The Board also requests comments on the questions outlined below.

Questions:

35. Should the reproposed standard and amendments be applicable for audits of EGCs? Why or why not? Please provide empirical data, examples and explanations for why the requirements should or should not be applicable for audits of EGCs.
36. Are related party transactions or significant unusual transactions more common at EGCs than the broader issuer population? Do financial relationships and transactions with executive officers at EGCs give rise to increased risks of material misstatements than the broader issuer population? Please provide any data you have to support your views.
37. Are there other characteristics of EGCs (e.g., the size of the company and the length of time it has been a reporting company) that the Board should consider?
38. Would EGCs benefit more or less from the reproposed standard and amendments than other companies? Would inherently riskier EGCs receive benefits relative to other EGCs because the market cannot observe certain undisclosed related party risks that the new standards would otherwise make available through better compliance by management with its disclosure obligations?
39. What costs would firms incur when implementing the reproposed standard and amendments for audits of EGCs? How will those costs differ from the costs for the larger issuer population? Which of the costs are initial or recurring or both?
40. Are there particular costs, benefits, or burdens applicable to EGCs that the Board should consider when determining whether to recommend to the Commission the application of the reproposed standard and amendments to audits of EGCs? For example, do EGCs share the same risk of material misstatement of the financial statements as the broader issuer population due to relationships and transactions with related parties?
41. Regardless of the applicability of the reproposed standard and amendments to audits of EGCs, would an audit firm perform the same



procedures for an audit of an EGC and an audit of a non-EGC to ensure a consistency in the training, methodology, and tools in their audit practice or to respond to risks of material misstatement with similar approaches?

42. Would the implementation and training costs that a firm would incur be dependent upon whether the standard is applicable to EGCs? Would such costs generally be fixed once required to be implemented, regardless of whether the standard is applicable to audits of EGCs?
43. For auditors of both EGCs and other SEC registrants, would it be more costly to not apply the repropoed standard and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?
44. Are there any other considerations relating to competition, efficiency, and capital formation that the Board should take into account when determining whether to recommend to the Commission the application of the repropoed standard and amendments to audits of EGCs?

V. Audits of Brokers and Dealers

As described in Section V. of the release, the Dodd-Frank Wall Street Reform and Consumer Protection Act gave the Board explicit oversight authority over audits of brokers and dealers that are required under SEC rules. In the event that the SEC directs that audits of brokers and dealers be conducted in accordance with PCAOB standards, the repropoed standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to such audits.

The Board requested comments from auditors of brokers and dealers and others on the proposed standard and amendments. Several commenters generally stated that the proposed standard and amendments are appropriate for audits of brokers and dealers.

Related Party Transactions at Brokers and Dealers: At the SAG discussion the point was raised that a robust auditing standard on related parties was important for both regulators of brokers and dealers and users of their financial statements. Several scenarios were discussed by which related party transactions might be improperly used by brokers and dealers, including to: overpay for goods or services and disguise capital withdrawals; avoid the imposition of higher capital requirements and various capital



charges; structure a broker's or dealer's business model to appear smaller; and transfer customer assets to parties that are not approved custodians.

Providing Exceptions for Audit Committee Communications: One commenter noted that many non-issuer securities broker-dealers may have no financial oversight or functional governance bodies other than the owner-managers, making audit committee communication of no practical benefit. That commenter recommended providing exceptions in these cases. The Board considered this comment and noted that the definition of "audit committee," including for audits of brokers and dealers, was established by Auditing Standard No. 16 and is not being amended by the new proposed auditing standard or the other repropoed amendments.^{95/} As discussed in the adopting release for Auditing Standard No. 16, this definition should allow the auditor to identify the appropriate persons within brokers and dealers to receive such communications. The proposed standard therefore has not been revised for this comment.

Questions:

45. Are the repropoed standard and repropoed amendments appropriate for audits of brokers and dealers? Why or why not?
46. Are there additional procedures specific to audits of brokers and dealers that should be included in the repropoed standard and repropoed amendments?
47. Should auditors of brokers and dealers be required to evaluate whether a broker's or dealer's relationships and transactions with its related parties impact that broker's or dealer's compliance with its regulatory requirements? Why or why not?
48. Should the auditor's communications to audit committees included in the repropoed 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.

^{95/} See earlier discussion of paragraph 19 of the repropoed standard in Section I.H. of this Appendix.



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VI. Effective Date

The Board anticipates that the repropoed standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2013. In developing the effective date, the Board considered the comments received regarding the anticipated effective date of the Board's proposal. The Board seeks comment regarding whether the anticipated effective date would allow sufficient time for PCAOB registered firms to incorporate the new requirements into their methodology, guidance and audit programs, and to provide training for staff.

Questions:

49. Is the Board's anticipated effective date appropriate? Why or why not?
50. Does the new proposed effective date allow sufficient time for firms to incorporate the new requirements into their methodology, guidance and audit programs, and training for staff? Why or why not?



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APPENDIX 5 – Comparison of the Objectives and Requirements of the Reproposed Standard and Amendments with the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

The Board is reproposing a new auditing standard, *Related Parties* (the "reproposed standard"); amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "reproposed amendments regarding significant unusual transactions"); and other amendments to PCAOB auditing standards (the "other reproposed amendments").^{1/} This Appendix discusses the reproposed standard in Appendix 1, the reproposed amendments regarding significant unusual transactions, in Appendix 2, and the other reproposed amendments in Appendix 3.

This appendix compares certain significant differences between the objectives and certain key requirements of the reproposed standard and amendments with the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA").

The analogous standards of the IAASB discussed in this comparison include:

- International Standard on Auditing 550, *Related Parties* ("ISA 550");
- International Standard on Auditing 210, *Agreeing the Terms of Audit Engagements* ("ISA 210");
- International Standard on Auditing 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* ("ISA 240");
- International Standard on Auditing 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* ("ISA 315");
- International Standard on Auditing 510, *Initial Audit Engagements-Opening Balances* ("ISA 510");
- International Standard on Auditing 560, *Subsequent Events* ("ISA 560");

^{1/} The reproposed amendments regarding significant unusual transactions and the other reproposed amendments are collectively referred to as the "reproposed amendments." The reproposed standard and reproposed amendments are collectively referred to as the "reproposed standard and amendments" or the "reproposal."



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- International Standard on Auditing 580, *Written Representations* ("ISA 580");
- International Standard on Auditing 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* ("ISA 600"); and
- International Standard on Review Engagements 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*, ("ISRE 2410").

The analogous standards of the ASB discussed in this comparison include:

- AU-C Section 550, *Related Parties* ("AU-C Section 550");
- AU-C Section 210, *Terms of Audit Engagements* ("AU-C Section 210");
- AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit* ("AU-C Section 240");
- AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* ("AU-C Section 315");
- AU-C Section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements* ("AU-C Section 510");
- AU-C Section 560, *Subsequent Events* ("AU-C Section 560");
- AU-C Section 580, *Written Representations* ("AU-C Section 580");
- AU-C Section 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* ("AU-C Section 600"); and
- AU-C Section 930, *Interim Financial Information* ("AU-C Section 930").^{2/}

This comparison is organized in the following sections: (I.) the repropoed auditing standard, (II.) the repropoed amendments regarding significant unusual transactions, and (III.) the other repropoed amendments to PCAOB auditing

^{2/} These AU-C Sections are contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification* ("SAS No. 122"). In October 2011, the ASB adopted SAS No. 122, which contains 39 clarified SASs with "AU-C" section numbers for each clarified SAS. The "AU-C" is a temporary identifier to avoid confusion with references to existing "AU" sections in AICPA Professional Standards. See <https://www.aicpa.org/interestareas/frc/auditattest/pages/improvingclarityasbstandards.aspx>.



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standards.^{3/} This comparison does not cover the application and explanatory material in the analogous standards of the IAASB or ASB.^{4/}

This appendix is provided for informational purposes only. It is not a summary of or substitute for the repropoed standard in Appendix 1 or the repropoed amendments in Appendices 2 and 3 of this release. This comparison may not represent the views of the IAASB or the ASB regarding the interpretations of their standards.

I. Repropoed Auditing Standard, *Related Parties* (Appendix 1)

A. Introduction (Paragraph 1 of the Repropoed Standard in Appendix 1)

PCAOB

The repropoed standard would refer auditors to the requirements of the U.S. Securities and Exchange Commission ("SEC") for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties", and the financial statement disclosure requirements with respect to related parties. The repropoed standard would not include definitions that might represent accounting guidance, including a definition for an arm's-length transaction.

IAASB

^{3/} This comparison does not cover the foundational requirements contained in the risk assessment standards. Appendix 11 of PCAOB Release No. 2010-004, *Auditing Standards Related to Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, contains a comparison of the objectives and requirements of those standards with the analogous standards of the IAASB and the ASB.

^{4/} Paragraph A59 of International Standard on Auditing 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, states that the Application and Other Explanatory Material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section."



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Paragraph 10(b) of ISA 550 defines a related party as a party that is either:

- i. A related party as defined in the applicable financial reporting framework;
or
- ii. Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - c. Another entity that is under common control with the reporting entity through having:
 - (i) Common controlling ownership;
 - (ii) Owners who are close family members; or
 - (iii) Common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

ISA 550 also defines an arm's-length transaction as a transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

ASB

AU-C Section 550 defines a related party as a related party as defined in generally accepted accounting principles. AU-C Section 550 also contains a definition of arm's-length transaction that is similar to the definition in ISA 550.

B. Objective (Paragraph 2 of the Reproposed Standard in Appendix 1)



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PCAOB

Paragraph 2 of the repropoed standard would state that the auditor's objective is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

IAASB

Paragraph 9 of ISA 550 states that the objectives of the auditor are:

- (a) Irrespective of whether the applicable financial reporting framework establishes related party requirements to obtain an understanding of related party relationships and transactions sufficient to be able:
 - i. To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
 - ii. To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:
 - a. Achieve fair presentation (for fair presentation frameworks); or
 - b. Are not misleading (for compliance frameworks); and
- (b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

ASB

AU-C Section 550 contains a similar objective to the objective in ISA 550 for fair presentation frameworks.



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C. Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 – 9 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 3 of the reproposed standard would require that the auditor 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 in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Paragraph 3 of the reproposed standard also would state that the procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company's process (paragraph 4);
- b. Performing inquiries (paragraphs 5-7); and
- c. Communicating with the audit engagement team and other auditors (paragraphs 8-9).

A note to paragraph 3 of the reproposed standard would state that 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.

Another note to paragraph 3 of the reproposed standard would state that performing the risk assessment procedures described in paragraphs 4-9 of the reproposed 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 related parties and relationships and transactions with related parties.

IAASB

Paragraph 11 of ISA 550 states that as part of the risk assessment procedures and related activities required by ISA 315 and ISA 240, the auditor shall perform the audit procedures and related activities set out in paragraphs 12-17 of ISA 550 to obtain



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information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Obtaining an Understanding of the Company's Process (Paragraph 4 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 4 of the reproposed standard would require that in conjunction with obtaining an understanding of internal control over financial reporting, the auditor obtain an understanding of the company's process for:

- a. Identifying related parties and relationships and transactions with related parties;
- b. Authorizing and approving transactions with related parties; and
- c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

IAASB

Paragraph 13 of ISA 550 requires that the auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to:

- a. Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
- b. Authorize and approve significant transactions and arrangements with related parties; and
- c. Authorize and approve significant transactions and arrangements outside the normal course of business.



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ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Performing Inquiries (Paragraphs 5 – 7 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 5 of the repropoed standard would require the auditor to inquire of management regarding:

- a. The names of the company's related parties during the period under audit, including changes from the prior period;
- b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);
- c. The nature of any relationships, including ownership structure, between the company and its related parties;
- d. The transactions entered into, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;
- e. The business purpose for entering into a transaction with a related party versus an unrelated party;
- f. 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; and
- g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

Paragraph 6 of the repropoed standard would require the auditor to inquire of others within the company regarding their knowledge of the matters in paragraph 5 of the repropoed standard. Paragraph 6 also would require the auditor to identify others within the company to whom inquiries should be directed, and determine the extent of



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such inquires, by considering whether such individuals are likely to have knowledge regarding:

- a. The company's related parties or relationships or transactions with related parties;
- b. The company's controls over relationships or transactions with related parties; and
- c. The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Paragraph 7 of the repropoed standard would require the auditor to inquire of the audit committee, or its chair, regarding:

- a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
- b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties, and, if so, the substance of those concerns.

IAASB

Paragraph 13 of ISA 550 requires the auditor to inquire of management regarding:

- a. The identity of the entity's related parties, including changes from the prior period;
- b. The nature of the relationships between the entity and these related parties; and
- c. Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.



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D. Identifying and Assessing Risks of Material Misstatement (Paragraph 10 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 10 of the reproposed standard would align with the existing requirements for the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 10 also would state that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties or relationships or transactions with related parties. Paragraph 59 of Auditing Standard No. 12 requires that the auditor identify which risks are significant risks. Further, paragraph 71 of Auditing Standard No. 12 provides factors that the auditor should evaluate in determining which risks are significant risks. Those factors include: (1) whether the risk involves significant transactions with related parties, (2) whether the risk involves significant transactions that are outside the normal course of business and (3) whether the risk is a fraud risk. The reproposed amendments regarding significant unusual transactions to AU sec. 316.85A.2 would state that a related party transaction that is also a significant unusual transaction (e.g., a significant related party transaction outside the normal course of business) is an example of a fraud risk factor.

A note to paragraph 10 of the reproposed standard would state that in identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4-9 of the proposed standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

IAASB and ASB

ISA 550 and AU-C Section 550 require that the auditor identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. ISA 550 and AU-C Section 550 require the auditor to treat identified significant related party transactions outside the normal course of business as giving rise to significant risks.



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E. Responding to the Risks of Material Misstatement (Paragraphs 11-13 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 11 of the reproposed standard would align with existing requirements that the auditor design and implement audit responses that address the identified and assessed risks of material misstatement. Paragraph 11 of the reproposed standard also would state that this includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.

A note to paragraph 11 of the reproposed standard would state that the auditor should look to the requirements of AU secs. 316.66-.67A for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). That note would further state that for such related party transactions, AU sec. 316.67 would require 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.

IAASB

Paragraph 20 of ISA 550 requires that the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21-24 of ISA 550.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk (Paragraph 12 of the Reproposed Standard in Appendix 1)



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PCAOB

Paragraph 12 of the repropoed standard would require that for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:

- a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. 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;
- c. Determine whether any exceptions to the company's established policies or procedures were granted;
- d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
- e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

A note to paragraph 12 of the repropoed standard would state that 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 in paragraph 12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

IAASB

Paragraph 23 of ISA 550 requires that for identified significant related party transactions outside the entity's normal course of business, the auditor shall:

- a. Inspect the underlying contracts or agreements, if any, and evaluate whether:



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- i. The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
 - ii. The terms of the transactions are consistent with management's explanations; and
 - iii. The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- b. Obtain audit evidence that the transactions have been appropriately authorized and approved.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

F. Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14-16 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 14 of the repropoed standard would require that the auditor evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Paragraph 14 also would require that in making that evaluation, the auditor take into account information gathered during the audit. Paragraph 14 would also require that as part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. A note to paragraph 14 of the repropoed standard would further state that Appendix A describes examples of information and sources of information that could indicate that related parties previously undisclosed to the auditor might exist.

A footnote to paragraph 14 of the repropoed standard would state that evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. That footnote would further state that this evaluation requires the auditor to perform procedures to test the accuracy and completeness of the



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related parties and relationships and transactions with related parties identified by the company.

As described in Section I.F. of Appendix 4, other PCAOB auditing standards might impose requirements relating to the sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist (e.g., reading confirmation responses and responses to inquiries of the company's lawyers).^{5/}

Paragraph 15 of the repropoed standard would require that if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Paragraph 15 also would state that those procedures should extend beyond inquiry of management.

Paragraph 16 of the repropoed standard would describe the procedures that the auditor would be required to perform if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Paragraph 16 of the repropoed standard would require that the auditor:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;

^{5/} See, e.g., AU sec. 330, *The Confirmation Process*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.



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- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of this standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;
- f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
- g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
- h. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor determines that it is likely that an illegal act has or may have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

IAASB

Paragraph 15 of ISA 550 requires the auditor to remain alert, during the audit, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. Paragraph 15 of ISA 550 further requires that, in particular, the auditor inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- (a) Bank and legal confirmations obtained as part of the auditor's procedures;
- (b) Minutes of meetings of shareholders and of those charged with governance; and
- (c) Such other records and documents as the auditor considers necessary in the circumstances of the entity.



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Paragraph 21 of ISA 550 requires that if the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships and transactions.

Paragraph 22 of ISA 550 requires that if the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

- a. Promptly communicate the relevant information to the other members of the engagement team;
- b. Where the applicable financial reporting framework establishes related party requirements;
 - (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation;
 - (ii) Inquire why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
- c. Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions;
- d. Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor and perform additional audit procedures as necessary.
- e. Evaluate the implications for the audit if the nondisclosure by management appears intentional (and, therefore, indicative of a risk of material misstatement due to fraud).

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.



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G. Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17—18 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 17 of the reproposed standard would align with the existing requirement that the auditor evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. Paragraph 17 would state that this includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.

IAASB

Paragraph 25 of ISA 550 requires that in forming an opinion on the financial statements, the auditor shall evaluate:

- a. Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- b. Whether the effects of the related party relationships and transactions:
 - (i) Prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or
 - (ii) Cause the financial statements to be misleading (for compliance frameworks).

ASB

AU-C Section 550 contains similar requirements to the requirements in ISA 550 for fair presentation frameworks.

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (Paragraph 18 of the Reproposed Standard in Appendix 1)



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PCAOB

Paragraph 18 of the repropoed standard would require that if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.

A note to paragraph 18 of the repropoed standard would further state that a preface to a statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

IAASB

Paragraph 24 of ISA 550 states that if management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

H. Communications with the Audit Committee (Paragraph 19 of the Repropoed Standard in Appendix 1)

PCAOB

Paragraph 19 of the repropoed standard would require that the auditor communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. Paragraph 19 of the repropoed standard also would require that the auditor communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;



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- b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and
- e. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

IAASB

Paragraph 27 of ISA 550 requires that the auditor communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

II. Reproposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions (Appendix 2)

A. Identifying Significant Unusual Transactions (Section A of the Reproposed Amendments in Appendix 2)

PCAOB

The repropose amendments to paragraph 56.a. of Auditing Standard No. 12 would require the auditor to inquire of management regarding whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involve related parties. The repropose amendments regarding significant unusual transactions to paragraph 56.b. of Auditing Standard No. 12 would require that the auditor inquire of the audit committee or equivalent, or its chair, regarding whether



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the company has entered into any significant unusual transactions. The repropoed amendments regarding significant unusual transactions to paragraph 56.c. of Auditing Standard No. 12 require similar inquiries of internal audit personnel.

A note to AU sec. 316.66 would state that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. That note would refer the auditor to paragraphs 14-16 of repropoed auditing standard, *Related Parties*. That note would further state that Appendix A of the proposed standard, *Related Parties*, includes examples of such information and examples of sources of such information.

IAASB and ASB

ISA 315, ISA 550, AU-C Section 315, and AU-C Section 550 do not contain similar requirements for the auditor to those in the PCAOB's repropoed amendments.

B. Evaluating Significant Unusual Transactions (Section B of the Repropoed Amendments in Appendix 2)

PCAOB

The repropoed amendments regarding significant unusual transactions would add paragraph .66A to AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. That paragraph would require the auditor to design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. AU sec. 316.66A would require that those procedures include the following:

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been appropriately authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and



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- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

The repropoed amendments to AU sec. 316.67 would require that the auditor evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. The repropoed amendments would require that, in making that evaluation, the auditor evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);
- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor;
- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company;
- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);
- 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 other, more clearly independent, parties on an arm's-length basis;
- The transaction enables the company to achieve certain financial targets;
- 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); and



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- Management has discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Further, the repropoed amendments would add paragraph 11A to Auditing Standard No. 13. That paragraph would require that because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-.67A.

The repropoed amendments to AU sec. 316.67A would require that the auditor evaluate whether significant unusual transactions identified by the auditor have been properly accounted for and disclosed in the financial statements.

IAASB

Paragraph 16 of ISA 550 requires that if the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required by paragraph 15 or through other audit procedures, the auditor shall inquire of management about:

- (a) The nature of these transactions; and
- (b) Whether related parties could be involved.

Paragraph 32(c) of ISA 240 requires the auditor to evaluate whether the business rationale (or the lack thereof) of a significant transaction outside the normal course of business suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. As discussed in Section I.E. of this Appendix, paragraph 23 of ISA 550 requires the auditor to perform certain procedures for identified significant related party transactions outside the entity's normal course of business.

ASB

AU-C Section 550 and AU-C Section 240 contain similar requirements to those in ISA 550 and ISA 240.



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III. **Other Reproposed Amendments to PCAOB Auditing Standards (Appendix 3)**

A. ***Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Appendix 3)***

PCAOB

The other reproposed amendments to paragraph 10A of Auditing Standard No. 12 would require that to assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers. The other reproposed amendments to Auditing Standard No. 12 also include a definition of executive officer that aligns with definitions used in SEC filings.

In addition, the other reproposed amendments would amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider:

- Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers, and
- Obtaining an understanding of the company's established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

IAASB and ASB

ISA 315 and AU-C Section 315 do not contain similar requirements for the auditor to those in the PCAOB's reproposed amendments.



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B. AU sec. 315, *Communications Between Predecessor and Successor Auditors* (Appendix 3)

PCAOB

The other repropoed amendments to other PCAOB Auditing Standards would amend AU sec. 315, *Communications Between Predecessor and Successor Auditors*, to require the auditor to inquire of the predecessor auditor regarding the predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions. The other repropoed amendments also would require the successor auditor to review documentation regarding related parties and significant unusual transactions.

IAASB and ASB

Neither ISA 210 and ISA 510, nor AU-C Section 210 and AU-C Section 510 contain similar requirements to those in the PCAOB's repropoed amendments.

C. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (Appendix 3)

PCAOB

The other repropoed amendments to AU sec. 316.81A would describe the auditor's responsibility, under certain conditions, to disclose possible fraud to the SEC to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change on Form 8-K and the fraud or related risk factors constitute a *reportable event* or are the source of a *disagreement*, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required pursuant to Section 10A(b) of the Exchange Act relating to an illegal act that the auditor concludes has a material effect on the financial statements.

IAASB and ASB

ISA 240 and AU-C Section 240 do not inform the auditor of certain obligations under Section 10A of the Securities Exchange Act of 1934, which is applicable to auditors of U.S. public companies registered with the PCAOB.



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D. AU sec. 333, *Management Representations* (Appendix 3)

PCAOB

The other repropoed amendments to AU sec. 333, *Management Representations*, would require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The other repropoed amendments to AU sec. 333 also would require the auditor to obtain written representation from management if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction.

IAASB and ASB

Neither ISA 580 and ISRE 2410, nor AU-C Section 580, and AU-C Section 930 contain similar requirements to those in the PCAOB's repropoed amendments.

E. AU sec. 560, *Subsequent Events* (Appendix 3)

PCAOB

The other repropoed amendments would amend paragraph .12 of AU sec. 560, *Subsequent Events*, to require that during the "subsequent period" the auditor inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:

- Whether there have been any changes in the company's related parties or significant new related party transactions, and
- Whether the company has entered into any significant unusual transactions.

IAASB and ASB

ISA 560 and AU-C Section 560 do not contain similar requirements to those in the PCAOB's repropoed amendments.



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F. AU sec. 722, *Interim Financial Information* (Appendix 3)

PCAOB

The other repropoed amendments to AU sec. 722, *Interim Financial Information*, would require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The other repropoed amendments to AU sec. 722 also would require the auditor to obtain written representations from management when management has made an assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in arm's-length transactions.

IAASB

ISA 550 and ISRE 2410 do not contain similar requirements to those in the PCAOB's repropoed amendments.

ASB

AU-C Section 550 and AU-C Section 930 do not contain similar requirements to those in the PCAOB's repropoed amendments.



The Cloud Computing Risk Intelligence Map™ provides a unique view on the pervasive, evolving, and interconnected nature of incremental risks associated with cloud computing that executives and managers may find useful in identifying risks that apply to their organizations.

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The Risk Intelligence Map is intended to serve as a guide on the journey toward Risk Intelligence by helping personnel in all functions of an organization broaden their perspective on risk and improve their ability to execute their risk-related responsibilities.

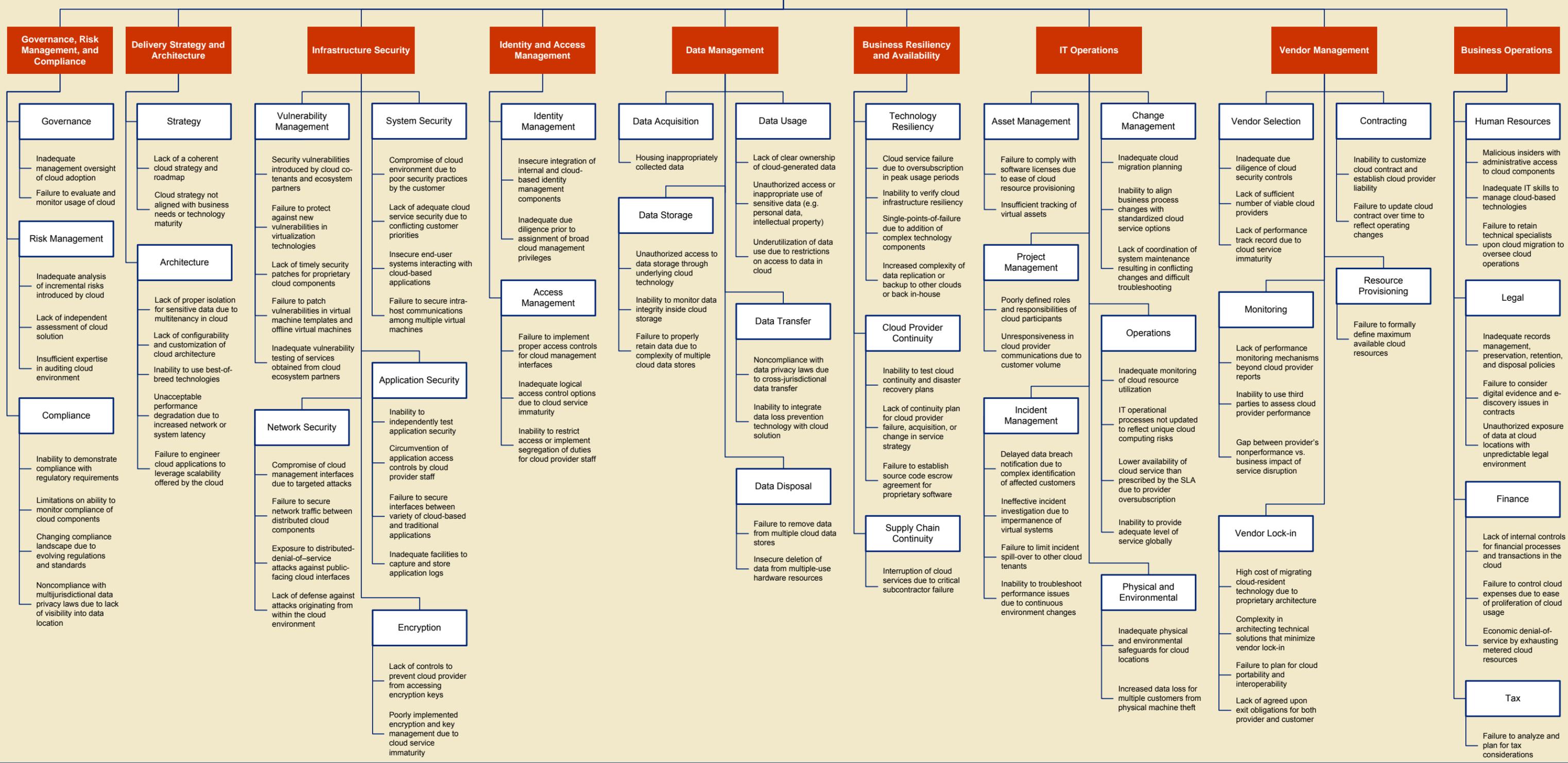
This may be accomplished by using the Risk Intelligence Map to:

- spur discussions about risk management topics, including risk identification, prioritization, measurement, and mitigation
- facilitate the connection of risk management silos
- identify redundant efforts in place to manage risk
- improve efficiency in compliance and risk management efforts
- develop risk event scenarios that require integrated responses

The Risk Intelligence Map is not a definitive or comprehensive representation of risks that may be encountered by an organization. Consider customizing the Risk Intelligence Map based on risks that impact your organization. Areas could include regulatory, geographic, industry, and company-specific issues.

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Cloud Computing Risk Intelligence Map



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 Item #7355



July 5, 2013

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

RE: Proposed Auditing Standard – *Related Parties; Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards*

PCAOB Rulemaking Docket Matter No. 038

To Whom It May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of Certified Public Accountants in Texas, as well as the public interest. The TSCPA has established a Professional Standards Committee (PSC) to represent those interests on accounting and auditing matters. The views expressed herein are written on behalf of the PSC, which has been authorized by the TSCPA Board of Directors to submit comments on matters of interest to the committee membership. The views expressed in this letter have not been approved by the TSCPA Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policy of the TSCPA.

We appreciate the opportunity to provide input into your deliberations on the above-referenced Exposure Draft (ED). Our discussion resulted in the following answers to the questions posed by the Board.

Question 1: Are the requirements of the repropoed standard appropriate? Why or why not?

Except as otherwise noted in this letter, we believe the repropoed standard is appropriate.

Question 2: Do the changes in the repropoal clarify the relationship of the repropoed standard with the risk assessment standards? Why or why not?

We believe the changes in the repropoal clarify the relationship of the repropoed standard with the risk assessment standard.

Question 3: Does the alignment of the repropoed standard with the risk assessment standards enable the auditor to introduce efficiencies in the audit approach? Why or why not?

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Although the alignment is an enhancement to the overall risk assessment process, we feel a standard that has additional requirements placed upon the auditor does not produce efficiencies in the audit process.

Question 4: Would the procedures required by the repropoed standard improve the auditor's understanding of a company's relationships and transactions with its related parties? Why or why not?

The required procedures appear to focus on the issues that would enhance an auditor's understanding of a company's relationships and transactions with related parties.

Question 5: Is the requirement in the repropoed standard to evaluate whether the company has properly identified the company's related parties and relationships and transactions with its related parties appropriate? Why or why not?

Yes, the requirement in the repropoed standard is appropriate. The repropoed standard will, in some cases, increase audit procedures through increased inquiries and testing procedures, but is more likely to provide for more complete and accurate disclosures. The repropoed standard's potential for increased communication with the audit committee could also provide another level of transparency, communication and interaction with the audit committee.

Question 6: Does the repropoed standard appropriately allow for the use of auditor judgment? Why or why not?

We do not believe the repropoed standard allows for an appropriate level of professional judgment. Although the repropoed standard appears to allow the auditor to determine to whom the inquiries will be directed and the extent of the inquiries, paragraphs 14 and 15, and specifically Appendix A, appear to require specific procedures to identify significant and unusual undisclosed related party transactions that "might" exist whether or not there is evidence leading the auditor to believe that such transactions "might" exist or not. Appendix 4 appears to indicate that the procedures outlined in Appendix A would not be considered necessary if the results of information gathered during the audit do not indicate that significant and unusual transactions with related parties exist. However, in order to follow the repropoed standard as written in paragraphs 14 and 15, it would seem to require the auditor to perform the specific procedures in Appendix A to gather such evidence. Accordingly, the auditor's judgment is limited to performing, at a minimum, the procedures outlined in 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? Are there other examples that should be included in the repropoed standard?

We do not believe the auditor's responsibilities for the examples of information and sources of information contained in Appendix A to the repropoed standard are clearly stated. While Appendix A provides a list of examples that help to identify related parties or transactions with related parties, it is not clear and appears inconsistent with the guidance in paragraphs 14 and 15 of the repropoed standard. Paragraph 14 appears to indicate the auditor's responsibility is to prove that no significant or

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unusual related party transactions exist, even when there are no indicators of such transactions. It is unclear whether the auditor is required to gather such information during the audit and prove no relationships exist or is only responsible when such information comes to the auditor's attention as a result of other procedures performed. To amplify on this point, one of the examples in Appendix A relates to "buying and selling goods or services at prices that differ significantly from prevailing market prices." The question this situation raises is: Would the auditor be responsible for obtaining the prevailing market price of goods or services bought in all situations or only when a potential disparity comes to the auditor's attention as a result of other audit procedures performed? We have no suggestions for additional examples for inclusion in Appendix A.

Question 8: Is the objective of the repropoed standard appropriate? Why or why not? Does the repropoing release clearly articulate that the objective of the repropoed standard works similarly to the objectives contained in other PCAOB auditing standards?

We believe the stated objective of the repropoed standard is appropriate and that it adequately addresses the auditor's responsibilities for addressing related party transactions. The repropoed release clearly articulates that the objective in the propoed standard is aligned with other PCAOB auditing standards, which require an auditor to obtain sufficient appropriate audit evidence to support audit conclusions that transactions are properly identified, accounted for, and disclosed in the financial statements.

Question 9: Does the requirement in the repropoed standard to perform specific procedures for each related party transaction required to be disclosed in the financial statements or determined to be a significant risk provide for a scaled approach? Why or why not?

We do not believe the repropoed standard provides for a scaled approach. The standard as propoed is prescriptive as to procedures and mandated for all transactions disclosed or deemed a significant risk providing for little scalability.

Question 10: Does the approach in the repropoed standard for the auditor to perform specific procedures for related party transactions that are required to be disclosed in the financial statements or that are determined to be a significant risk represent a cost-sensitive, yet effective, approach? Why or why not?

We do not believe the approach is necessarily cost sensitive since the document is very prescriptive as to the procedures that must be performed. There appears to be very little room for the exercise of professional judgment on the part of the auditor.

Question 11: What additional guidance, if any, regarding the auditor's responsibility for performing procedures on intercompany account balances pursuant to paragraph 13 of the repropoed standard is necessary?

We see no need for additional guidance necessary in the area of intercompany account balances.

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Question 12: Are the repropoed amendments regarding the auditor's identification of significant unusual transactions appropriate? Why or why not?

We believe the repropoed amendments regarding the auditor's identification of significant unusual transactions to be appropriate.

Question 13: Are the repropoed amendments regarding the auditor's evaluation of significant unusual transactions appropriate? Why or why not?

We are in agreement with the repropoed amendments regarding the auditor's evaluation of significant unusual transactions.

Question 14: Would the procedures required by the repropoed amendments regarding significant unusual transactions improve the auditor's identification and evaluation of a company's significant unusual transaction? Why or why not?

We believe the new required procedures will create a heightened awareness of significant unusual transactions resulting in better identification and evaluation of these transactions and the issues surrounding them.

Question 15: Are the repropoed amendments regarding significant unusual transactions appropriately aligned with the risk assessment standards? Why or why not?

We find the repropoed amendments regarding significant unusual transactions to be appropriately aligned with the risk assessment standards.

Question 16: Do the repropoed amendments regarding significant unusual transactions appropriately allow for the use of auditor judgment? Why or why not? Does the requirement that the auditor perform specific procedures for each significant unusual transaction identified by the auditor provide for a scaled approach? Why or why not?

The repropoed amendments regarding significant unusual transactions seem to allow for an appropriate amount of auditor judgment in their application. Also, the requirement that the auditor perform specific procedures for each significant unusual transaction identified does provide for an appropriately scaled approach.

Question 17: Is the complementary relationship between the amendments regarding significant unusual transactions and the repropoed standard clear? Why or why not?

We believe this complementary relationship is clearly presented in the repropoed standard.

Question 18: Are the other repropoed amendments appropriate to address risks of material misstatement of the financial statements? Why or why not?

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We have no reason to believe that the repropoed amendments would not adequately serve to address the risks of material misstatements in the financial statements.

Question 19: Is it sufficiently clear that the auditor (a) should obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment and (b) should not assess the appropriateness of executive officer compensation? Why or why not?

We believe the repropoed standard is abundantly clear about the auditor's responsibility regarding an understanding of the financial relationships and transactions between the company and its executive officers. Also, the repropoed standard is clear in its prohibition of an auditor's assessment of the appropriateness of executive officer compensation.

Question 20: Are "executive officers" the appropriate population for the audit procedures designed to provide the auditor with an understanding of the company's financial relationships and transactions as part of its risk assessment process? Why or why not?

We believe the "executive officers" of a company constitute the most logical and appropriate group to provide information to the auditor regarding an understanding of the company's financial relationships and transactions as part of its risk assessment process.

Question 21: Would improving the auditor's understanding of a company's relationships and transactions with its related parties assist the auditor in obtaining sufficient appropriate evidence necessary to support the audit opinion? Would improving the auditor's understanding promote the exercise of professional skepticism? Would improving the auditor's understanding increase the likelihood of the auditor identifying material misstatements? Are there additional benefits that the Board should consider?

A better understanding of an entity's related party transactions would always enhance the auditor's ability to obtain more reliable evidence. Regarding the exercise of professional skepticism, it would appear that a better understanding of an entity's related party transaction would make the exercise of professional skepticism more relevant and provide a better basis for a greater or lesser amount of skepticism in the performance of the audit. Also, to the extent that related party transactions are better identified, the less likelihood exists that material misstatements will not be identified.

Question 22: Could the required communications with audit committees in the repropoed standard result in improvements to audit committees' abilities to fulfill their duties?

The required communications with audit committees will enhance communications between the auditor and the audit committee members thus resulting in more relevant consideration of issues facing the company. This is a benefit that we see improving as the communication process becomes more open and candid.

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Question 23: Could the improved communications between the audit committee and the auditor lead to an improvement in the company's financial statement disclosures about its relationships and transactions with its related parties?

We believe that improved communications with audit committees can't help but enhance financial statement disclosure and a greater amount of transparency in the manner in which related party transactions are communicated to financial statement users.

Question 24: Would improving the auditor's identification and evaluation of significant unusual transactions increase the likelihood of the auditor identifying potential misstatements, including misstatements due to fraud? Would improving the auditor's identification and evaluation of significant unusual transactions promote the exercise of professional skepticism by the auditor? Are there additional benefits that the Board should consider?

Based on the fact that unusual transactions often result in an increased risk of misstatements or fraud, we believe the auditor's identification and evaluation of significant unusual transactions will increase the likelihood that auditors identify misstatements and fraud. We do not necessarily believe that improving the auditor's identification of significant unusual transactions promotes the exercise of professional skepticism. However, we believe the evaluation of the transaction, particularly the need to evaluate the business purpose (or lack thereof) may enhance the auditor's application of professional skepticism. We have no suggestions for additional benefits that should be considered by the Board.

Question 25: Could the repropoed amendments regarding significant unusual transactions lead to an improvement in the company's disclosures about its significant unusual transactions?

We believe that inquiries and procedures performed by an auditor regarding significant unusual transactions will often lead to an improvement in the disclosure of such transactions.

Question 26: What benefits are associated with auditors obtaining an understanding of a company's financial relationships and transactions with its executive officers as part of its risk assessment? Are there additional benefits that the Board should consider?

We believe that numerous benefits result when the auditor understands a company's financial relationships and transactions with its executive officers. Such benefits include the motivation of the executive officers, the ability of the executive officers to affect the outcome of the transactions, the details of the transactions to more fully assess the recording and reporting of the transactions, and a clear understanding of the risks associated with these transactions. We believe these benefits result in better risk assessment in this area and more relevant audit testing. We have no additional benefits for the Board to consider.

Question 27: What benefits are associated with the other repropoed amendments?

We have no additional benefits to suggest to the Board.

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Question 28: What costs will audit firms incur when implementing the repropoed standard and amendments? Please discuss both initial costs and recurring costs.

In implementing the repropoed standards and amendments, we foresee an audit firm incurring initial costs for staff training. Other initial costs involve incorporating changes to audit methodologies and audit programs. We would not anticipate significant recurring costs.

Question 29: What costs will companies incur as a result of the implementation of the repropoed standard and amendments?

Companies may incur initial costs in training of personnel and audit committee members. However, recurring costs of implementation would not be significant.

Question 30: Could the repropoed standard and amendments lead to other changes in behavior by the auditor, the company, or the audit committee that the Board should consider?

We are not aware of any other change in behavior of the auditor, the company, or the audit committee that needs to be considered by the Board.

Question 31: Are there considerations relating to smaller companies that the Board should be aware of in considering its repropoal? Do smaller companies share the same risk of material misstatement of the financial statements regarding related party transactions and significant unusual transactions as the broader issuer population? Are related party transactions more common in smaller companies than the broader issuer population? Would the repropoed standard and amendments result in smaller companies experiencing unnecessarily greater or disproportionate costs compared to those experienced by larger companies? If so, how could such costs be controlled while improving audit quality?

Smaller companies, we believe, pose a higher risk of material misstatement of the financial statements with respect to related party and significant unusual transactions than the broader issuer population because there are generally, as a percent of the total transactions, more of these types of transactions. In addition, accounting departments in smaller companies have fewer employees, are less sophisticated, and internal controls are weaker. However, we don't believe the costs resulting from the implementation of the repropoed standard would be unduly burdensome.

Question 32: Are there any unique considerations regarding costs for audits of brokers and dealers?

Based on our knowledge of broker and dealer audits, we are not aware of unique considerations regarding costs of implementing the repropoed standards.

Question 33: Are there unique considerations regarding costs for specific types of companies based on characteristics other than size of the transaction (e.g., industry)?

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There are no unique implementation cost considerations based on specific types of companies or industries.

Question 34: Are there additional considerations relating to competition, efficiency, and capital formation that the Board should take into account with respect to the repropoed standard and amendments? Specifically, are there benefits in lowered cost of capital from confidence in audits of issuers with related party disclosures?

We are not aware of any other issues relating to competition, efficiency, and capital formation that should be considered by the Board.

Question 35: Should the repropoed standard and amendments be applicable for audits of EGCs? Why or why not? Please provide empirical data, examples and explanations for why the requirements should or should not be applicable for audits of EGCs.

Yes, in our opinion the repropoed standard and amendments should be applicable for audits of emerging growth companies (EGCs). We believe the inherent risk of material misstatement of the financial statements relating to the topics covered by the repropoed standard is similar to, or in certain cases higher than, the inherent risk to non-EGC companies.

Question 36: Are related party transactions or significant unusual transactions more common at EGCs than the broader issuer population? Do financial relationships and transactions with executive officers at EGCs give rise to increased risks of material misstatements than the broader issuer population? Please provide any data you have to support your views.

Relative to total transactions for EGCs, we feel that there is a high probability that related party transactions or significant unusual transactions are more common in EGCs than in the broader issuer population. With respect to financial relationships and transactions with executive officers at EGCs, we believe the greater amount of control and influence exerted by officers in smaller organizations results in a greater amount of risk of material misstatement than in the broader issuer population.

Question 37: Are there other characteristics of EGCs (e.g., the size of the company and the length of time it has been a reporting company) that the Board should consider?

The one characteristic we believe the Board should consider is the likelihood of more pervasive overlap of the Board of Directors and management in EGCs.

Question 38: Would EGCs benefit more or less from the repropoed standard and amendments than other companies? Would inherently riskier EGCs receive benefits relative to other EGCs because the market cannot observe certain undisclosed related party risks that the new standards would otherwise make available through better compliance by management with its disclosure obligations?

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In general, we believe the benefits will be similar between EGCs and other companies. However, we do see a possibility for more benefits to EGCs in those EGCs where related party and unusual transactions are more prevalent or represent a greater percentage of total transactions.

Question 39: What costs would firms incur when implementing the repropoed standard and amendments for audits of EGCs? How will those costs differ from the costs for the larger issuer population? Which of the costs are initial or recurring or both?

Other than implementation costs of complying with the new standard, we don't see any significant increases in other costs.

Question 40: Are there particular costs, benefits, or burdens applicable to EGCs that the Board should consider when determining whether to recommend to the Commission the application of the repropoed standard and amendments to audits of EGCs? For example, do EGCs share the same risk of material misstatement of the financial statements as the broader issuer population due to relationships and transactions with related parties?

Beyond the discussions currently included in the repropoed standard, we are not aware of any particular costs, benefits or burdens applicable to EGCs that the Board should consider. We believe the risks of material misstatement for EGCs in the areas of related party and unusual transactions are consistent with the broader issuer population. A slight potential for a higher risk of material misstatements for EGCs might result from maintaining a less comprehensive set of internal controls. This, of course, is due to the generally smaller size of the entity. If EGCs are required to implement additional internal controls, then increased costs could occur. However, we believe any cost increase in this area would be offset by the potential benefits of the added controls.

Question 41: Regardless of the applicability of the repropoed standard and amendments to audits of EGCs, would an audit firm perform the same procedures for an audit of an EGC and an audit of a non-EGC to ensure a consistency in the training, methodology, and tools in their audit practice or to respond to risks of material misstatement with similar approaches?

We believe the procedure would be substantially the same. The only difference might be the extent of such procedures due to the relative size of the entities involved.

Question 42: Would the implementation and training costs that a firm would incur be dependent upon whether the standard is applicable to EGCs? Would such costs generally be fixed once required to be implemented, regardless of whether the standard is applicable to audits of EGCs?

We believe in a vast majority of the cases, the implementation and training costs that a firm would incur would not depend on whether the standard is applicable to EGCs. Once a firm has implemented training for non-EGCs, there should be little or no additional costs to apply the guidance in the standard to EGCs. The training costs are primarily fixed costs.

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Question 43: For audits of both EGCs and other SEC registrants, would it be more costly to not apply the repropoed standard and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?

We believe it would be more costly.

Question 44: Are there any other considerations relating to competition, efficiency, and capital formation that the Board should take into account when determining whether to recommend to the Commission the application of the repropoed standard and amendments to audits of EGCs?

We are unaware of any other considerations that the Board should examine in this area. We believe Appendix 4, Part IV provides sufficient discussion of the considerations relating to EGCs.

Question 45: Are the repropoed standard and repropoed amendments appropriate for audits of brokers and dealers? Why or why not?

We believe the repropoed standard and repropoed amendments for audits of brokers and dealers are appropriate.

Question 46: Are there additional procedures specific to audits of brokers and dealers that should be included in the repropoed standard and repropoed amendments?

We have no suggestions regarding additional procedures specific to audits of brokers and dealers that should be included in the repropoed standard and repropoed amendments.

Question 47: Should auditors of brokers and dealers be required to evaluate whether a broker's or dealer's relationships and transactions with its related parties impact that broker's or dealer's compliance with its regulatory requirements? Why or why not?

We are in agreement with the requirement for auditors to evaluate whether a broker's or dealer's relationships and transactions with its related parties impact that broker's or dealer's compliance with its regulatory requirements.

Question 48: Should the auditor's communications to audit committees included in the repropoed 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.

We believe an auditor's communications to audit committees included in the repropoed standard should be applicable to audits of brokers and dealers.

Question 49: Is the Board's anticipated effective date appropriate? Why or why not?

See answer to Question 50.

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Question 50: Does the new proposed effective date allow sufficient time for firms to incorporate the new requirements into their methodology, guidance and audit programs, and training staff? Why or why not?

We believe that the effective date is appropriate and will allow sufficient time for firms to incorporate the new requirements into their methodologies, guidance, audit programs, and staff training provided the final standard is issued prior to September 30, 2013. Issuing the final standard later than that date will serve as a hardship on firms transitioning to the new requirements.

We appreciate the opportunity to provide input into the standard-setting process.

Sincerely,

A handwritten signature in cursive script that reads "Sandra K. Brown".

Sandra K. Brown, CPA
Chair, Professional Standards Committee
Texas Society of Certified Public Accountants



CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

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July 8, 2013

Ms. Phoebe W. Brown
 Secretary
 Public Company Accounting Oversight Board
 1666 K Street, N.W.
 Washington, DC 20006-2803

Re: PCAOB Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards (PCAOB Release No. 2013-004, May 7, 2013, and PCAOB Rulemaking Docket Matter No. 038)

Dear Ms. Brown:

The U.S. Chamber of Commerce (the “Chamber”) is the world’s largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information. The Chamber created the Center for Capital Markets Competitiveness (“CCMC”) to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy. The CCMC believes that businesses must have a strong system of internal controls and recognizes the vital role external audits play in capital formation. The CCMC supports efforts to improve audit effectiveness and appreciates the opportunity to comment on the Public Company Accounting Oversight Board (“PCAOB”) *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (“the Proposal”).

We commend the PCAOB’s consideration of the comments on the February 2012 exposure draft and taking action to addressing some of those issues. However, not all of our concerns are fully addressed in the Proposal and we have attached our

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previous comment letter to reiterate these issues for the record. Additionally, this letter will further elaborate our concerns regarding the Proposal.

Discussion

The Proposal is the second time the PCAOB has released for comment a proposed auditing standard on related parties and proposed amendments on auditing significant unusual transactions and financial relationships and transactions with executive officers. The PCAOB received 37 comment letters on the initial exposure draft issued in February 2012. The CCMC provided comments on the initial exposure draft.¹

I. Cost Benefit Analysis

The PCAOB's February 2012 exposure draft did not contain a cost-benefit analysis. Thus, the CCMC's letter of May 30, 2012 noted:

[T]hat commenters are therefore unable to ascertain what the estimated costs are and the burdens that will be placed upon businesses and auditors as a result of the Proposal. This inhibits the ability of commenters to provide the PCAOB with a fully informed analysis that could lead to beneficial changes in the Proposal.

The Proposal recognizes that the 2012 Jumpstart Our Business Startups Act (JOBS) now makes economic analysis a necessary pre-condition for applying new PCAOB auditing standards to an audit of any emerging growth company (EGC). Specifically, JOBS Section 103(a) (3) requires that rules adopted by the Board after the date of enactment of JOBS shall not apply to an audit of any EGC, unless the Commission determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation.

¹ See the May 30, 2012 letter from the United States Chamber of Commerce Center for Capital Markets Competitiveness on the PCAOB *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (PCAOB Release No. 2012-001, February 28, 2012 and PCAOB Rulemaking Docket Matter No. 038).

Ms. Phoebe W. Brown
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The CCMC recognizes that one reason the PCAOB issued this second exposure draft is to solicit information on the estimated costs and burdens that will be placed upon businesses and auditors as a result of the Proposal, and to solicit other information on how the Proposal would contribute to investor protection and promote efficiency, competition, and capital formation. For example, of the 50 questions included in the Proposal on which the Board requests comments, at least 24 relate to economic considerations, including audits of EGCs.

Further, the CCMC recognizes that the Proposal does not represent a final standard. Thus, additional evidence and analysis will need to be collected and analyzed any ensuing standard adopted by the Board and submitted for approval by the Securities and Exchange Commission (“SEC”).

Nonetheless, given the information available in the Proposal, in particular information in Section IV on “Economic Considerations, Including Audits of Emerging Growth Companies,”² the CCMC has concerns about elements of the PCAOB’s approach to economic analysis and the nature and substance of that analysis.

The Proposal includes a number of assertions as part of the PCAOB’s economic analysis.³

² See page A4-96 through A4-117 in the Proposal.

³ As an example, the following assertions can be found on pages A4-96, A4-97, A4-99 and A4-104 of the Proposal:

- The proposed auditing requirements *have the potential* to enhance audit quality in ways that could also enhance the quality of a company’s financial reporting and, therefore, they *could*:
 - Reduce information asymmetry between companies and investors because they *may*
 - improve the auditor’s identification and assessment of risks of material misstatement of financial statements and response to those risks, which *may* lead to higher quality accounting and disclosures for investors
 - result in a more meaningful exchange of information between the auditor and a company’s audit committee
 - Reduce the cost of capital for issuers
- The Proposal reflects a risk-based and scaled approach because the audit procedures performed and, therefore, the associated costs are commensurate with the risks of material misstatement
 - Thus, companies *without* extensive relationships or transactions with related parties, significant unusual transactions, or financial relationships and transactions with the company’s executive officers would not be expected to incur a significant change in audit costs
- The Proposal is necessary to align PCAOB auditing standards on transactions and relationships with related parties, significant unusual transactions, and relationships and transactions with executive officers with the PCAOB’s suite of risk assessment standards (AS 8 through AS 15)
- Other auditing standards-setters have revised their requirements on related parties, for example:
 - The International Auditing and Assurance Standards Board (“IAASB”) issued a revised standard in July 2008
 - The Auditing Standards Board (“ASB”) issued a revised standard in October 2011

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 July 8, 2013
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Many of these assertions are generic or speculative and are not linked to the elements of the Proposal. In fact, they could be made for almost any proposed auditing standard regardless of topic or substance. It appears to the CCMC, therefore, that the Proposal fails to explicitly articulate any appropriate economic baseline against which to measure the proposed requirements likely economic impact.

The CCMC appreciates that the Proposal does attempt to reference various types of evidence as support for revising audit standards, but fails to provide specifics for how it relates to the Proposal itself.⁴

The Proposal states that the PCAOB determined 579 SEC registrants have identified themselves as EGCs as of November 15, 2012. This number is up from the 196 EGCs noted in the PCAOB's economic analysis for AS No. 16, *Communications with Audit Committees*, sent to the Commission on August 28, 2012. The Proposal provides some general descriptive data about EGC's, which reveal that EGCs are a diverse group and generally appear to be companies new to the SEC reporting process.⁵ Based on these data, the Proposal briefly suggests qualitative-type conjectures related to information asymmetry, investor confidence, competition, and costs. However, the Proposal contains no substantive analysis of the economic impact of the proposed requirements on EGCs, EGCs vis-à-vis other companies, or

⁴ For example see the following that can be found at page 5, A4-96, A4-98, A4-99, A4-114, of the Proposal:

- An analysis of alleged audit failures from 1997-2003 by the Quality Control Inquiry Committee largely involves cases before The Sarbanes-Oxley Act of 2002 ("SOX") and before a number of other legislative, regulatory, and standard-setting actions over the last decade.
- General references to instances of fraudulent financial reporting involving related party transactions, significant transactions outside the normal course of business, and transactions and relationships with executives include cases prior to SOX and prior to the promulgation of revised auditing standards such as Statement of Auditing Standard No. 99 on *Consideration of Fraud in a Financial Statement Audit* (December 15, 2002).
- References to two PCAOB 4010 reports on inspection results from 2004-2006 and 2007-2010 for tri-annually inspected audit firms issued February 25, 2013 and October 22, 2007, respectively, report that inspection deficiencies involved related parties, but the Proposal
 - Does *not* provide any specificity about the number of instances;
 - Does *not* discuss any root cause analysis in order
 - To rule out that the observed deficiencies related to problems with auditor performance;
 - To provide support that the observed deficiencies related to gaps in auditing standards and the proposed requirements would address these identified deficiencies.
- Settled SEC enforcement actions and PCAOB disciplinary actions to date which, by their very nature, would seem to indicate auditor performance problems rather than gaps in auditing standards.

⁵ See pages A4-112 through A4-115 in the Proposal. The Proposal also reports that a review of 450 audited financial statements from a self-identified sample of EGCs indicates that 54 percent disclosed at least one related party transaction (see footnote 94 on page A4-115 in the Proposal)

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companies generally, although the CCMC appreciates that the Proposal does request commenters views and empirical evidence on these issues.⁶

Finally, the Proposal does not adequately address potential alternatives to the proposed requirements. The CCMC appreciates that the Board issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010) (“Staff Alert”) before deciding to issue its initial proposal. However, the Proposal fails to discuss or provide evidence on why this Staff Alert was inadequate.

As another example of the lack of evidence on the consideration of potential alternatives, the PCAOB provides a comparison of significant differences among the objectives and requirements of this Proposal versus other analogous standards of the IAASB and ASB.⁷ However, this comparison contains no analysis of or rationale for why the PCAOB chose not to converge the proposed auditing requirements with those of the IAASB and ASB. As a result, the Proposal adds to audit complexity and raises doubt that the proposed requirements would be cost/benefit effective.

II. CCMC Recommendation

The CCMC appreciates that the PCAOB faces challenges in doing economic analysis for auditing standards. However, the concerns just discussed suggest that all stakeholders would be well served if the PCAOB would reconsider its approach to economic analysis.

The CCMC suggests that the PCAOB needs an appropriate and transparent framework for economic analysis—one that will serve as a template for such analysis across all PCAOB rulemaking initiatives. One example of such a framework is the SEC staff memorandum, “Current Guidance on Economic Analysis in SEC Rulemakings” dated March 16, 2012.

Thus, the CCMC recommends that the PCAOB develop guidance on economic analysis for PCAOB rulemaking. Once developed, the PCAOB should expose the framework for public comment and the finalized framework should be

⁶ See page A4-115 in the Proposal.

⁷ See Appendix 5 in the Proposal.

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publicly disclosed. As a starting point, the PCAOB could consider adapting the framework in the SEC staff memorandum to an audit context.

III. Other Matters

Similar to the prior exposure draft, the Proposal includes proposed amendments to existing PCAOB auditing standards that would add requirements for auditors to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers, including executive compensation. The intent of this added requirement is to assist the auditor in identifying and assessing risks of material misstatement—not to call into question the policies and procedures of the company. However, the CCMC previously expressed concern that media coverage of the proposed amendments indicated that the PCAOB's intent was not well understood and that an expectation gap was being created.

We appreciate that the PCAOB acknowledged this problem and revised the wording of the proposed amendment to paragraph 10A of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. This revision partially reflects wording suggested in our previous comment letter. Notwithstanding this revision, we continue to recommend that the PCAOB include more expansive language in the standard itself to provide clarity on intent and to avoid problems down the road. The language recommended in our prior letter, including a statement that “these audit procedures are not intended to call into question the policies and procedures of the company ...,” could be added as a note to paragraph 10A.

Finally, the Proposal now states that the Board anticipates the proposed standard and proposed amendments would be effective for audits of financial statements for fiscal years beginning on or after December 15, 2013. This proposed effective date is not unreasonable as long as the PCAOB adopts and the SEC approves a final standard before the end of 2013.

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Conclusion

Once again, the CCMC appreciates the opportunity to comment on the Proposal. Thank you for your consideration and the CCMC stands ready to assist in these efforts.

Sincerely,

A handwritten signature in black ink, appearing to read 'TK' followed by a long horizontal flourish.

Tom Quadman

ROBERT N. WAXMAN, CPA
866 UNITED NATIONS PLAZA, FL 4
NEW YORK, NY 10017

July 8, 2013

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

comments@pcaobus.org

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 TransactionsSection AAuditing Standard No. 5: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial StatementsParagraph 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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NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on May 15, 2013 that relates to Related Parties/Significant Unusual Transactions. The other topics discussed during the May 15, 2013 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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STANDING ADVISORY GROUP

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MEETING

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WEDNESDAY
MAY 15, 2013

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The Standing Advisory Group convened at the Westin City Center Hotel, located at 1400 M Street, Northwest, Washington, D.C. at 8:30 a.m., Martin Baumann, Standing Advisory Group Chairman, presiding.

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14 MR. SCATES: Thank you, Marty. As Brian Degano
15 and Nick Grillo are joining me, I'll first introduce
16 this.

17 As Chairman Doty said in his remarks, the Board
18 repropose for comment a new standard on related parties.
19 There's three elements here. First, the standard itself
20 would replace the existing standard AU Section 334. The
21 second part is amendments. We're repropose amendments
22 with respect to the auditor's identification and

1 evaluation of significant unusual transactions. In the
2 third element are other amendments to existing standards
3 of the PCAOB. And one of those items has to do with
4 respect to the auditor's assessment of a company's
5 relationships and transactions with its executive
6 officers.

7 As a backdrop here, the standard itself, the
8 original proposal went out on February 28th of 2012. It
9 was also discussed, you might recall, at last year's SAG
10 meeting in May.

11 We received 37 comment letters. And the Board
12 repropoed this standard and these amendments for two
13 principal reasons: One being we did -- like I said, we
14 received comments on the original proposal. Generally
15 the commenters were in agreement with our approach,
16 however, they did have some good recommendations. We
17 listened. And for example, some of the commenters said
18 that the auditors are not responsible for identifying
19 related parties. We agree. That is first and foremost
20 with the company, with management. Management is
21 required to identify the related parties, all
22 transactions and relationships with those related

1 parties. We believe the auditor's responsibility is to
2 evaluate the company's identification, the accounting for
3 and disclosure of those transactions. So it's the
4 auditor's responsibility to evaluate what management has
5 done.

6 The second reason we repropose it is, as Marty
7 mentioned earlier in his remarks, this original proposal
8 out on February 28th, but that was prior to the enactment
9 of the JOBS Act. So in this reproposal we are now
10 seeking comment specifically with respect to empirical
11 data and other information that will help us and assist
12 us in making a decision as we go forward. We want to get
13 information on economic considerations and information
14 about the applicability of this reproposal with respect
15 to emerging growth companies.

16 The comment period ends on July
17 8th. And what I'd like to do now is to turn it over to
18 Brian Degano and he will go over a few aspects with
19 respect to the related party standard and the amendments
20 with respect to significant unusual transactions. Brian?

21 MR. BAUMANN: Before Brian speaks I just want to
22 make one comment just to make sure that what you said

1 isn't misunderstood.

2 The original proposal, the way it was drafted put
3 a sort of burden that it was the auditor's responsibility
4 to identify related party transactions without really
5 acknowledging management's primary responsibility that
6 they have to do that.

7 Having said that, the auditor still has a
8 responsibility to evaluate management's identification
9 of related parties and determine whether there are any
10 unidentified related parties or related party
11 transactions. So there are still significant auditor
12 responsibilities in this audit standard in that regard.

13 Brian?

14 MR. DEGANO: The repropoed standard is designed
15 to strengthen existing audit procedures for identifying,
16 assessing and responding to the risk and material
17 misstatements associated with a company's related party
18 transactions. And some of the key requirements in the
19 repropoed standard are that the auditor will be required
20 to perform procedures, to obtain an understanding of the
21 company's relationships and transactions with its related
22 parties, perform specific procedures for each related

1 party transaction that's either required to be disclosed
2 in the financial statements or that is determined to be
3 a significant risk, perform specific procedures when the
4 auditor determines that a related party or relationship
5 or transaction with a related party previously
6 undisclosed to the auditor exists. We've already talked
7 about one of the next ones, evaluating whether the
8 company has properly identified its related parties and
9 relationships and transactions with related parties. And
10 lastly, communicating to the audit committee the
11 auditor's evaluation of the company's identification of
12 accounting for and disclosure of its relationships and
13 transactions with its related parties.

14 And as Greg mentioned, we made several change to
15 the repropoed standard, and those include clarifying the
16 relationships with the risk assessment standards. So
17 commenters had requested clarification of this and the
18 new standard clarifies that the specific risk assessment
19 procedures performed pursuant to the repropoed standard
20 are done in conjunction with the risk assessment
21 procedures required by Auditing Standard No. 12.

22 Second, clarifying the auditor's responsibility

1 to evaluate if the company has properly identified its
2 related parties. And commenters wanted some
3 clarification on this. And as has been pointed out, in
4 the staff's view the clarifications recognize that the
5 company is responsible for the preparation of the
6 financial statements, including in the first instance the
7 identification of the company's related parties. And the
8 auditor begins the audit with all the information that
9 they obtain from management.

10 A third area where we made some changes from the
11 originally proposed standard is allowing additional
12 auditor judgment. And one example of that is that the
13 repropose standard no longer includes a requirement that
14 the auditor treat each previously undisclosed related
15 party transaction identified by the auditor as a
16 significant risk.

17 As Greg mentioned, there's also repropose
18 amendments regarding significant unusual transactions,
19 and those repropose amendments are designed to improve
20 the auditor's identification and evaluation of a
21 company's significant unusual transactions. And I won't
22 go through all of these, but some of the key requirements

1 are that the auditor be required to perform specific
2 procedures to identify a company's significant unusual
3 transactions, perform specific procedures to obtain an
4 understanding of the business purpose of those identified
5 significant unusual transactions, and then some other
6 procedures to enhance the auditor's evaluation of the
7 business purpose of those identified significant unusual
8 transactions.

9 And the key changes made in this part of the
10 proposal were to enhance the linkage between the
11 repropoed standard and the repropoed amendments to
12 better show the complementary nature of the auditor's
13 efforts regarding its work on a company's significant
14 unusual transactions and a company's related parties.
15 So for example, the repropoed standard includes a
16 footnote which notes to the auditor that the information
17 obtained in identifying and evaluating a company's
18 significant unusual transactions could identify
19 information that indicates that undisclosed related
20 parties might exist. So we've tried to improve the
21 linkage between those areas.

22 I'll turn it back over to Greg for the other

1 repropoed amendments.

2 MR. SCATES: The last item has to do with the
3 other amendments we're repropoing. What I wanted to
4 focus on has to do with respect to the auditors'
5 understanding or risk when they perform their risk
6 assessment procedures. They need to gain an
7 understanding of the risk associated with the executive
8 officers' relationship with the company. That would be
9 all relationships including compensation arrangements
10 with the company. The executive officers are related
11 parties, so this repropoal complements the repropoal
12 on the related party standard.

13 And when we first went out with the original
14 propoal back in February of 2012, we were somewhat
15 surprised when we got the comments in. We were expecting
16 to get a significant amount, you know, a number of
17 comments on related parties and significant unusual
18 transactions. And we did, but unfortunately there were
19 some that were -- the press misread what we were
20 propoing and that we wanted to -- we did clarify in this
21 repropoal the auditor is not going to opine, the auditor
22 is not going to make any type of determination or any

1 recommendation with respect to compensation arrangements.
2 That clearly resides with the board of directors of the
3 appropriate company. So we did clarify that in this
4 reproposal.

5 We thought it was clear before, but we went back
6 and put the pen to paper and made it even a little more
7 clear, that the auditor's responsibility here is, with
8 respect to its risk assessment process, to ensure that
9 their audit procedures address any heightened risk with
10 respect to the executive officers' relationships with the
11 company.

12 Now what I'd like to do is to open it up for a
13 SAG discussion similar to what we did with respect to the
14 proposal on reorganization of our standards. Any
15 comments that we make will be a part of our rulemaking
16 docket, but we'd like to have an opportunity now for you
17 to -- if you have any comments or any questions, please
18 raise your tent cards.

19 Denny Beresford?

20 MR. BERESFORD: Thanks. I'd like to comment on
21 the communications with the audit committee, and I guess
22 going in both directions. First of all, the point that

1 was made on one of the slides about the requirement to
2 communicate to the audit committee, the auditor's
3 evaluation of the identification and so forth, again, I
4 think that's well-intentioned, but it simply adds to the
5 normal communications that would be under -- I guess it
6 is Auditing Standard 16. One of my comments on what led
7 up to that document was that this is becoming somewhat
8 of a boiler plate communication that just has an awful
9 lot of content that sometimes doesn't get a lot of
10 attention because there's just so much of it. Depending
11 on the particular company, assuming that this would be
12 in writing, I believe that the document -- I didn't see
13 in the 200 pages that it said it had to be in writing.
14 Maybe I missed that, but --

15 MR. BAUMANN: It can be oral.

16 MR. BERESFORD: Pardon me?

17 MR. BAUMANN: It can be oral.

18 MR. BERESFORD: Okay. But I assume that probably
19 because of inspections or otherwise that most auditors
20 would probably put this in writing, and depending on the
21 company, it could be a lot of pages. It could be quite
22 a bit of information that could be in here. And frankly,

1 it's not a lot of information that I think that would be
2 critically important to most audit committees. I think
3 that some parts of it might be informative to the extent
4 that it would otherwise be disclosed in the financial
5 statements. Obviously that would be important. Other
6 information may or may not be too important.

7 The other requirement that the auditor asks the
8 audit committee or the chairman whether they are aware
9 of related party transactions, I suspect the common
10 response would be something like, gee, I thought that was
11 your responsibility to go out and find those during your
12 audit or ask management for that. I'm being a little
13 facetious, but the audit committee chair would probably
14 have some very general knowledge, and clearly if they
15 were aware of something at kind of a high level, they
16 could respond, much the same as they would respond to the
17 requirement on fraud. I mean the typical response is,
18 gee, again, if there's something huge that had hit the
19 company, they'd respond, but they're not aware of kind
20 of the day-to-day small-type things.

21 And so again, I think both of these things are
22 things that are requirements that aren't going to

1 necessarily create a lot of activity, I guess you might
2 say. And I do get concerned that perhaps in the interest
3 of improving or getting the audit committee involved with
4 the auditor that we not have -- you know, might say every
5 new standard involves still one more communication being
6 added to the list that creates even more of a boiler
7 plate communication that doesn't get paid attention to.

8 MR. BAUMANN: Thanks. Greg, you may have further
9 comments.

10 And, Denny, I appreciate your comments and
11 concerns.

12 We think this is an area that is an important
13 dialogue between the auditor and the audit committee.
14 Some of the most prominent frauds over the last decade
15 have involved transactions with related parties that in
16 some cases were disclosed in footnotes, but clearly it
17 seemed neither the auditor nor the audit committee -- or
18 certainly the investors at the end of the day who lost
19 a lot of money didn't really understand what would happen
20 in certain circumstances with respect to these related
21 party transactions and how significant the impact was.
22 Enron being a poster child for that, but Tyco and many

1 others are well known.

2 So we think that discussion of evaluation of the
3 related party transactions, the risks there, certainly
4 the auditor can evaluate. Some of them are normal
5 transactions and they didn't present any difficulty, but
6 when there are unusual relationships that cause a
7 potential transfer of cash or shares between the company
8 and the related party under adverse circumstances, the
9 complexity of those transactions, I think the audit
10 committee would benefit from that dialogue.

11 So we've put it out in the reproposal for
12 comment. I think we had it in the proposal actually for
13 comment. I don't think we got many negative comments on
14 that aspect of it, but again we appreciate those
15 comments.

16 Someone else?

17 MR. SCATES: Loretta Cangialosi?

18 MS. CANGIALOSI: Thank you. Just two comments,
19 one on what Denny just said.

20 I would say, you know, I appreciate what you're
21 trying to do, and it makes a lot of sense because, as you
22 just stated, for significant and complex transactions you

1 definitely would want the audit committee to know. But
2 for standard stuff that really does not have a
3 significant impact or a company that does not have
4 significant related party transactions, just to have this
5 in there seems like you're just kind of tossing in
6 something that doesn't necessarily add a lot of value.
7 So that was just one comment.

8 My second comment really has to do with the
9 significant unusual transactions. And again, here I
10 support, you know, kind of the whole evaluation,
11 obviously, of what we're trying to do. What I would say
12 is just be careful of the knock-on effects in the
13 inspection process when we look at significant unusual
14 transactions because there are complex and significant
15 transactions that you know you really want to pay
16 attention to. Actually you want to pay attention to all
17 of them, but some of them are very obvious. Okay?
18 Company decides to sell a bunch of products. You know,
19 what's the business purpose? Well, it's pretty obvious.

20 So I think, you know, when this comes off in
21 practice, trying to not have heavy documentation around
22 the obvious versus clearly what you want them to get into

1 around these significant unusual transactions, which are
2 complex things that don't quite make sense, you
3 definitely want them to get into. So that would be my
4 only caution there.

5 MR. SCATES: Thank you, Loretta.

6 And, Gaylen Hansen?

7 MR. HANSEN: Previously unidentified related
8 parties is what I wanted to ask about. So in the
9 original proposal then those were identified as
10 significant deficiencies and additional work was going
11 to be required. And it seems like we've come out of that
12 based on the comments, so I'm not sure what the standard
13 is saying on previously unidentified related parties.
14 It seems to me like something should be required. And
15 I'm not reading on that anything in here that that gets
16 picked up. Is it judgment only then in those
17 circumstances? So that was one question that I had, if
18 you'd maybe comment on.

19 And the other one is on compensation
20 arrangements. It seems to me that -- and I'm all for
21 where you're going on this with executive officers,
22 especially bonus sorts of arrangements that are tied into

1 earnings, but it seems to me like some of that, isn't it
2 already picked up in AU-316 or SAS 99 considerations?
3 So I don't know if it's just the linkage, or are we
4 trying to write parallel with AU-316?

5 MR. SCATES: I'll take the last one first,
6 Gaylen. AU-316 does not specifically address on point
7 the issue here, and the issue here is, we believe, in
8 order to carry out an appropriate risk assessment process
9 early on in the audit the auditor needs to gain a good
10 understanding, a thorough understanding of the
11 relationships that its executive officers -- and again,
12 it's that population of executive officers -- those
13 relationships with the company. The auditor needs to be
14 aware of all of the relationships, and not just the
15 compensation arrangements, any relationship the officer
16 has with the company. That way the auditor can
17 appropriately assess the risk and then carry out and plan
18 his or her audit accordingly once they've made that
19 assessment. That's not really brought out in 316, but
20 now we want to bring it out through amendments to AS-12.
21 And I think that would be appropriate. And we think it's
22 appropriate to do that.

1 Your first question though, Gaylen, I'm not sure
2 -- you were talking about the unidentified related
3 parties?

4 MR. HANSEN: Previously unidentified related
5 parties that I gather you at some point pick up on that
6 hadn't been disclosed to you by management and have some
7 concerns about those and have to dive into it. But now
8 you don't?

9 MR. SCATES: Yes. Well, those were brought out
10 in the standard, in the reproposal. And that once if an
11 auditor comes across and identifies a new related party
12 or a new relationship that the auditor's not aware of,
13 then that is obviously a serious concern to the auditor
14 and then the auditor is going to have to reassess the
15 risk associated with that. And also the auditor is going
16 to then have to obviously bring that to the attention of
17 the audit committee, because that is a serious concern
18 in that the auditor was never made aware of it. And so
19 there is a breakdown within the controls of the company.
20 And if the management's not aware of it, or if they were,
21 why did they not disclose it to the auditor? So there
22 are some very serious concerns there. And we

1 specifically pointed that out and made that a part of
2 this reproposed standard.

3 MR. HANSEN: If I might follow up then. One
4 other thing that I noticed in going through these
5 materials is circulating a list of related parties to the
6 engagement team. It doesn't say when. And I think it
7 would be strengthened a little bit if that was done early
8 in the engagement during risk assessment. You know, if
9 you become aware of it at the end of the audit, I mean
10 it may not be worth as much as if it came out earlier.

11 MR. SCATES: We agree with you on that, Gaylen.
12 We anticipate it would be earlier. That's a good point.
13 We may have to clarify that, that we expect that to be
14 early on in the risk assessment process.

15 Damon Silvers?

16 MR. SILVERS: I just want to speak in general in
17 strong support of what you're doing here. You know, it
18 was mentioned a couple of moments ago that unusual
19 related party transactions were very significant in the
20 collapse of a number of large-cap firms 12 years ago.
21 There are some more recent examples, starting with Lehman
22 Brothers, where these issues were very consequential.

1 And I think that the proposed resubmitted standard gets
2 at, at least to my non-expert eye, the key thing here,
3 which is that in each of these cases, at the time that
4 the companies were entering into these arrangements and
5 seeking to characterize them in ways to keep them off
6 their financial statements or to hide them in footnotes
7 and the like, there was always at the time an argument,
8 and it was an argument of course that in a number of
9 these circumstances turned out to be so thin that
10 criminal proceedings resulted, but ex ante there was
11 always an argument for why they could be treated this
12 way.

13 And I think what the Board has identified and
14 it's instructing auditors to do is to say, you know,
15 listen, you have a responsibility when extraordinary
16 arrangements of this kind are underway to identify them
17 and call them to the audit committee's attention in a way
18 that will ensure enhanced scrutiny. And that seems to
19 me to go right to the nature of the kind of looking-the-
20 other-way mentality that develops in these circumstances.
21 And the consequences on related party transactions, both
22 for the companies involved and their investors, and for

1 the larger U.S. economy over the last 20 years has truly
2 been on a scale I think that might have been unimaginable
3 in the past.

4 I think the same thing is true in a different
5 sort of way in relation to executive compensation. While
6 executive compensation has not directly led to profound
7 global economic crisis in the way that one might argue
8 related party transactions have, on the other hand
9 improperly accounted for executive compensation is
10 profoundly corrosive to the corporate governance system
11 and to the whole body of relationships that underlie
12 effective functioning of public companies. And again,
13 I think, the Board in this proposal has really identified
14 the right way to ask auditors to look at it and to
15 scrutinize it.

16 And so a lot of this I think is long overdue and
17 I really want to commend the staff and the Board for
18 taking it on.

19 MR. SCATES: Thank you, Damon. And now Roman
20 Weil?

21 MR. WEIL: In just a second I'm going to focus on
22 the second bullet point from the bottom of slide 15.

1 I'll get there in a second, but that's where I'm going.

2 I have never audited anything for a living, so
3 take that as a given. And now I'm about to commit an
4 incidence of H.L. Mencken's law, which says whenever A
5 injures or annoys B on the pretense of saving or
6 improving X, then A is a scoundrel. So I am A and the
7 staff is B and the X is the auditing profession.

8 Can we get slide 15 up there, and look at the
9 third bullet point, second bullet point from the bottom?

10 So I'm thinking I'm an auditor and I'm going to
11 be annoyed by that second bullet. I'm thinking about
12 fraud. I don't have an obligation to find fraud, but if
13 I find it, I got to report it. What am I supposed to do
14 in the audit? I don't have an obligation here to find
15 the related parties; that's management's job, but I got
16 to go find it anyway. Clarify the responsibility. I get
17 the feeling that this is like a side letter. How is an
18 auditor supposed to find the side letter that is a
19 primary way of committing fraud in revenue recognition?
20 They're not supposed to be there. Management is supposed
21 to seek them out. The auditor doesn't have a
22 responsibility to seek them out. But if the auditor

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1 finds it, he's got to report it. But we're not giving
2 the auditor guidance of what to do, and when is enough,
3 and when you can't get sued for it.

4 So the auditor's responsibility to figure out
5 whether the related parties are not being disclosed, I
6 think you got to be clear about where the limits of the
7 auditor's responsibility end so we're not going to get
8 more lawsuits against auditors. And then I wonder how
9 come the auditors aren't saying this? Why is the
10 outsider, the non-auditor the one who's worried about
11 this? So I may be completely off base.

12 MR. DEGANO: Well, I think one thing to keep in
13 mind here; and this is why we tried to make some
14 amendments here to emphasize the linkage between the
15 repropoed standard on related parties and the
16 significant unusual transactions, is that one of the
17 underlying ideas here is that these efforts are
18 complementary. So looking for unusual transactions will
19 help the auditor identify an undisclosed related party
20 transaction. So we've given the auditor additional
21 information, specific procedures, specific procedures to
22 identify to unusual transactions, specific procedures to

1 evaluate them.

2 And one of the ideas is that the auditor in
3 looking for unusual transactions; transactions outside
4 the ordinary course, or that are otherwise unusual, could
5 include non-arms-length terms, that would be a population
6 that could include an undisclosed related party
7 transaction. And we're just sharpening the auditor's
8 focus to remain alert for things that indicate that an
9 undisclosed related party transaction exists. And when
10 they find one, then they have specifics procedures, like
11 Gaylen was asking about, that they have to perform for
12 each of those transactions that was previously
13 undisclosed to them that is a related party transaction.

14 So I think that's one of the key changes here in
15 the reproposal, and we're really emphasizing the
16 complementary nature between these two areas.

17 MR. BAUMANN: We have time for one more question
18 and then we're -- everybody's been very patient here.
19 Well, we have actually two questions. We've got Rick
20 Murray and then Bob Herz. And then we've got a group I
21 think that's ready for a break.

22 Rick?

1 MR. MURRAY: A quick clarification question. I
2 understand the logic and share the logic of expanding the
3 auditor's involvement in identifying related parties and
4 the consequences. The language seems to say; Brian, you
5 just described this, is if you run into something that
6 raises your curiosity, you've got to run it to ground
7 including the related party issue. There is some
8 language in the material here and in the proposal that
9 suggests there is also, independent of what you happen
10 to find, a separate responsibility to audit the integrity
11 of the list of related parties issued by management,
12 which is the other side of the coin of saying you look
13 at every party that there has been a transaction with and
14 audit to determine whether or not there is a relationship
15 that hasn't been disclosed. It sounded from this
16 discussion as though that's not really how far you plan
17 to take this, but the language seems to imply that you
18 do.

19 MR. DEGANO: Yes, there's no intent to send
20 auditors out looking for something that they would be
21 checking every single transaction to find. This is a
22 very targeted approach saying there are specific things

1 you do in identifying or in evaluating the company's
2 identification of accounting for and disclosure of its
3 related parties. There's a complementary area where the
4 auditor goes out and identifies and evaluates a company's
5 significant unusual transactions, and a third area that's
6 also complementary, the financial relationships and
7 transactions with the executive officers. Taken
8 together, this positions the auditor to do a more robust
9 effort on identifying undisclosed related party
10 transactions.

11 But one of the clarifications in the reproposal
12 is that the auditor will be doing work to examine the
13 accuracy and completeness of the company's identification
14 of its related parties. They'll be obtaining an
15 understanding of the company's process regarding its
16 related parties. They'll be doing other procedures such
17 as reading the minutes of the board of directors'
18 meetings.

19 And there's an appendix attached to the
20 reproposed standard that was in the proposed standard
21 that includes examples of information that could indicate
22 the existence of an undisclosed related party and sources

1 of information that could indicate the existence of an
2 undisclosed related party or transaction. And many of
3 the items in Appendix A were contained in the existing
4 standard, AU Section 334, and auditors are very familiar
5 with those sources of information and the procedures that
6 they perform. And they already perform many procedures
7 to test the accuracy and completeness of the company's
8 identification.

9 So we think this is just sharpening the auditors'
10 focus on these areas without sending them out looking for
11 something that is going to incur excessive costs.

12 MR. BAUMANN: Again we just have Bob Herz. And
13 then you said Lisa Roth is on the phone. So just those
14 two and then we definitely have to take our break. We
15 have other topics we have to get to this morning.

16 So, Bob?

17 MR. HERZ: On the related parties part of this
18 proposal, I just wondered whether it might in any way
19 impact on the auditor's responsibility or no
20 responsibility for other parts of SEC disclosure
21 documents. You know, for example in the periodic filings
22 there's a section, certain transactions. There are

1 disclosures related to transactions with affiliates. Of
2 course there are all the disclosures on executive comp
3 and CD&A and all of that. So, you know, the auditor now
4 has to kind of correlate the two of those and read those
5 and say, gee, those, you know, don't seem to be some way
6 in sync with what I found through my related parties
7 work, you know, the consistency of -- I read the other
8 parts and nothing came to my attention, or did come to
9 my attention.

10 MR. BAUMANN: Well, I agree that those are
11 sources of information that the auditor would look to in
12 terms of are there related party transactions or certain
13 types of transactions that I should certainly be aware
14 of to then apply audit procedures to. And it may lead
15 to what you just said, that maybe they're not
16 characterized correctly. If that's the case, then
17 auditors have other responsibilities with respect to
18 information that may not be characterized properly in
19 another document. So, yes, it has both aspects.

20 MR. SCATES: And also to add to that, Bob, in our
21 reproposal with respect to the company's relationships
22 and transactions with its executive officers, the auditor

1 would be required to read the most recent proxy
2 information statement. So at least again that's another
3 document that could inform the auditor.

4 And now we have Lisa Roth on the phone. Lisa?

5 MS. ROTH: Yes, thank you. Good morning. I'm
6 sorry I can't be there in person. I wanted to just make
7 two quick comments on the topic of the audits of broker-
8 dealers and the repropoed standard.

9 I just wanted to comment briefly that I don't
10 believe that the proposals are going to be applicable to
11 -- or I should say that they will be very difficult to
12 apply to about 90 percent of the broker-dealer
13 community, that percent of the community with fewer than
14 10 associated persons or employees. You know, the
15 obvious, they're not going to have an audit committee.
16 But I believe there are other nuances to this. These
17 proposals simply won't apply to that particular
18 community.

19 Secondly though, I'm really intrigued by this
20 question about whether or not the auditors of broker-
21 dealers should be required to evaluate the compliance
22 aspects of the related parties. My first instinct answer

1 was no they shouldn't because the issue of compliance of
2 the interrelated parties is already subject to a lot of
3 disclosure and subject to examination. I also believe
4 there are nuances to those interactions of related
5 parties; issues of jurisdiction, for instance, that are
6 complex and beyond the scope of what a financial auditor,
7 especially the auditor of a small broker-dealer would be
8 competent at without significant additional research and
9 study. And then also, because FINRA is very actively
10 involved in a project related to risk identification and
11 management.

12 However, all that said, I recognize that our own
13 regulators, FINRA in particular, hasn't been particularly
14 successful in identifying fraud and compliance issues
15 with respect to related parties. So I just wanted to
16 suggest that you actively communicate and engage in a
17 dialogue with FINRA about this topic, either for the
18 purpose of gaining confidence that the PCAOB auditors
19 don't have to engage in this aspect of analysis, or for
20 the purposes of identifying complementary reviews, areas
21 where your programs do or don't intersect in an way that
22 might help to identify fraud.

1 MR. BAUMANN: Thanks, Lisa. The reproposal has
2 a specific section where it talks about broker-dealers,
3 and we would expect to apply this standard to audits of
4 broker-dealers. But we ask questions of our commenters
5 to give us further information as to the applicability
6 of this standard to broker-dealers, any particular
7 challenges with respect to audits of broker-dealers that
8 we didn't recognize, or are there particular
9 relationships that are often common between broker-
10 dealers and other parties that they're affiliated with
11 that we should consider in enhancing the standards?

12 So we hope that you send in a comment letter and
13 we hope to hear from FINRA with respect to this standard
14 and broker-dealers.

15 With that, I'd like to wrap up this morning's
16 discussion of the standard-setting projects. We've had
17 a lot. I think people are ready for a break. We have
18 a number of important things yet to cover this morning.

19 Our break ended at 11:10 and it's now 11:15. So
20 with that, let's try to have an efficient break and be
21 back here in 10 or 15 minutes. Thank you.

22 (Whereupon, the above-entitled matter went off



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AUDITING STANDARD No. 18 –)	
)	
RELATED PARTIES)	PCAOB Release No. 2014-002
)	June 10, 2014
AMENDMENTS TO CERTAIN PCAOB AUDITING)	
STANDARDS REGARDING SIGNIFICANT)	PCAOB Rulemaking
UNUSUAL TRANSACTIONS)	Docket Matter No. 038
)	
AND OTHER AMENDMENTS TO PCAOB)	
AUDITING STANDARDS)	
)	

Summary: After public comment, the Public Company Accounting Oversight Board ("PCAOB" or "Board") is adopting: (i) Auditing Standard No. 18, *Related Parties*; (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions; and (iii) other amendments to PCAOB auditing standards. Auditing Standard No. 18 supersedes the Board's interim auditing standard, AU sec. 334, *Related Parties*.

Board
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I. Introduction

The Board is adopting a new auditing standard and amendments to its auditing standards to strengthen auditor performance requirements in three critical areas that historically have represented increased risks of material misstatement in company financial statements. Related party transactions; 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"); and a company's



financial relationships and transactions with its executive officers,^{1/} have been contributing factors in numerous financial reporting frauds over the last several decades.^{2/} Prominent corporate scandals involving these critical areas served to undermine investor confidence and resulted in significant losses for investors, as well as the loss of many jobs.^{3/} These critical areas have continued to be contributing factors in more recent cases.^{4/} As discussed below, the Board's oversight activities indicate that there are continuing weaknesses in auditors' scrutiny of these areas.

^{1/} A company's related party transactions, significant unusual transactions, and financial relationships and transactions with its executive officers, are collectively referred to herein as "the critical areas" or "these critical areas."

^{2/} Such prominent corporate scandals include Enron Corporation, Tyco International, Ltd., Refco, Inc., and WorldCom, Inc. For a more detailed discussion of such financial reporting frauds, see: (i) *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (the "proposing release" or the "proposal"), PCAOB Release No. 2012–001 (February 28, 2012) at 9-11, http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2012-001_Related_Parties.pdf and (ii) *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (the "reproposing release" or the "reproposal"), PCAOB Release No. 2013–004 (May 7, 2013) at 2, http://pcaobus.org/Rules/Rulemaking/Docket038/Release%202013-004_Related%20Parties.pdf. See also Section II. of Appendix 5.

^{3/} In one such example, Enron Corporation was the nation's largest natural gas and electric marketer, with reported annual revenue of more than \$150 billion. When it filed for bankruptcy on December 2, 2001, its stock price had dropped, in less than a year, from more than \$80 per share to less than \$1. See *SEC Settles Civil Fraud Charges Filed Against Richard A. Causey, Former Enron Chief Accounting Officer; Causey Barred From Acting as an Officer or Director of a Public Company* (U.S. Securities and Exchange Commission ("SEC" or "Commission") Litigation Release No. 19996, February 9, 2007).

^{4/} See, e.g., SEC Accounting and Auditing Enforcement Release ("AAER") No. 3447, *SEC v. Keyuan Petrochemicals, Inc. and Aichun Li* (February 28, 2013), and SEC AAER No. 3385, *SEC v. China Natural Gas, Inc. and Qinan Ji* (May 14, 2012).



The Board developed the standard and amendments because, as described more fully below, the Board believes its existing requirements need to be strengthened to heighten the auditor's attention to areas that have been associated with risks of fraudulent financial reporting and that also may pose increased risks of error. The Board has concluded that its existing requirements in these critical areas do not contain sufficient required procedures and are not sufficiently risk-based, which can lead to inadequate auditor effort in the critical areas. The auditor, serving in the role as a gatekeeper^{5/} in the financial reporting system, should be alert to the possibility that transactions in these critical areas pose increased risks and, thus, require heightened scrutiny during the audit.^{6/} Increased auditor attention to these critical areas should, in the Board's view, increase the likelihood of the auditor identifying material misstatements.

^{5/} According to the SEC:

The federal securities laws, to a significant extent, make independent auditors "gatekeepers" to the public securities markets. These laws require, or permit us to require, financial information filed with us to be certified (or audited) by independent public accountants. Without an opinion from an independent auditor, the company cannot satisfy the statutory and regulatory requirements for audited financial statements and cannot sell its securities to the public. The auditor is the only professional that a company must engage before making a public offering of securities and the only professional charged with the duty to act and report independently from management.

See SEC Securities Act Release No. 33-7870, *Proposed Rule: Revision of the Commission's Auditor Independence Requirements* (June 30, 2000) at Section II.A. See also, SEC Securities Act Release No. 33-7919, *Final Rule: Revision of the Commission's Auditor Independence Requirements* (November 21, 2000) at Section III.A.

^{6/} See, e.g., SEC AAER No. 3427, *In the Matter of the Application of Wendy McNeeley, CPA*, at 10–12 (December 13, 2012), <http://www.sec.gov/litigation/opinions/2012/34-68431.pdf>. That opinion states, in part, that the SEC and courts have repeatedly held that related party transactions require heightened scrutiny by auditors. See also *McCurdy v. SEC*, 396 F3d 1258, 1261 (D.C. Cir. 2005) (citing *Howard v. SEC*, 376 F3d 1136, 1149 (D.C. Cir. 2004) noting that related-party transactions "are viewed with extreme skepticism in all areas of finance," aff'g *James Thomas McCurdy, CPA*, 57 S.E.C. 277 (2004)).



The standard and amendments being adopted by the Board include: Auditing Standard No. 18, *Related Parties* (the "standard"); amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "amendments regarding significant unusual transactions"); and other amendments to PCAOB auditing standards (the "other amendments"). The amendments regarding significant unusual transactions and the other amendments are collectively referred to herein as the "amendments." As described below, the standard and amendments address:

- Relationships and Transactions with Related Parties;
- Significant Unusual Transactions; and
- Financial Relationships and Transactions with Executive Officers.

Relationships and Transactions with Related Parties: The standard addresses the auditing of relationships and transactions between a company and its related parties. A company's related party transactions could pose increased risks of material misstatement, as their substance might differ materially from their form.^{7/} Related party transactions also may involve difficult measurement and recognition issues that can lead to errors in financial statements. Such transactions potentially provide more of an opportunity for management to act in its own interests, rather than in the interests of the company and its investors. Moreover, in some instances, related party transactions have been used to engage in fraudulent financial reporting and to conceal misappropriation of assets – types of misstatements that are relevant to the auditor's consideration of fraud.^{8/} The importance to investors of auditing related party transactions is reflected in Section 10A of the Securities Exchange Act of 1934 (the "Exchange Act"), which requires each audit of financial statements of an issuer to include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."^{9/} The standard is designed to strengthen auditor performance requirements by setting forth specific procedures for the auditor's evaluation of a company's identification of, accounting for,

^{7/} See also Section II.B. of Appendix 5 for additional discussion of such risks.

^{8/} See paragraph .06 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

^{9/} See Section 10A(a)(2) of the Exchange Act, 15 U.S.C. §78j-1(a)(2), which was added to the Exchange Act by the Private Securities Litigation Reform Act, enacted by Congress in 1995.



and disclosure of relationships and transactions between the company and its related parties. The standard supersedes the Board's existing standard, AU sec. 334, *Related Parties*, (the "existing standard"), which has not been substantively updated since it was issued in 1983.^{10/}

Significant Unusual Transactions: The amendments regarding significant unusual transactions recognize that a company's significant unusual transactions can create complex accounting and financial statement disclosure issues that could pose increased risks of material misstatement. In some instances, significant unusual transactions have been used to engage in fraudulent financial reporting. For example, significant unusual transactions, especially those close to period end that pose difficult "substance-over-form" questions, may be entered into to obscure a company's financial position or operating results.^{11/} In such cases, management may place more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction. Existing audit requirements regarding significant unusual transactions are principally contained in AU sec. 316. The amendments regarding significant unusual transactions include specific procedures that are designed to improve the auditor's identification and evaluation of a company's significant unusual transactions and, in particular, to enhance the auditor's understanding of the business purpose (or the lack thereof) of such transactions.

Financial Relationships and Transactions with Executive Officers: The other amendments include, among other things, improved audit procedures addressing a company's financial relationships and transactions with its executive officers. A company's executive officers are in a unique position to influence a company's accounting and disclosures. A company's financial relationships and transactions with its executive officers (as one example, executive officer compensation) can create incentives and pressures for executive officers to meet financial targets, which can result in risks of material misstatement to a company's financial statements. The other

^{10/} AU sec. 334 is one of the Board's interim auditing standards. Shortly after the Board's inception, the Board adopted the existing standards of the American Institute of Certified Public Accountants ("AICPA"), as in existence on April 16, 2003, on an initial, transitional basis. *See Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (April 18, 2003).

^{11/} *See, e.g.,* SEC AAER No. 1631, *In the Matter of Dynegey Inc., Respondent* (September 24, 2002), <http://www.sec.gov/litigation/admin/33-8134.htm>; and SEC AAER No. 2775, *In the Matter of Michael Lowther, CPA, Respondent* (January 28, 2008), <http://www.sec.gov/litigation/admin/2008/34-57210.pdf>.



amendments modify Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, to require the auditor to perform specific procedures, as part of the auditor's risk assessment process,^{12/} to obtain an understanding of the company's financial relationships and transactions with its executive officers. However, these amendments do not require the auditor to make any determination regarding the reasonableness of compensation arrangements or recommendations regarding compensation arrangements.

The auditor's efforts regarding these critical areas are, in many ways, complementary. For example, the auditor's efforts to identify and evaluate a company's significant unusual transactions could identify information that indicates that a related party or relationship or transaction with a related party previously undisclosed to the auditor might exist. Likewise, obtaining an understanding of a company's financial relationships and transactions with its executive officers also could identify such information. The standard and amendments direct the auditor to consider the linkage between a company's relationships and transactions with its related parties, its significant unusual transactions, and its financial relationships and transactions with its executive officers. This complementary audit approach should help the auditor "connect the dots" between different aspects of the audit. Both the auditor and the investor benefit from a comprehensive and consistent examination of the critical areas, not only because of the risk of material misstatement due to fraud, but also because these transactions, due to their nature, could pose a risk of material misstatement due to error.

In addition, the standard imposes new requirements relating to the auditor's communications with the company's audit committee. These changes recognize that the new auditor performance requirements contained in the standard relate to areas of the audit that warrant discussion with the audit committee. The new communication requirements in the standard work in concert with the communication requirements in Auditing Standard No. 16, *Communications with Audit Committees*,^{13/} and require the

^{12/} In 2010, the Board adopted eight standards on assessing and responding to risk in an audit (the "risk assessment standards"), which cover the entire audit process, from initial planning activities to evaluating audit evidence to forming the opinion to be expressed in the auditor's report. See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release 2010-004 (August 5, 2010).

^{13/} See *Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU Sec. 380*, PCAOB Release No. 2012-004 (August 15, 2012).



auditor to include, as one of the auditor's required communications with the audit committee, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships with related parties. Additionally, the amendments regarding significant unusual transactions are intended to enhance the discussion between the auditor and the audit committee regarding the business purpose (or the lack thereof) of a company's significant unusual transactions required by Auditing Standard No. 16.^{14/} Similarly, requiring the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers is intended to improve the auditor's identification of fraud risks or other significant risks, which are also already required to be discussed with the audit committee pursuant to Auditing Standard No. 16.^{15/}

As discussed below, recommendations to improve the requirements in the critical areas have been longstanding. The standard and amendments reflect public input, including discussions with the Board's Standing Advisory Group ("SAG")^{16/} and comments received on a proposal in 2012^{17/} and a reproposal in 2013.^{18/} A wide range

^{14/} See paragraph 13.d. of Auditing Standard No. 16, as revised by the amendments regarding significant unusual transactions in Appendix 2.B. As revised, the auditor is required to communicate to the audit committee the auditor's understanding of the business purpose (or the lack thereof) of significant unusual transactions.

^{15/} See paragraph 9 of Auditing Standard No. 16, which requires the auditor to discuss with the audit committee the significant risks identified during the auditor's risk assessment procedures.

^{16/} The SAG discussed the topic of related parties at a number of its meetings prior to the issuance of the Board's proposal, including at meetings occurring on: September 8-9, 2004; June 21, 2007; and October 14-15, 2009. The SAG also discussed the proposal and reproposal on May 17, 2012 and May 15, 2013, respectively. See the SAG Meeting Archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>.

^{17/} See the proposing release, which included: (i) an auditing standard, *Related Parties* ("proposed standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions; and (iii) other amendments to PCAOB auditing standards (collectively, these are referred to as the "proposed standard and amendments").

^{18/} See the reproposing release, which included: (i) an auditing standard, *Related Parties* ("reproposed standard"); (ii) amendments to certain PCAOB auditing



of commenters, including audit firms serving companies of all sizes, were supportive overall of the need to improve existing standards in these critical areas. During the standard-setting process, the Board considered various alternatives, including some proposed by commenters, in order to develop new requirements that would promote investor protection, but that also would provide opportunities for efficient implementation. After considering the comments received on the reproposal, the Board is adopting the standard and amendments substantially as repropoed.

In general, the Board's new performance requirements for auditors are designed to promote heightened scrutiny in the critical areas, with the goal of promoting the auditor's ability to identify, evaluate, and respond to risks of material misstatement. The new requirements represent a targeted approach, focusing on areas that have historically reflected increased risks of fraudulent financial reporting and that also may pose increased risks of error. The Board believes that the standard and amendments, which are aligned with the risk assessment standards, represent a cohesive audit approach that will contribute to audit effectiveness and provide opportunities for an efficient implementation. In the Board's view, the new requirements further the Board's overall mission of improving audit quality, protecting the interests of investors, and furthering the public interest in the preparation of informative, accurate, and independent audit reports.^{19/}

II. Background and Need for Improvement

As described more fully in the Board's proposing and repropoing releases, the Board developed the standard and amendments against the backdrop of several decades of financial reporting frauds involving companies' relationships and

standards regarding significant unusual transactions; and (iii) other proposed amendments to PCAOB auditing standards (collectively, these are referred to as the "repropoed standard and amendments").

^{19/} See Section 101 of the Sarbanes–Oxley Act of 2002 ("Sarbanes–Oxley" or the "Act"), Pub. L. 107-204, 116 Stat. 745. Under Section 101 of the Act, the mission of the PCAOB is "to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports...."



transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers.^{20/}

In considering the need for improvement, the Board noted that some of its existing requirements in these critical areas had not been updated to address significant developments since their issuance. For example, the existing standard addressing the auditing of related parties, AU sec. 334, had remained largely unchanged for many years, despite prominent corporate scandals.^{21/} The Board observed that the existing standard provided guidance and examples of procedures the auditor could perform, in lieu of specific required procedures. This could result in inadequate audit effort in an area that could pose increased risks of material misstatement. Additionally, the nature and extent of audit procedures addressing a company's related party transactions could vary widely. AU sec. 334 also does not reflect the risk-based approach taken in the Board's risk assessment standards, adopted in 2010, which provide an overall framework for the audit, based on the auditor's assessment of, and response to, risks of material misstatement.^{22/}

The Board's view was also informed by a number of prominent reports and studies that supported the need to improve its existing requirements in the critical areas to better address issues pertinent to fraudulent financial reporting. These included studies by the audit profession that predated the establishment of the Board, and that suggested improvements to certain auditing standards adopted by the Board on an

^{20/} See also Appendix 5, which further elaborates on the Board's consideration of the need, the alternatives considered, and the Board's existing requirements and current audit practices, in connection with the Board's consideration of the economic impacts of the standard and amendments.

^{21/} Audit procedures regarding a company's related parties have remained largely unchanged since the issuance of AU sec. 335, *Related Party Transactions*, in July 1975. In 1983, AU sec. 335 was replaced with AU sec. 334, but the nature and extent of the auditor's responsibilities and procedures pertaining to related parties in AU sec. 335 were carried over into AU sec. 334. AU sec. 334 removed guidance relating to accounting considerations and disclosure standards for related parties (in response to the issuance of Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, which is now contained in FASB Accounting Standards Codification Topic 850, *Related Party Disclosures*), along with other related technical changes.

^{22/} See PCAOB Release 2010-004 (August 5, 2010).



interim basis in 2003. For example, the Report of the Quality Control Inquiry Committee (the "QCIC Report") of the AICPA's SEC Practice Section recommended, after studying more than 200 cases involving audit failures, that "required audit procedures be broadened to help ensure the auditor gains a more complete understanding of related-party transactions, including the business aspects of the transactions."^{23/}

The Board also considered the results of its oversight activities. For example, the Board has observed that the facts underlying a significant percentage of the Board's settled disciplinary actions to date have involved auditors' failures to perform sufficient procedures regarding related party transactions.^{24/} Many of these cases involve smaller audit firms. Likewise, the Board's inspection program has identified a range of deficiencies in auditing related party transactions, particularly with respect to audits of smaller public companies that were conducted by smaller domestic audit firms.^{25/} The

^{23/} See AICPA SEC Practice Section, Memo To Managing Partners of SECPS Member Firms, "Recommendations for the Profession Based on Lessons Learned from Litigation" (October 2002), which includes the QCIC Report as an attachment.

^{24/} See, e.g., *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of P. Parikh & Associates, Ashok B. Rajagiri, CA, Sandeep P. Parikh, CA, and Sundeeep P S G Nair, CA, Respondents*, PCAOB Release No. 105-2013-002 (April 24, 2013); *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Jaspers + Hall, PC, Thomas M. Jaspers, CPA, and Patrick A. Hall, CPA, Respondents*, PCAOB Release No. 105-2008-002 (October 21, 2008); *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Williams & Webster, P.S., Kevin J. Williams, CPA, and John G. Webster, CPA, Respondents*, PCAOB Release No. 105-2007-1 (June 12, 2007); and *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA, Respondents*, PCAOB Release No. 105-2005-022 (November 22, 2005).

^{25/} See *Report on 2007-2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies*, PCAOB Release No. 2013-001 (February 25, 2013) at 29, http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf, which states, in part:

Inspections staff have observed deficiencies related to firms' failures to test for undisclosed related parties or transactions with undisclosed related parties. Some of those firms failed to identify and address the lack of disclosure of related party transactions in the financial statements.



audit deficiencies cited included failures to test for undisclosed related parties and failures to address risks posed by known related party transactions, including failures to obtain an understanding of the business purpose of such transactions. The types of audit deficiencies observed by the Board indicate that audit practice is inconsistent under the existing framework, which suggests that this is a challenging area warranting additional auditor effort and focus.

Significantly, the need for heightened scrutiny of related party transactions has been highlighted by SEC enforcement actions. For example, in a 2012 opinion issued by the SEC involving a company's transactions with its executive officers, the SEC stated "although in an ordinary arms-length transaction, one may assume that parties will act in their own economic interest, this assumption breaks down when the parties are related."^{26/} Additionally, a study performed by the SEC of five years of enforcement actions that was required by Section 704 of the Act examined 227 enforcement matters and found that 23 of those cases included the failure to disclose related party transactions.^{27/}

Inspections staff have also identified deficiencies relating to the firms' failure to obtain an understanding of the nature and business purpose of transactions with related parties and to evaluate whether the accounting for those transactions reflects their economic substance.

See also *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms*, PCAOB Release No. 2007-010, at 7 (October 22, 2007), http://pcaobus.org/Inspections/Documents/2007_10-22_4010_Report.pdf.

^{26/} See SEC, *In the Matter of the Application of Wendy McNeeley, CPA*, AAER No. 3427, at 15 (December 13, 2012), <http://www.sec.gov/litigation/opinions/2012/34-68431.pdf>. As previously noted, that opinion states, in part, that the SEC and courts have repeatedly held that related party transactions require heightened scrutiny by auditors and notes the importance of the auditor understanding the business purpose of material related party transactions.

^{27/} Section 704 of the Act directed the SEC to study enforcement actions over the five years preceding its enactment "to identify areas of issuer financial reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management." See *Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002* (January 24, 2003) at 6.



SEC enforcement cases also have highlighted the role played by executive officers in fraudulent financial reporting by public companies. For example, a study examining SEC AAERs from 1998 to 2007 noted that the most commonly cited motivations for fraud included the need to: (i) meet external earnings expectations of analysts and others; (ii) meet internally set financial targets or make the company look better; (iii) conceal the company's deteriorating financial condition; (iv) increase the stock price; (v) bolster financial position for pending equity or debt financing; (vi) increase management compensation through achievement of bonus targets and through enhanced stock appreciation; and (vii) cover up assets misappropriated for personal gain.^{28/} That study indicated that the chief executive officer and/or chief financial officer were named in 89 percent of the cases involving fraudulent financial reporting brought by the SEC during that period.

The Board further considered that other standard-setters already have taken action to update their standards in related areas. For example, in July 2008, the International Auditing and Assurance Standards Board ("IAASB") took action to update and revise its auditing standard on related parties with the issuance of International Standard on Auditing No. 550, *Related Parties*. The IAASB emphasized that its new standard was warranted given the public focus on the accounting and auditing of related party relationships and transactions after recent major corporate scandals.^{29/} The Auditing Standards Board ("ASB") of the AICPA also revised its auditing standard on related parties with the issuance of AU-C Section 550, *Related Parties*, contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification*, in October 2011.

These considerations, particularly the magnitude and number of financial fraud cases over the last several decades involving companies' relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers, strongly indicate the need to strengthen existing

^{28/} See Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson, and Terry L. Neal, *Fraudulent Financial Reporting 1998–2007: An Analysis of U.S. Public Companies*, Committee of Sponsoring Organizations of the Treadway Commission (May 2010) at 3, http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.

^{29/} See IAASB Exposure Draft, *Related Parties* (December 2005). In addition, the IAASB staff issued guidance in August 2010 addressing the auditing of significant unusual or highly complex transactions. See IAASB Staff Questions and Answers, *Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions* (August 2010).



auditing standards addressing these critical areas to promote audit quality and investor protection.

III. **The Board's Proposals and Development of the Board's Approach**

The following discussion highlights a number of key decisions made by the Board as it developed the standard and amendments, beginning with its proposal in 2012.^{30/}

The Board's Proposals: The Board issued its proposal on February 28, 2012.^{31/} The Board received 37 comment letters on the proposed standard and amendments and discussed the proposed standard and amendments with the SAG on May 17, 2012.^{32/}

In general, commenters were supportive of the Board's standard-setting efforts to enhance the auditor's efforts in the critical areas addressed by the proposal. However, commenters suggested several areas in which the proposed standard and amendments could be clarified or improved, including with respect to the other proposed amendments regarding a company's financial relationships and transactions with its executive officers.

In response to comments received, the Board made a number of revisions to its proposal and issued a reproposal for comment on May 7, 2013.^{33/} The Board's

^{30/} Prior to proposing the standard and amendments, the Board considered a number of alternatives. As noted above, Section IV. of Appendix 5 contains a more detailed discussion of alternatives considered by the Board, including alternatives considered before the Board determined to issue the proposed standard and amendments in 2012.

^{31/} See the proposing release http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2012-001_Related_Parties.pdf.

^{32/} The comment period was extended from May 15, 2012 until May 31, 2012 to accommodate the discussion and comments received in connection with the SAG meeting. The transcript of the SAG's discussion of the proposed standard and amendments is available at http://pcaobus.org/Rules/Rulemaking/Docket038/2012-05-17_Transcript-Related_Parties.pdf.

^{33/} See the reproposing release http://pcaobus.org/Rules/Rulemaking/Docket038/Release%202013-004_Related%20Parties.pdf.



reproposing release discussed the Board's consideration of comments received and the reasons for making the changes in the repropoed standard and amendments. Additionally, the Board sought comment, and empirical data, on the potential economic implications of the repropoed standard and amendments, as well as on issues pertinent to the application of the repropoed standard and amendments to audits of brokers and dealers. Further, as a result of the enactment of the Jumpstart Our Business Startups Act (the "JOBS Act"), the Board also sought comment in its repropoal on issues pertinent to the applicability of the repropoed standard and amendments to audits of emerging growth companies ("EGCs").^{34/}

The Board received 24 comment letters on the repropoed standard and amendments and discussed the repropoed standard and amendments with the SAG on May 15, 2013.^{35/} In general, commenters were supportive overall of the Board's efforts to improve existing standards in these critical areas. Notably, virtually all of those who commented on the repropoed amendments regarding a company's financial relationships and transactions with its executive officers indicated that the repropoed amendments sufficiently clarified an issue raised during the initial proposal, i.e., that the requirement for the auditor to obtain an understanding of the company's financial relationships and transactions with its executive officers does not require the auditor to assess the appropriateness of the compensation of the company's executive officers. Those who commented on the applicability of the standard were generally supportive of applying the standard and amendments to companies of all sizes, as well as to audits of brokers and dealers and audits of EGCs.

In response to the Board's request for input and empirical data regarding economic considerations, commenters provided their views regarding whether the standard and amendments would improve audit quality, as well as their views regarding potential costs and implementation issues. However, commenters did not provide empirical data.^{36/}

^{34/} Pub. L. No. 112-106 (April 5, 2012). See Section 103(a)(3)(C) of the Act (15 U.S.C. §7213(a)(3)(C)), as added by Section 104 of the JOBS Act.

^{35/} The transcript of the SAG's discussion of the repropoed standard and amendments is available at http://pcaobus.org/Rules/Rulemaking/Docket038/2013-05-15_SAG%20Transcript-Related_Parties.pdf.

^{36/} See Section V. for a summary discussion of economic considerations. Appendix 5 discusses the Board's consideration of the economic impacts regarding the standard and amendments in greater detail.



As noted above, after consideration of the comments received, the Board is adopting the standard and amendments substantially as repropoed, with some clarifications and revisions in response to certain comments received. Appendix 4 contains a detailed discussion of comments received by the Board during the repropoal process, including the Board's response to significant comments received on the repropoed standard and amendments. Additionally, to assist the auditor in implementing the standard and amendments, Appendix 4 includes discussion and examples from the Board's propoing and repropoing releases modified to address the standard and amendments being adopted by the Board.

The Board's Overall Approach: The following discussion describes the Board's overall approach to developing the standard and amendments, and highlights some of the alternatives and policy choices made as the Board moved from its proposal to its repropoal and then to the adoption of the standard and amendments. In general, in developing the standard and amendments, the Board determined to develop an approach that would promote the auditor's heightened scrutiny of the critical areas but that would, at the same time, also provide opportunity for efficient implementation. Key considerations included:

- *Aligning with the Risk Assessment Standards:* The Board initially proposed to align the auditor's efforts with the risk assessment standards, which require the auditor to consider the risks of material misstatement, whether due to error or fraud, throughout the audit. In the Board's view, this overall risk assessment approach promotes a cohesive audit, with opportunities to integrate audit effort where appropriate, and, at the same time, positions the auditor to identify areas in which there may be increased risks of material misstatement in company financial statements. In response to comments on its proposal, the Board took steps in its repropoal to more closely align the repropoed standard and amendments with its risk assessment standards. Commenters who addressed this aspect of the repropoal generally agreed that the revisions improved the alignment with the risk assessment standards. This approach is retained in the standard and amendments being adopted by the Board.
- *Addressing Complementary Audit Areas:* The proposed standard and amendments were intended to highlight: (i) linkages between the standard and amendments and (ii) the opportunity for complementary audit work, which could improve audit effectiveness and offer opportunities for efficient implementation. For example, the auditor's work in identifying and evaluating significant unusual transactions could assist the auditor in identifying related parties or relationships or transactions with related

parties previously undisclosed to the auditor by management. In its reproposal, the Board made revisions to improve the linkage between the reproposed standard and amendments. This approach is retained in the standard and amendments being adopted by the Board.

- *Using Existing Concepts and Procedures:* The Board included some existing auditing concepts and procedures in its proposed standard and amendments. This was intended to permit audit firms to build on existing methodologies and training. This approach could minimize the costs of implementing the standard and amendments. In its reproposal, the Board sought comment on such issues. Several auditing firms who commented indicated that they would be able to update their methodologies and train staff to apply the standard and amendments in a short period, suggesting that the implementation of the standard would not be unduly burdensome. This approach is retained in the standard and amendments being adopted by the Board.
- *Providing Opportunity for a Scaled Approach:* The proposed standard was intended to provide for a scaled approach, establishing basic required procedures intended to assist the auditor in identifying red flags that indicate potential risks of material misstatement. The basic procedures were supplemented by more in-depth procedures that are commensurate with the facts and circumstances of the company under audit. Such facts and circumstances may include the size or complexity of the transaction, the nature of the company's relationships or transactions with its related parties, and the related risk of material misstatements in the financial statements. In response to a request for comments arising out of the Board's reproposal, many commenters agreed that the reproposed standard and amendments provide for a scaled approach. This approach is retained in the standard and amendments being adopted by the Board.

Additionally, commenters raised a variety of issues for consideration by the Board during the standard-setting process. A number of such comments resulted in revisions and clarifications to the standard and amendments.^{37/} Some of the more significant of these include:

^{37/} Appendix 4 contains a more detailed discussion of comments received by the Board during the reproposal process, including the Board's response to significant comments received on the reproposed standard and amendments.

- *Expanding Auditor Judgment:* In response to comments, the Board made changes to the proposed standard to allow for more auditor judgment, in appropriate circumstances. For example, in its proposal, all related party relationships or transactions that were not previously disclosed to the auditor, as well as those that would require disclosure in the company's financial statements, would have been considered to be a significant risk, requiring additional audit attention in all cases. In response to comments, the Board removed from the reproposal the requirement that the auditor always treat each related party relationship or transaction previously undisclosed by management as a significant risk. In making this change, the Board observed that not all undisclosed related party relationships or transactions might represent a significant risk. Instead, the additional procedures would only be required in circumstances where previously undisclosed transactions were determined by the auditor to require disclosure in the financial statements or consideration as a significant risk. This change, which is retained in the standard being adopted by the Board, could eliminate potentially unnecessary audit work.
- *Clarifying the Auditor's Responsibilities to Identify a Company's Related Parties:* In response to comments received, the Board made clarifications to the proposed standard to emphasize that the auditor's efforts to identify a company's related parties and relationships and transactions with its related parties begins with management's work. The approach taken in the Board's reproposal in this area recognizes that the company is responsible for the preparation of its financial statements, including the identification of the company's related parties, and that the auditor begins the audit with information obtained from the company. This approach is retained in the standard being adopted by the Board. Additionally, in response to comments received on the repropounded standard, several clarifying changes have been made. Those changes emphasize more prominently the auditor's responsibility to perform procedures to test the accuracy and completeness of the company's identification of its related parties, taking into account the information gathered during the audit. Those changes also clarify that Appendix A of the standard contains examples of information and sources of information that may be gathered by the auditor during the audit.
- *Clarifying the Focus Regarding Executive Officers:* As proposed, the other amendments provided direction to the auditor to consider the potential risks of material misstatement relating to a company's executive compensation arrangements as part of the auditor's risk assessment procedures. While some commenters were fully supportive of this



approach, other commenters on the proposal raised concerns regarding whether the Board intended that the auditor make an assessment of the reasonableness of executive compensation arrangements. As repropoed, the other amendments relating to this area were clarified to explicitly provide that the procedures required for the auditor to obtain an understanding of a company's financial relationships and transactions with its executive officers do not require the auditor to make any determinations regarding the appropriateness or reasonableness of the company's compensation arrangements with its executive officers. This approach is retained in the amendments being adopted by the Board.

IV. Overview of the Standard and Amendments and Key Improvements from Existing Standards

The following discussion provides a summary of the standard and amendments being adopted by the Board, key improvements from existing standards, and changes being made to the repropoed standard and amendments.

Auditing Standard No. 18, *Related Parties*

Overview of the Standard: The standard is intended to strengthen auditor performance requirements for identifying, assessing, and responding to the risks of material misstatement associated with a company's relationships and transactions with its related parties. Among other things, the standard requires the auditor to:

- Perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties, including 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 transactions involving related parties. The new procedures are performed in conjunction with the auditor's risk assessment procedures pursuant to Auditing Standard No. 12.
- Evaluate whether the company has properly identified its related parties and relationships and transactions with its related parties.^{38/} In making that

^{38/} To further assist the auditor's efforts in this area, the other amendments include a complementary provision that expands existing management representations contained in AU sec. 333, *Management Representations*. However, the auditor may not rely solely on management's representations since they are not a substitute for the



evaluation, the auditor performs procedures to test the accuracy and completeness of management's identification, taking into account information gathered during the audit. If the auditor identifies information that indicates that undisclosed relationships and transactions with a related party might exist, the auditor performs procedures necessary to determine whether undisclosed relationships or transactions with related parties in fact exist.

- Perform specific procedures if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists.
- Perform specific procedures regarding each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk.
- Communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, and other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

The Existing Standard: The existing requirements for auditing relationships and transactions with related parties are contained primarily in AU sec. 334. AU sec. 334 recognizes that the auditor performs procedures to identify and evaluate a company's relationships and transactions with its related parties as part of performing an audit of financial statements. In doing so, AU sec. 334 provides guidance and examples of procedures for the auditor's consideration in identifying and evaluating related party transactions. Examples of procedures in AU sec. 334 include procedures to obtain information from management (such as obtaining the names of all related parties and inquiring whether there were any transactions with these parties during the period) as well as procedures intended to assist the auditor in identifying related parties that have not been disclosed to the auditor by management (such as reviewing filings with the SEC, reviewing company accounting records and certain invoices, and making inquiries of other auditors). Notably, AU sec. 334 states that not all of the procedures may be required in every audit. It further states that, in the absence of evidence to the contrary, related party transactions should not be assumed to be outside the ordinary course of

application of those audit procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.



business.^{39/} Finally, AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions.

Key Improvements from the Existing Standard: The standard includes some auditing concepts and procedures from AU sec. 334 that relate to identifying and evaluating related parties and related party transactions. However, the standard differs from AU sec. 334 in a number of key respects. These include:

- *Adding Basic Requirements:* AU sec. 334 suggests procedures for the auditor's consideration, noting that not all of them may be required in every audit. The standard requires basic procedures for the auditor's response to the risks of material misstatement associated with a company's relationships and transactions with its related parties that focus on those related party transactions that require disclosure in the financial statements or that are determined to be a significant risk. These procedures are designed to assist the auditor in identifying red flags that indicate potential risks of material misstatement. Additionally, the standard requires more in-depth procedures that are designed to be scalable and commensurate with the company's facts and circumstances.
- *Enhancing Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties:* Unlike AU sec. 334, which includes limited direction for obtaining an understanding of the company's relationships and transactions with its related parties, the standard requires the performance of specific procedures in this area, including obtaining an understanding of the terms and business purposes (or the lack thereof) of related party transactions.
- *Aligning with the Risk Assessment Standards:* Since the adoption of AU sec. 334, the Board adopted and amended a number of auditing standards, including its risk assessment standards. The standard is designed to align with and build upon the risk assessment standards that were adopted in 2010. The new procedures are intended to be performed in conjunction with the procedures performed during the auditor's risk assessment.

^{39/} Thus, AU sec. 334 could be misunderstood to create a "presumption of validity" for the business purpose of related party transactions in situations where experience suggests a need for heightened scrutiny.



- *Improving the Auditor's Focus on Accounting:* As noted above, AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions. The standard requires that the auditor evaluate both the accounting for, and disclosure of, related party transactions.
- *Adding Audit Committee Communications:* AU sec. 334 does not mention communications with audit committees regarding related party transactions. The standard requires the auditor to communicate with the audit committee (or its chair) to obtain information during the auditor's risk assessment, as well as to communicate to the audit committee regarding the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.
- *Emphasizing a Complementary Audit Approach:* The standard requires the auditor to take into account information gathered during the audit when evaluating a company's identification of its related parties, for example, information with respect to significant unusual transactions.

Changes from the Reproposed Standard: The Board is adopting the standard substantially as repropose, except for certain clarifications and changes that are being made largely in response to comments. One change more prominently emphasizes that the auditor's evaluation of whether a company has properly identified its related parties and relationships and transactions with related parties requires the auditor to perform procedures to test the accuracy and completeness of the company's identification of its related parties and relationships and transactions with its related parties. That change also provides that the auditor's evaluation takes into account the information gathered during the audit. Another change clarifies that Appendix A of the standard contains examples of information and sources of information that may be gathered by the auditor during the audit. More detail regarding the changes made to the standard is included in Section II. of Appendix 4.

Amendments Regarding Significant Unusual Transactions

The amendments regarding significant unusual transactions revise AU sec. 316 and other PCAOB auditing standards with the intent of strengthening the auditor's performance requirements for the identification and evaluation of significant unusual transactions. Among other things, the amendments regarding significant unusual transactions:

- Require the auditor to perform procedures to identify significant unusual transactions;



- Require the auditor to perform procedures to obtain an understanding of, and evaluate, the business purpose (or the lack thereof) of identified significant unusual transactions; and
- Add factors for the auditor to consider in evaluating whether significant unusual transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

The amendments regarding significant unusual transactions include targeted enhancements to AU sec. 316, as well as amendments to Auditing Standard No. 12 and Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*. The amendments regarding significant unusual transactions also include conforming changes to other PCAOB auditing standards to provide for consistency in the use of the term "significant unusual transactions" throughout the Board's standards. During the reproposal process, the Board added a number of clarifying changes, including some intended to enhance the complementary linkages between the auditor's work relating to significant unusual transactions and related party transactions. This approach is maintained in the amendments being adopted by the Board.

Existing Standards Regarding Significant Unusual Transactions: Existing auditing requirements regarding significant unusual transactions are principally contained in AU sec. 316.^{40/} Specifically, AU sec. 316.66 recognizes that during a financial statement audit, the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment. AU sec. 316.66 requires that, if the auditor becomes aware of significant unusual transactions during the course of an audit, the auditor should gain an understanding of the business rationale of such transactions and whether that rationale (or the lack thereof) suggests that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. In addition, the existing risk assessment standards anticipate that the auditor will consider risks of material misstatement that are posed by significant transactions that are outside the normal course of business for the company or otherwise appear unusual due to their timing, size, or nature.^{41/}

^{40/} See AU secs. 316.66–.67.

^{41/} See paragraph 71.g. of Auditing Standard No. 12.



Key Improvements from the Existing Standards: The amendments regarding significant unusual transactions are designed to improve existing Board standards in the following key respects:

- *Conforming Descriptions of Significant Unusual Transactions:* The amendments regarding significant unusual transactions amend AU sec. 316.66 to describe significant unusual transactions as 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. The amendments regarding significant unusual transactions also include conforming changes to introduce a uniform description of "significant unusual transactions" throughout the Board's standards.
- *Improving Requirements for Identifying Significant Unusual Transactions:* The amendments regarding significant unusual transactions require the performance of specific procedures intended to improve the auditor's identification of significant unusual transactions, for example, by amending Auditing Standard No. 12 to require the auditor to make inquiries of management and others.
- *Improving the Auditor's Evaluation of Significant Unusual Transactions:* The amendments regarding significant unusual transactions to AU secs. 316.66-.67A include basic procedures for obtaining information for evaluating significant unusual transactions. The basic procedures include: (i) reading the underlying documentation relating to significant unusual transactions and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction; (ii) determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures; and (iii) evaluating the financial capability of the other parties to the transaction with respect to significant uncollected balances, guarantees, and other obligations. The basic procedures are designed to assist the auditor in identifying red flags that indicate potential risks of material misstatement. Additionally, the standard requires more in-depth procedures that are designed to be scalable and commensurate with the facts and circumstances of the audit.
- *Enhancing Attention to the Business Purpose (or the Lack Thereof) of Significant Unusual Transactions:* The amendments regarding significant unusual transactions to AU secs. 316.66-.67 are intended to enhance the auditor's evaluation of the business purpose of significant unusual



transactions by, among other things, expanding the factors considered by the auditor in evaluating whether the business purpose (or the lack thereof) indicates that such transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

- *Emphasizing a Complementary Audit Approach:* The amendments to AU secs. 316.66-.67A emphasize a complementary audit approach by requiring the auditor to take into account other work performed during the audit, for example, information gathered with respect to related party transactions, when identifying a company's significant unusual transactions.
- *Emphasizing Accounting and Disclosure:* The amendments regarding significant unusual transactions to AU sec. 316.67A are intended to heighten the auditor's attention to accounting matters relative to significant unusual transactions. The new requirements emphasize that the auditor must evaluate whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework.^{42/}

Changes from the Reproposed Amendments: The Board is adopting the amendments substantially as repropose, with some clarifying changes. More detail regarding those changes is included in Section III. of Appendix 4.

Financial Relationships and Transactions with Executive Officers

The other amendments are intended to provide for improved audit procedures in complementary areas, including requiring that the auditor perform procedures, as part of the auditor's risk assessment, to obtain an understanding of the company's financial relationships and transactions with its executive officers.^{43/} These new procedures are intended to heighten the auditor's attention to incentives or pressures for the company to achieve a particular financial position or operating result, recognizing the key role that

^{42/} See paragraphs 30-31 of Auditing Standard No. 14, *Evaluating Audit Results*, which address the auditor's evaluation of the presentation of the financial statements, including the disclosures.

^{43/} See Section IV.A. of Appendix 4 for a discussion of the applicable definition of the term "executive officer."



a company's executive officers may play in the company's accounting decisions or in a company's financial reporting.

As discussed previously, clarifications were made to the other amendments to explicitly provide that the auditor's work relating to a company's financial relationships and transactions with its executive officers does not include an assessment of the appropriateness or reasonableness of executive compensation arrangements.

The Existing Standards and Key Improvements: The existing risk assessment standards require the auditor to consider obtaining an understanding of compensation arrangements with senior management (including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses) as part of obtaining an understanding of the company. The other amendments strengthen existing requirements by requiring the auditor, as part of the audit risk assessment process, to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. This reflects that a company's executive officers are a group that, because of their position in the company, can exert influence over the company's accounting and financial statement presentation.

No Changes from Reproposed Amendments: The Board is adopting the amendments regarding financial relationships and transactions with executive officers as repropoed. A discussion of the comments received is included in Section IV. of Appendix 4.

Other Amendments to PCAOB Auditing Standards

In addition to the other amendments relating to financial relationships and transactions with executive officers, the other amendments being adopted by the Board revise other auditing standards to conform them to the standard and amendments and, where appropriate, include new requirements that complement the standard and amendments regarding significant unusual transactions.

For example, the other amendments include changes to AU sec. 333, relating to management's written representations to the auditor, to include a representation that management has made available to the auditor the names of all related parties and relationships and transactions with related parties. Additionally, the other amendments to AU sec. 333 require the auditor to obtain relevant written representations from management: (i) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor, and (ii) if the company's financial statements include an assertion that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction.



Other new requirements in the other amendments complement the requirements in the standard and amendments through improvements to the auditor's: (i) communications with a predecessor auditor; (ii) procedures during the period subsequent to the date of the auditor's report; and (iii) procedures during reviews of interim financial information. These and the other amendments being adopted by the Board are discussed in greater detail in Appendix 4.

The Board is adopting the other amendments substantially as repropoed, with only minor clarifying changes. More detail regarding those changes is included in Section IV. of Appendix 4.

V. Economic Considerations, Including Benefits and Costs

The Board is adopting the standard and amendments pursuant to its mandate to protect the interest of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

The Board is mindful of the potential economic impacts of its standard-setting. Appendix 5 discusses in greater detail the economic impacts considered by the Board as it developed the standard and amendments, including likely benefits and costs.

In general, the Board believes that the standard and amendments will benefit investors by requiring the auditor to focus appropriate auditing attention on critical areas that warrant heightened scrutiny during the audit. The auditor's heightened scrutiny of transactions in the critical areas, and the enhanced understanding of such transactions, both by the auditor and the audit committee, should improve the quality of the audit and also may result in improvements in companies' accounting and disclosures in these areas. Additionally, the standard and amendments have the potential to improve both the auditor's and the audit committee's understanding of the critical areas, enabling the auditor to be more effective in identifying and addressing risks, and contributing to the audit committee's oversight of the company's financial reporting. Enhancing the quality of a company's financial reporting should serve to reduce information asymmetry^{44/} between management and investors, and foster increased public confidence in the financial markets and improve the efficiency of capital allocation decisions.

^{44/} Information asymmetry refers to situations involving two or more parties in a relationship in which one party has more, or better, information than the other party. For more information on matters related to the separation of ownership and control of companies and the implications on financial markets, see Section II.A. of Appendix 5.



The benefits and costs considered by the Board are difficult to quantify reliably. As noted previously, the Board specifically requested commenters' views regarding the economic impacts of the repropoed standard and amendments, and was particularly interested in obtaining empirical data regarding both benefits and costs that could relate to the repropoed standard and amendments. Commenters provided views on a wide range of issues pertinent to economic considerations, including potential benefits and costs, but did not provide empirical data. Therefore, the Board's economic discussion is qualitative in nature.

In general, commenters supported the Board's standard-setting efforts and agreed that the existing standards should be improved in the critical areas. Many commenters indicated that the new requirements could have a positive impact on audit quality. Some commenters cited improvements in specific areas such as the auditor's: (i) identification of material misstatements due to fraud; (ii) overall risk assessments for the audit; and (iii) application of professional skepticism. Additionally, other benefits noted by commenters included improvements in audit committee communications and company financial statement disclosures.

The Board understands that the new requirements will result in some additional audit effort and costs. Commenters who addressed potential costs provided information on potential costs that was generally consistent with the discussion of economic considerations in the repropoing release. Commenters noted that there would be some increased costs but did not provide data regarding the extent of such costs. However, commenters generally agreed that the standard and amendments are appropriate for audits of companies of all types and sizes, with some noting the particular risks posed by transactions between smaller companies and related parties. Appendix 5 discusses in greater detail potential benefits and costs considered by the Board in developing the standard and amendments.

After considering the record developed by the Board through its proposal and repropoal, including comments received reflecting widespread overall support for the Board's efforts to improve its existing standards in these critical areas, the Board believes that its new auditor performance requirements will advance investor protection and improve audit quality. The Board also believes that its new requirements reflect a reasoned approach that considers and is intended to limit unnecessary audit effort and potential costs.

VI. Applicability to Audits of Emerging Growth Companies

As noted above, the Board is adopting the standard and amendments pursuant to its authority under the Act. Before rules adopted by the Board can take effect, they must be approved by the SEC. Pursuant to Section 107(b)(3) of the Act, the SEC shall



approve a proposed rule if it finds that the rule is "consistent with the requirements of [the] Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors."

Additionally, Section 104 of the JOBS Act^{45/} amended the Act to provide that any additional rules adopted by the PCAOB after April 5, 2012 do not apply to audits of EGCs^{46/} unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."^{47/} As a result, the standard and amendments will be subject to a separate determination by the SEC regarding their applicability to audits of EGCs.

The Board is providing information, which is set forth in Appendix 5, to assist the SEC in its consideration of whether it is "necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation," to apply the standard and amendments to audits of EGCs. This information includes data and analysis of EGCs identified by the Board's staff from public sources.

As more fully discussed in Appendix 5, the Board believes that the standard and amendments are in the public interest and, after considering the protection of investors and the promotion of efficiency, competition, and capital formation, the Board is recommending that the standard and amendments apply to audits of EGCs. The Board stands ready to assist the SEC in considering any comments the SEC receives on these matters during the SEC's public comment process.

VII. Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")^{48/} provided the Board with oversight authority with respect to audits of brokers and dealers that are registered with the SEC. In light of the authority

^{45/} Pub. L. No. 112–106, 126 Stat. 306 (2012).

^{46/} Section 3(a)(80) of the Exchange Act defines the term "emerging growth company."

^{47/} See Section 103(a)(3)(C) of the Act (15 U.S.C. §7213(a)(3)(c)), as amended by Section 104 of the JOBS Act, Pub. L. No. 112–106 (2012).

^{48/} Pub. L. No. 111–203, 124 Stat. 1376 (July 21, 2010).



granted to the Board by the Dodd-Frank Act, the SEC adopted on July 30, 2013, amendments to Rule 17a-5 under the Exchange Act to require, among other things, that audits of brokers' and dealers' financial statements be performed in accordance with the standards of the PCAOB for fiscal years ending on or after June 1, 2014.^{49/}

In its reproposal, issued before the SEC's adoption of amendments to Rule 17a-5, the Board solicited comment regarding whether there were specific issues relating to audits of brokers and dealers of which the Board should be aware. As more fully described in Appendix 4, some commenters provided views regarding certain issues pertinent to audits of brokers and dealers and also generally stated that the reproposed standard and amendments should apply to audits of brokers and dealers.

The standard and amendments, if approved by the SEC, will be applicable to all audits performed pursuant to PCAOB standards, including audits of brokers and dealers.

VIII. Effective Date

The Board determined that the standard and amendments will be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of interim financial information within these fiscal years.

Section VI. of Appendix 4 discusses the comments received relating to the effective date of the standard and amendments in further detail. Commenters generally stated that the effective date in the reproposing release was reasonable, provided the standard and amendments were approved three to four months prior to the effective date in the reproposing release.

IX. Appendices

This release contains the following appendices:

- Appendix 1 contains the standard, *Related Parties*.
- Appendix 2 contains the amendments to certain PCAOB auditing standards regarding significant unusual transactions.

^{49/} See *Broker-Dealer Reports*, Release No. 34-70073, (July 30, 2013), 78 Federal Register 51910 (August 21, 2013), <http://www.sec.gov/rules/final/2013/34-70073.pdf>.



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- Appendix 3 contains the other amendments to PCAOB auditing standards.
- Appendix 4 provides additional discussion of the standard and amendments. Appendix 4 also includes discussion of significant comments received and the Board's consideration of such comments. Additionally, to assist auditors in implementation of the standard and amendments, Appendix 4 includes discussion and examples from the Board's proposing and reproposing releases modified to address the standard and amendments being adopted by the Board.
- Appendix 5 contains a discussion of economic considerations, including for audits of EGCs.
- Appendix 6 contains a comparison of certain significant differences between the objective and key requirements of the standard and the amendments and the analogous standards of the IAASB and the ASB.

* * *

On the 10th day of June, in the year 2014, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

June 10, 2014



APPENDIX 1

Auditing Standard No. 18

Related Parties

Introduction

1. This standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.^{1/}

Objective

2. The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.^{2/}

Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties

3. The auditor should 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 in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. The

^{1/} The auditor should look to the requirements of the U.S. Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties" and the financial statement disclosure requirements with respect to related parties.

^{2/} See, e.g., paragraphs 30-31 of Auditing Standard No. 14, *Evaluating Audit Results*. See also paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.



procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company's process (paragraph 4);
- b. Performing inquiries (paragraphs 5-7); and
- c. Communicating with the audit engagement team and other auditors (paragraphs 8-9).

Note: 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.

Note: Performing the risk assessment procedures described in paragraphs 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 related parties and relationships and transactions with related parties.

Obtaining an Understanding of the Company's Process

4. In conjunction with obtaining an understanding of internal control over financial reporting, the auditor should obtain an understanding of the company's process for:^{3/}
 - a. Identifying related parties and relationships and transactions with related parties;

^{3/} See, e.g., paragraph 18 of Auditing Standard No. 12, which requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures. See also paragraph 20 of Auditing Standard No. 12, which states that obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.



- b. Authorizing and approving transactions with related parties; and
- c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

Performing Inquiries

- 5. The auditor should inquire of management regarding:^{4/}
 - a. The names of the company's related parties during the period under audit, including changes from the prior period;
 - b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);
 - c. The nature of any relationships, including ownership structure, between the company and its related parties;
 - d. The transactions entered into, modified, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;
 - e. The business purpose for entering into a transaction with a related party versus an unrelated party;
 - f. 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; and
 - g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

^{4/} See also AU sec. 333, *Management Representations*. Obtaining such representations from management complements the performance of procedures in paragraph 5 and is not a substitution for those inquiries.



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

- a. The company's related parties or relationships or transactions with related parties;
- b. The company's controls over relationships or transactions with related parties; and
- c. The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.^{6/}

7. The auditor should inquire of the audit committee,^{7/} or its chair, regarding:

- a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
- b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

^{5/} Examples of "others" within the company who may have such knowledge include: personnel in a position to initiate, process, or record transactions with related parties and those who supervise or monitor such personnel; internal auditors; in-house legal counsel; the chief compliance/ethics officer or person in equivalent position; and the human resources director or person in equivalent position.

^{6/} For purposes of this standard, the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties.

^{7/} The term "audit committee" has the same meaning as the term used in Auditing Standard No. 16, *Communications with Audit Committees*.



Communicating with the Audit Engagement Team and Other Auditors

8. The auditor should communicate to engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.^{8/}

9. 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.^{9/} The auditor also should inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.

Identifying and Assessing Risks of Material Misstatement

10. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level.^{10/} This includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties.

^{8/} This communication, which can be more effective when it occurs at an early stage of the audit, complements the discussion among engagement team members regarding risks of material misstatement in accordance with paragraph 49 of Auditing Standard No. 12. See also paragraph 5 of Auditing Standard No. 10, *Supervision of the Audit Engagement*, which establishes requirements regarding supervision of the engagement team members, including directing engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities.

^{9/} See AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements.

^{10/} See paragraph 59 of Auditing Standard No. 12.



Note: In identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4-9 of this standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

Responding to the Risks of Material Misstatement

11. The auditor must design and implement audit responses that address the identified and assessed risks of material misstatement.^{11/} This includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.^{12/}

Note: The auditor also should look to the requirements in paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). For such related party transactions, AU sec. 316.67 requires 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.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk

12. For each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:

^{11/} See paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

^{12/} See generally, Auditing Standard No. 13 and paragraph 17 of Auditing Standard No. 15, *Audit Evidence*, which provides that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.



- a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. 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;
- c. Determine whether any exceptions to the company's established policies or procedures were granted;^{13/}
- d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;^{14/} and
- e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Note: 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 in paragraph 12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

^{13/} Information gathered while obtaining an understanding of the company also might assist the auditor in identifying agreements prohibiting or restricting related party transactions (for example, loans or advances to related parties).

^{14/} Examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.



Intercompany Accounts

13. The auditor should perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

Note: The procedures performed should address the risks of material misstatement associated with the company's intercompany accounts.

Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties

14. The auditor should evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, taking into account the information gathered during the audit.^{15/} As part of this evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

Note: Appendix A contains examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

15. If the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether

^{15/} Information obtained from identifying and evaluating a company's significant unusual transactions and obtaining an understanding of a company's financial relationships and transactions with its executive officers could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.



previously undisclosed relationships or transactions with related parties, in fact, exist.^{16/} These procedures should extend beyond inquiry of management.

16. If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;^{17/}
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of this standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk; and

^{16/} See paragraph 29 of Auditing Standard No. 15, which states that if audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

^{17/} See AU sec. 333.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.



- f. Perform the following procedures, taking into account the information gathered from performing the procedures in a. through e. above:
 - i. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
 - ii. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk;^{18/} and
 - iii. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1.

Evaluating Financial Statement Accounting and Disclosures

17. The auditor must evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. This includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.^{19/}

^{18/} See paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.

^{19/} See paragraphs 30-31 of Auditing Standard No. 14.



Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions

18. If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.^{20/}

Note: Transactions with related parties might not be conducted on terms equivalent to those prevailing in arm's-length transactions (e.g., a company may receive services from a related party without cost). Except for routine transactions, it may not be possible for management to determine whether a particular transaction would have taken place, or what the terms and manner of settlement would have been, if the parties had not been related. Accordingly, it may be difficult for the auditor to obtain sufficient appropriate audit evidence to substantiate management's assertion that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. A preface to a statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

^{20/} See paragraph .06.I. of AU sec. 333, which requires the auditor to obtain written representations from management if the financial statements include such an assertion. Representations from management alone are not sufficient appropriate audit evidence. See also paragraphs .35–.36 of AU sec. 508, *Reports on Audited Financial Statements*.



Communications with the Audit Committee

19. The auditor should communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.^{21/} The auditor also should communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and
- e. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

^{21/} See Auditing Standard No. 16 regarding the timing of the communications to the audit committee.



APPENDIX A – Examples of Information and Sources of Information That May Be Gathered During the Audit That Could Indicate That Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor Might Exist

A1. This Appendix contains examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Specifically, paragraph A2. of this Appendix contains examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Similarly, paragraph A3. contains examples of sources that could contain such information. The examples contained in this Appendix are not intended to represent a comprehensive listing.

A2. The following are examples of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Buying or selling goods or services at prices that differ significantly from prevailing market prices;
- Sales transactions with unusual terms, including unusual rights of return or extended payment terms generally not offered;
- "Bill and hold" type transactions;
- Borrowing or lending on an interest-free basis or with no fixed repayment terms;
- Occupying premises or receiving other assets or rendering or receiving management services when no consideration is exchanged;
- Engaging in a nonmonetary transaction that lacks commercial substance;
- Sales without economic substance (e.g., funding the other party to the transaction to facilitate collection of the sales price, or entering into a transaction shortly prior to period end and unwinding that transaction shortly after period end);
- Loans to parties that, at the time of the loan transaction, do not have the ability to repay and possess insufficient or no collateral;
- Loans made without prior consideration of the ability of the party to repay;



- A subsequent repurchase of goods that indicates that at the time of sale an implicit obligation to repurchase may have existed that would have precluded revenue recognition or sales treatment;
- Advancing company funds that are used directly or indirectly to pay what would otherwise be an uncollectible loan or receivable;
- Sales at below market rates to an intermediary whose involvement serves no apparent business purpose and who, in turn, sells to the ultimate customer at a higher price, with the intermediary (and ultimately its principals) retaining the difference;
- Guarantees and guarantor relationships outside the normal course of business; or
- Transactions between two or more entities in which each party provides and receives the same or similar amounts of consideration (e.g., round-trip transactions).

A3. The following are examples of sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies;
- Disclosures contained on the company's website;
- Confirmation responses and responses to inquiries of the company's lawyers;
- Tax filings and related correspondence;
- Invoices and correspondence received from the company's professional advisors, for example, attorneys and consulting firms;
- Relevant internal auditors' reports;
- Conflicts-of-interest statements from management and others;
- Shareholder registers that identify the company's principal shareholders;
- Life insurance policies purchased by the company;
- Records of the company's investments, pension plans, and other trusts established for the benefit of employees, including the names of the officers and trustees of such investments, pension plans, and other trusts;
- Contracts or other agreements (including, for example, partnership agreements and side agreements or other arrangements) with management;



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- Contracts and other agreements representing significant unusual transactions;
- Significant contracts renegotiated by the company during the period under audit;
- Records from a management, audit committee, or board of directors' whistleblower program;
- Expense reimbursement documentation for executive officers; or
- The company's organizational charts.



APPENDIX 2

Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

A. Identifying Significant Unusual Transactions (Section III.A. of Appendix 4)

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

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, as amended, is amended as follows:

In paragraph 14:

- The first bullet point is replaced with:

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 those that result in late or unusual journal entries;^{10A/} and

- Footnote 10A is added at the end of the first bullet:

^{10A/} See paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

Auditing Standard No. 9, *Audit Planning*

Auditing Standard No. 9, *Audit Planning*, as amended, is amended as follows:

In paragraph 12, subparagraph a. is replaced with:

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.^{14/}



Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

a. In paragraph 13:

- The fifth bullet point is replaced with:

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");^{7A/} and

- Footnote 7A is added at the end of the fifth bullet:

^{7A/} See AU secs. 316.66-.67A.

b. In paragraph 56.a.:

- In item (6), delete the word "and" at the end of the item.
- In item (7), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
- Add Item (8):

(8) Whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties.^{31A/}

- Add footnote 31A at the end of item (8):

^{31A/} See AU secs. 316.66-.67A.

c. In paragraph 56.b.:

- In item (3), delete the word "and" at the end of the item.



- In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add item (5):
 - (5) Whether the company has entered into any significant unusual transactions.
- d. In paragraph 56.c.:
- In item (3), delete the word "and" at the end of the item.
 - In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
 - Add item (5):
 - (5) Whether the company has entered into any significant unusual transactions.
- e. In paragraph 57, the third bullet point is replaced with:
- Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements, a significant unusual transaction, or a significant related party transaction;
and
- f. Paragraph 71.g., is replaced with:
- Whether the risk involves significant unusual transactions.
- g. Paragraph 73A is added after paragraph 73:
- 73A. The auditor should obtain an understanding of the controls that management has established to identify, authorize and approve, and account for and disclose significant unusual transactions in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18-40 and 72-73 of this standard.



Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, as amended, is amended as follows:

- a. The second sentence of footnote 3 to paragraph 5.d. is replaced with:

See also paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and paragraphs .04 and .06 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

- b. Paragraph 15.c. is replaced with:

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 may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets (AU secs. 316.66-.67A).

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. The first item in paragraph .85A.2, section a., under "Opportunities" is replaced with the following two items:
- Related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business)
 - Significant transactions with related parties whose financial statements are not audited or are audited by another firm
- b. The fourth item in paragraph .85A.2, section a., under "Opportunities" is replaced with:



- o Significant or highly complex transactions or significant unusual transactions, especially those close to period end, that pose difficult "substance-over-form" questions
- c. The following item is added as the last item to paragraph .85A.2, section a., under "Opportunities":
 - o Contractual arrangements lacking a business purpose

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

- a. In paragraph .55, Appendix B, paragraph B1., the tenth bullet is replaced with the following two bullets:
 - The occurrence of infrequent transactions
 - The occurrence of significant unusual transactions

B. Evaluating Significant Unusual Transactions (Section III.B. of Appendix 4)

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, as amended, is amended as follows:

- a. Paragraph 11A is added after paragraph 11:
 - 11A. *Responding to Risks Associated with Significant Unusual Transactions.* Paragraph 71.g. of Auditing Standard No. 12 indicates that one of the factors to be evaluated in determining significant risks is whether the risk involves significant unusual transactions. Also, AU secs. 316.66-.67A establish requirements for performing procedures to respond to fraud risks regarding significant unusual transactions. Because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of



potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-.67A.

Auditing Standard No. 16, *Communications with Audit Committees*

Auditing Standard No. 16, *Communications with Audit Committees*, is amended as follows:

- a. In paragraph 13.d., the phrase "rationale for" is replaced with the phrase "purpose (or the lack thereof) of."

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. Paragraph .66 is replaced with:
 - .66 Evaluating whether the business purpose for significant unusual transactions indicates that the transactions may have been entered into to engage in fraud.** 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.

Note: The auditor's identification of significant unusual transactions should take into account information obtained from: (a) the risk assessment procedures required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial reporting) and (b) other procedures performed during the audit (e.g., reading minutes of the board of



directors meetings and performing journal entry testing).

Note: The auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. See paragraphs 14-16 of Auditing Standard No. 18, *Related Parties*. Appendix A of Auditing Standard No. 18, *Related Parties*, includes examples of such information and examples of sources of such information.

b. Paragraph .66A is added after paragraph .66:

.66A The auditor should design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. The procedures should include:

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;
fn 24A and
- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

Note: Paragraph 11A of Auditing Standard No. 13 requires the auditor to take into account the types of potential misstatements



that could result from significant unusual transactions in designing and performing further audit procedures.

- c. Footnote 24A is added after subparagraph c. of paragraph .66A

^{fn 24A} Examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

- d. Paragraph .67 is replaced with:

.67 The auditor should evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. In making that evaluation, the auditor should evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);
- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor; ^{fn 25A}
- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party of the company;
- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);



- 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 other, more clearly independent, parties on an arm's-length basis;
- The transaction enables the company to achieve certain financial targets;
- 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); and
- Management has discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Note: Paragraphs 20-23 of Auditing Standard No. 14, *Evaluating Audit Results*, provide requirements regarding the auditor's evaluation of whether identified misstatements might be indicative of fraud.

- e. Footnote 25 is deleted and footnote 25A is added at the end of the third bullet in paragraph .67:

^{fn 25A}

Related parties or relationships or transactions with related parties previously undisclosed to the auditor includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties. Auditing Standard No. 18, *Related Parties*, requires the auditor to perform certain procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

- f. Paragraph .67A is added after paragraph 67:

.67A 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 evaluating



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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.^{fn 25B}

Note: The auditor considers management's disclosure regarding significant unusual transactions in other parts of the company's Securities and Exchange Commission filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

- g. Footnote 25B is added at the end of paragraph.67A:

^{fn 25B} See paragraphs 30-31 of Auditing Standard No. 14.



APPENDIX 3

Other Amendments to PCAOB Auditing Standards

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

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

- a. The following sentence is added to the end of footnote 3 of paragraph 4:

Also, Auditing Standard No. 18, *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.

- b. In paragraph 10, the note following the final bullet is deleted.

- c. Paragraph 10A is added after paragraph 10:

10A. To assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's financial relationships and transactions with its **executive officers** (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the Securities and Exchange Commission and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.

- d. In paragraph 11:

- The third bullet is replaced with:



Obtaining an understanding of compensation arrangements with senior management other than executive officers referred to in paragraph 10A, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses;

- In the fourth bullet, delete the period (.) and add a semicolon (;) at the end of the bullet.

- Add a fifth bullet:

Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and

- Add a sixth bullet:

Obtaining an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

- e. In Appendix A, paragraph A3A is added after paragraph A3:

A3A. Executive officer – For issuers, the president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policy-making functions for the company. (See Rule 3b-7 under the Exchange Act.) For brokers and dealers, the term "executive officer" includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions. (See Schedule A of Form BD.)



Auditing Standard No. 16, *Communications with Audit Committees*

Auditing Standard No. 16, *Communications with Audit Committees*, is amended as follows:

- a. The phrase "AU sec. 334, *Related Parties*" in footnote 25 is replaced with the phrase "Auditing Standard No. 18, *Related Parties*."
- b. The following bullet is inserted after the third bullet in Appendix B:
 - Auditing Standard No. 18, *Related Parties*, paragraphs 7 and 19.

AU sec. 315, "Communications Between Predecessor and Successor Auditors" (Section IV.B. of Appendix 4)

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows:

- a. The following bullet is added to the end of paragraph .09:
 - The predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions.^{fn 5A}
- b. Add the following footnote to the end of paragraph .09:

^{fn 5A} Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, describes significant unusual transactions.
- c. In paragraph .11, replace the fifth sentence with:

The predecessor auditor should ordinarily permit the successor auditor to review working papers, including documentation of planning, internal control, audit results, and other matters of continuing accounting and auditing significance, such as the working papers containing an analysis of balance sheet accounts, those relating to contingencies, related parties, and significant unusual transactions.



AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"
(Section IV.C. of Appendix 4)

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows:

- a. The heading before paragraph .79 is replaced with:

Communication about Possible Fraud to Management, the Audit Committee, the Securities and Exchange Commission, and Others ^{fn 37}

- b. Paragraph .81A is added after paragraph .81:

.81A The auditor has a responsibility, under certain conditions, to disclose possible fraud to the Securities and Exchange Commission to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change and the fraud or related risk factors constitute a reportable event or are the source of a disagreement, as these terms are defined in Item 304 of Regulation S-K and Item 16F of Form 20-F. These requirements also include reports that may be required pursuant to Section 10A(b) of the Securities Exchange Act of 1934 relating to an illegal act that the auditor concludes has a material effect on the financial statements.

- c. For paragraph .82:

- Footnotes 39 and 41 are deleted.
- The paragraph is replaced with:

.82 The auditor also may have a duty to disclose the existence of possible fraud to parties outside the entity in the following circumstances:

- a. To a successor auditor when the successor makes inquiries in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors*.^{fn 40}
- b. In response to a subpoena.



- c. To a funding agency or other specified agency in accordance with requirements for the audits of companies that receive governmental financial assistance.
- d. The following item is added to paragraph .85A.2, section b., under "Opportunities":
 - o The exertion of dominant influence by or over a related party

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), as amended, is amended as follows:

- a. Footnote 2 to paragraph .27 is replaced with:

Auditing Standard No. 18, *Related Parties*, establishes requirements regarding the auditor's evaluation of relationships and transactions between the company and its related parties.

AU sec. 333, "Management Representations" (Section IV.D. of Appendix 4)

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

- a. The third sentence of paragraph .03 is replaced with:

For example, after the auditor performs the procedures described in Auditing Standard No. 18, *Related Parties*, the auditor should obtain a written representation that management has no knowledge of any relationships or transactions with related parties that have not been properly accounted for and adequately disclosed. The auditor should obtain this written representation even if the results of those procedures indicate that relationships and transactions with related parties have been properly accounted for and adequately disclosed.

- b. In paragraph .06:
 - Subparagraph c. is replaced with:



Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Subparagraph f. is replaced with:

Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.

- Subparagraph l. is replaced with:

Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.^{fn9}

- c. Footnote 9 to paragraph .06 is replaced with:

See paragraph 18 of Auditing Standard No. 18, *Related Parties*.

- d. The second sentence in paragraph 4 of Appendix A is replaced with:

Examples are fraud, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in Auditing Standard No. 18, *Related Parties*.

- e. In paragraph 6 of Appendix A:

- Item 2.a. is replaced with:

Financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Item 11.d. is added:

Side agreements or other arrangements (either written or oral) that have not been disclosed to you.

AU sec. 334, "Related Parties"

SAS No. 45, Omnibus Statement on Auditing Standards — 1983 (AU sec. 334, "Related Parties"), as amended, is superseded.



AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," as amended, is superseded.

AU sec. 336, "Using the Work of a Specialist"

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336, "Using the Work of a Specialist"), as amended, is amended as follows:

- a. Footnote 6 of paragraph .10 is replaced with:

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.

AU sec. 560, "Subsequent Events" (Section IV.E. of Appendix 4)

SAS No. 1, "Codification of Auditing Standards and Procedures," section 560, "Subsequent Events" (AU sec. 560, "Subsequent Events"), as amended, is amended as follows:

- a. In paragraph .12b.:

- Item (v) is added:

Whether there have been any changes in the company's related parties.

- Item (vi) is added:

Whether there have been any significant new related party transactions.

- Item (vii) is added:

Whether the company has entered into any significant unusual transactions.



AU sec. 722, "Interim Financial Information" (Section IV.F. of Appendix 4)

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows:

a. In paragraph .24:

- Subparagraph g. is replaced with:

Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Subparagraph j. is replaced with:

Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.

- Subparagraph m. is replaced with:

Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

b. The second sentence of paragraph C5 of paragraph .56 is replaced with:

Examples are *fraud*, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in Auditing Standard No. 18, *Related Parties*.

c. Within paragraph C6 of paragraph .56, within the first illustrative representation letter (1.) for a review of interim financial information (statements):

- Item 2.a. is replaced with:

All financial records and related data, including the names of all related parties and all relationships and transactions with related parties.



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- d. Within paragraph C6 of paragraph .56, within the second illustrative representation letter (2.) for a review of interim financial information (statements):
- Item 2.a. is replaced with:

All financial records and related data, including the names of all related parties and all relationships and transactions with related parties.
 - Item 12.d. is added:

Side agreements or other arrangements (either written or oral) that have not been disclosed to you.



APPENDIX 4 – Additional Discussion of the Standard and Amendments

I. Introduction

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is adopting: (i) Auditing Standard No. 18, *Related Parties* (the "standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "amendments regarding significant unusual transactions"); and (iii) other amendments to PCAOB auditing standards (the "other amendments").^{1/} The standard supersedes the Board's existing auditing standard AU sec. 334, *Related Parties* (the "existing standard").

This Appendix discusses the standard in Appendix 1, the amendments regarding significant unusual transactions in Appendix 2, and the other amendments in Appendix 3.^{2/} This Appendix also provides background information regarding the standard and amendments and includes a discussion of significant comments received on the repropose standard and amendments, including revisions the Board has made.^{3/} This Appendix also includes additional discussion and examples that could be useful to auditors in implementing the standard and amendments.

The standard and amendments result from several years of careful consideration, including outreach to the Board's Standing Advisory Group ("SAG"). The Board first proposed the standard and amendments on February 28, 2012.^{4/} On May 7,

^{1/} A company's related party transactions, significant unusual transactions, and financial relationships and transactions with its executive officers, are collectively referred to in this Appendix 4 as "the critical areas" or "these critical areas."

^{2/} The amendments regarding significant unusual transactions and the other amendments are collectively referred to as the "amendments." The standard and amendments are collectively referred to as the "standard and amendments."

^{3/} Appendix 5 also provides a discussion of comments received relevant to economic considerations and the Board's consideration of such comments.

^{4/} See *Proposed Auditing Standard-Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (the "proposing release"), PCAOB Release No. 2012-001 (February 28, 2012), <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>. The proposed



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2013, the Board issued a repropoed auditing standard (the "repropoed standard"), repropoed amendments regarding significant unusual transactions (the "repropoed amendments regarding significant unusual transactions") and the other repropoed amendments (the "other repropoed amendments").^{5/} In its repropoal, the Board requested comment on all aspects of the repropoal, including the potential economic impacts of its repropoal. In particular, the Board sought empirical data regarding both the benefits and costs and other effects that could relate to the repropoed standard and amendments. The comment period for the repropoal ended on July 8, 2013.

The Board received 24 comment letters on its repropoal. The Board also discussed the repropoed standard and amendments with its SAG on May 15, 2013 (the "SAG discussion").^{6/} The Board considered all comments received. In general, commenters were supportive of the Board's standard-setting efforts to improve the existing standards in these critical areas. Many commenters noted that the repropoed standard and amendments could improve audit quality.

After considering the comments received, the Board is adopting the standard and amendments substantially as repropoed, except for certain clarifications and changes that are being made largely in response to comments.

amendments regarding significant unusual transactions and the other proposed amendments are collectively referred to as the "proposed amendments." The proposed standard and proposed amendments are collectively referred to as the "proposed standard and amendments" or the "proposal."

^{5/} See *Proposed Auditing Standard-Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (the "repropoing release"), PCAOB Release No. 2013–004 (May 7, 2013), <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>. The repropoed amendments regarding significant unusual transactions and the other repropoed amendments are collectively referred to as the "repropoed amendments." The repropoed standard and repropoed amendments are collectively referred to as the "repropoed standard and amendments" or the "repropoal."

^{6/} The transcript of the SAG's discussion of the repropoed standard and amendments is available at http://pcaobus.org/Rules/Rulemaking/Docket038/2013-05-15_SAG%20Transcript-Related_Parties.pdf.



A recurring theme from comments received on both the proposal and reproposal dealt with including additional discussion and examples in the standard and amendments. Several commenters requested that the Board include additional discussion and examples contained in the proposing and reproposing releases in the text of the standard and amendments. Some commenters suggested that not including additional discussion and examples could affect the consistency of implementation and the initial and recurring implementation costs.

The Board considered these comments and determined, as it has done in other projects, to include performance requirements in the standard and amendments and to provide additional discussion and examples primarily in an appendix to its adopting release. As noted in the reproposal, this approach promotes a clear separation between the required procedures and the Board's additional discussion regarding the application of the standard and amendments. To assist auditors in implementing the standard and amendments, this Appendix includes additional discussion and examples previously included in the proposing and reproposing releases, modified to address the standard and amendments being adopted by the Board.

This Appendix includes the following sections: (II.) Auditing Standard No. 18, *Related Parties*; (III.) Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions; (IV.) Other Amendments to PCAOB Auditing Standards; (V.) Audits of Brokers and Dealers; and (VI.) Effective Date.

II. Auditing Standard No. 18, *Related Parties* (Appendix 1)

As noted above, commenters generally supported the Board's standard-setting efforts to strengthen the existing auditing standard, with many commenters noting that the reproposed standard could have a positive impact on audit quality. Many commenters also suggested changes for further improving the reproposed standard, including some clarifications and editorial suggestions.

The Board is adopting the standard, substantially as reproposed, but is making certain revisions to clarify and refine various aspects of the standard. The most significant changes include:

- *Clarifying the Scope of the Auditor's Inquiries Regarding Related Party Transactions (Paragraph 5):* Paragraph 5 of the standard includes a revision to clarify the scope of the auditor's inquiries of management to include transactions with its related parties that were modified during the period under audit.



- *Including Examples of Others Within the Company of Whom the Auditor Might Inquire (Paragraph 6):* A footnote has been added to paragraph 6 of the standard to provide examples of others within the company that the auditor might inquire of regarding the company's relationships and transactions with related parties.
- *Providing Direction Regarding Timing of Communications (Paragraph 8):* Paragraph 8 of the standard includes a revision that notes that the communication to engagement team members pursuant to paragraph 8 can be more effective when it occurs at an early stage of the audit.
- *Providing Direction Regarding Intercompany Accounts (Paragraph 13):* A note has been added to paragraph 13 of the standard to clarify that the procedures performed by the auditor should address the risks of material misstatement associated with the company's intercompany accounts.
- *Clarifying the Auditor's Responsibility for Evaluating the Company's Identification of its Related Parties (Paragraph 14):* Paragraph 14 includes revisions to highlight that the auditor's evaluation of a company's identification of its related parties includes performing procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, and that such evaluation takes into account the information gathered during the audit.
- *Clarifying the Auditor's Responsibility Regarding Appendix A (Paragraph 14):* Language has been added to paragraph 14 and Appendix A (referred to in paragraph 14) to clarify that Appendix A contains examples of information and sources of information that may be gathered during the audit.
- *Expanding the Examples Contained in Appendix A (Appendix A):* The examples of sources of information contained in Appendix A of the standard have been expanded to include the company's "disclosures contained on the company's website" (in addition to the company's disclosures in SEC filings, which is already included as an example in Appendix A).
- *Clarifying the Procedures Performed If the Auditor Identifies a Related Party or Relationship or Transaction with a Related Party Previously Undisclosed to the Auditor (Paragraph 16):* Paragraph 16 includes a



number of clarifications, the most significant of which include revisions clarifying that paragraph 16 requires the auditor to perform initial procedures intended to help the auditor understand and evaluate the nature of the undisclosed related party or relationship or transaction with a related party identified by the auditor. Taking into account the information gathered from performing those procedures, the auditor then performs additional procedures to evaluate any broader implications for the audit.

The following sections discuss the standard being adopted by the Board, the existing standard, significant comments received, and the Board's responses, including a description of the changes from the repropoed standard. The following sections also include additional discussion and examples that could be useful to auditors in implementing the standard. The sections are organized by the following topical areas:

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A. Introduction (Paragraph 1 of the Standard in Appendix 1)

Discussion of Paragraph 1 of Auditing Standard No. 18

Paragraph 1 of the standard states that the standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.

A footnote to paragraph 1 of the standard provides that the auditor should look to the requirements of the U.S. Securities and Exchange Commission ("SEC" or the "Commission") for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties" and the financial statement disclosure requirements with respect to related parties (which is referred to as a "framework neutral" approach).^{7/}

In contrast to the specific required procedures contained in the standard, AU sec. 334 provides guidance on procedures that the auditor should consider to identify related party relationships and transactions, and to satisfy himself concerning the required financial statement accounting and disclosures.^{8/} The standard also improves upon the existing standard by using a framework neutral approach. The existing standard, on the other hand, refers the auditor to the definition of a related party contained in GAAP.

After considering all comments received, the Board is adopting paragraph 1 of the standard as reposed.

^{7/} For SEC filings that include financial statements prepared in accordance with or reconciled to U.S. Generally Accepted Accounting Principles ("GAAP"), see, e.g., Financial Accounting Standards Board's ("FASB") Accounting Standards Codification Topic 850, *Related Party Disclosures*. For SEC filings that include financial statements prepared in accordance with International Financial Reporting Standards, as issued by the International Accounting Standards Board ("IFRS"), see, e.g., International Accounting Standard No. 24, *Related Party Disclosures*.

^{8/} See AU secs. 334.01–.02.



B. Objective (Paragraph 2 of the Standard in Appendix 1)

Discussion of Paragraph 2 of Auditing Standard No. 18

Paragraph 2 of the standard states that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements. A footnote refers the auditor to other relevant standards, including paragraphs 30-31 of Auditing Standard No. 14, *Evaluating Audit Results*, and paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*.

The intent of the objective is to focus the auditor on the end result - obtaining sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

In contrast, the existing standard does not specifically describe an objective for the auditor's work regarding a company's relationships and transactions with its related parties.

Discussion of Comments Received on Paragraph 2 of the Reproposed Standard

The Board considered all comments received, including the following significant comments:

Including the Consideration of "Fraud" as an Explicit Objective: A few commenters recommended that the objective of the standard refer to the risk of fraud as an explicit objective of the standard. The Board considered similar comments received on the proposal in developing its reproposal. As noted in the reproposal, related party transactions warrant special attention by the auditor, in part, because of their historic association with material misstatements that are associated with fraudulent financial reporting. The standard requires the auditor to perform specific procedures intended to provide for heightened scrutiny of the company's identification of, accounting for, and disclosure of its related parties and relationships and transactions with related parties. Since some related party transactions may be routine and occur in the ordinary course of business, the Board determined to take a risk-based approach that aligns with and



builds upon its risk assessment standards.^{9/} The risk assessment standards emphasize that the auditor's responsibilities for assessing and responding to fraud are an integral part of the audit process rather than a separate, parallel process. In the Board's view, this represents an effective and efficient audit approach. This is in contrast to the approach taken in the existing standard, which states that in the absence of evidence to the contrary, related party transactions should not be assumed to be outside the ordinary course of business.^{10/}

Incorporating Materiality into the Objective: A few commenters recommended including a reference to materiality in the objective of the standard. The Board considered these comments but noted that auditing standards require the auditor to design and perform audits to identify material misstatements. Also, direction regarding the auditor's considerations of materiality already is contained in Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*.

The Board is adopting paragraph 2 of the standard as repropoed, except for an additional reference to paragraph 30 of Auditing Standard No. 14 that has been added to footnote 2.

C. Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 through 9 of the Standard in Appendix 1)

Discussion of Paragraphs 3 through 9 of Auditing Standard No. 18

Paragraph 3 of the standard builds upon the foundational risk assessment requirements contained in Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Chiefly, paragraph 3 of the standard requires the auditor to perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the

^{9/} See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to Other PCAOB Standards*, PCAOB Release 2010–004 (August 5, 2010).

^{10/} AU sec. 334.06.



risks of material misstatement of the financial statements, in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12.^{11/}

Understanding the nature and business purpose (or the lack thereof) of a company's relationships and transactions with its related parties is important for the auditor's evaluation of the company's accounting for and disclosure of related party transactions because a company's relationships and transactions with its related parties could pose increased risks of material misstatement. For example, to improve the appearance of its financial condition, a company and a related party could attempt to "dress up" the appearance of the company's balance sheet at period end by agreeing to have the company temporarily pay down its related party debt prior to the balance sheet date while having an undisclosed side agreement to subsequently borrow the same or a comparable amount shortly after period end.

Paragraph 3 further provides that the procedures to be performed to obtain an understanding of the company's relationships and transactions include: (i) procedures to obtain an understanding of the company's process; (ii) performing inquiries; and (iii) communicating with the audit engagement team and other auditors.

The existing standard suggests some similar procedures for the auditor's consideration. For example, the existing standard states in AU sec. 334.05 that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component of the entity to the total entity. AU sec. 334.05 further states that the auditor should consider controls over management activities and the business purpose served by the various components of the entity. AU sec. 334.09 states that, after identifying related party transactions, the auditor should apply the procedures that the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. Additionally, paragraph 71 of Auditing Standard No. 12 states that one factor to be considered in determining whether a risk represents a significant risk is whether the risk involves significant transactions with related parties.

^{11/} In addition, as described in Section IV.A of this Appendix, the other amendments contained in Appendix 3 make a conforming amendment to Auditing Standard No. 12.



Obtaining an Understanding of the Company's Process (Paragraph 4 of the Standard in Appendix 1)

Paragraph 4 of the standard also aligns with and builds upon the requirements in Auditing Standard No. 12. Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to: (i) identify the types of potential misstatement; (ii) assess the factors that affect the risks of material misstatement; and (iii) design further audit procedures.^{12/} Paragraph 4 of the standard requires that, in conjunction with obtaining an understanding of internal control over financial reporting, the auditor obtain an understanding of the controls that management has established to: (i) identify related parties and relationships and transactions with related parties; (ii) authorize and approve transactions with related parties; and (iii) account for and disclose relationships and transactions with related parties in the financial statements.

Obtaining an understanding of the company's controls, including its policies and procedures, is important to an auditor's consideration of the risks that a company's relationships and transactions with related parties may pose for material misstatement of the company's financial statements. The standard recognizes that material features of companies' policies and procedures for the review, approval, or ratification of related party transactions will vary depending on both the size and complexity of the company and the types of transactions covered by such policies and procedures. The standard should not be read to imply that such policies and procedures should be in writing or adhere to any particular framework.

AU sec. 334, issued before the adoption of the risk assessment standards, is similar, but not as specific. Among other things, AU sec. 334.05 states that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities. AU sec. 334.05 further states that the auditor should consider controls over management activities.

Performing Inquiries (Paragraphs 5 through 7 of the Standard in Appendix 1)

Briefly, paragraphs 5 through 7 of the standard require the auditor to make specific inquiries of: (i) company management; (ii) others within the company likely to

^{12/} See paragraph 18 of Auditing Standard No. 12.



have additional knowledge regarding the company's related parties or relationships or transactions with the company's related parties; and (iii) the company's audit committee.

Appropriately focused inquiries can inform the auditor's understanding of the nature of the relationships between the company and its related parties, and the terms and business purposes (or the lack thereof) of transactions involving related parties. In addition, inquiries can assist the auditor in determining the extent of audit procedures that should be performed to determine whether the company has identified its related parties and relationships and transactions with its related parties.

The inclusion of the phrase "(or the lack thereof)" throughout the standard and amendments is intended to promote a questioning and skeptical approach by the auditor when obtaining an understanding of the business purpose of related party transactions. Sharpening the auditor's focus on evaluating the business purpose of related party transactions is particularly appropriate in view of the risk of material misstatement involving related party transactions.^{13/} The importance of identifying transactions that appear to lack a business purpose also is reinforced in other parts of the standard. For example, the standard requires the auditor to communicate to the audit committee the identification of significant related party transactions that appear to the auditor to lack a business purpose.

Paragraph 5 contains a list of inquiries of management that consist of basic information that the auditor should obtain as part of obtaining an understanding of the company's financial relationships and transactions with its related parties, such as the names of the company's related parties and the nature of the company's relationships and transactions with those related parties. A footnote to paragraph 5 refers the auditor to AU sec. 333, *Management Representations*, and notes that obtaining such representations from management complements the performance of procedures in paragraph 5 and is not a substitution for those inquiries.

^{13/} See, e.g., paragraph 15 of FASB Statement No. 57, *Related Parties*, which states "[w]ithout disclosure to the contrary, there is a general presumption that transactions reflected in financial statements have been consummated on an arm's-length basis between independent parties. However, that presumption is not justified when related party transactions exist because the requisite conditions of competitive, free-market dealings may not exist. Because it is possible for related party transactions to be arranged to obtain certain results desired by the related parties, the resulting accounting measures may not represent what they usually would be expected to represent."



Paragraph 6 provides that the auditor also inquire of others within the company regarding their knowledge of the same matters that are the subject of the auditor's inquiries of management pursuant to paragraph 5 of the standard.

A footnote to paragraph 6 states that examples of "others" within the company who may have such knowledge include: personnel in a position to initiate, process, or record transactions with related parties and those who supervise or monitor such personnel; internal auditors; in-house legal counsel; the chief compliance/ethics officer or person in equivalent position; and the human resource director or person in equivalent position. These examples of "others" included in the standard are not intended to imply that these individuals could not also be members of "management" for a particular company.

The inquiries required in paragraph 6 provide an opportunity for the auditor to corroborate the information obtained from management. Paragraph 6 does not, however, require the auditor to inquire of others within the company regarding matters that the auditor does not believe are reasonably within their knowledge.

Paragraph 7 of the standard provides that the auditor also should make inquiries of the company's audit committee, or its chair, regarding the audit committee's understanding of the company's relationships and transactions with related parties, focusing on those that are significant to the company.^{14/} Additionally, the standard provides that the auditor should inquire as to whether any member of the audit committee has concerns regarding the company's relationships or transactions with related parties. The inquiries of the audit committee, or its chair, pursuant to paragraph 7 of the standard work in concert with the auditor's communications with the audit committee pursuant to paragraph 19 of the standard to provide an opportunity for the auditor to corroborate management's responses. The audit committee communication requirements in the standard are intended to provide the auditor with a forum to discuss sensitive areas that potentially may involve the financial interests of members of the company's management.

The inquiries in paragraphs 5 through 7 of the standard could be performed at the same time as the inquiries about the risks of material misstatement, including fraud risks, that are performed as part of the auditor's risk assessment, as required by paragraphs 54 through 58 of Auditing Standard No. 12. These inquiries also would

^{14/} Paragraph 8 of Auditing Standard No. 16, *Communications with Audit Committees*, also requires the auditor to make certain inquiries of the audit committee.



provide an opportunity for the auditor to discuss, as appropriate, the company's financial relationships and transactions with its executive officers with the audit committee, or its chair, as part of the auditor's procedures to obtain an understanding of the company's relationships and transactions with its related parties.

In contrast to the new requirements contained in the standard, the existing standard describes a variety of specific audit procedures for the auditor's consideration in determining the existence of related parties.^{15/} These specific procedures include requesting from appropriate management personnel the names of all related parties and inquiring whether there were any transactions with these parties during the period. The existing standard has no audit committee communication requirement. The procedures in paragraph 5 through 7 of the standard provide more specific procedures for the auditor regarding the use of inquiries of management and others.

Communicating with the Audit Engagement Team and Other Auditors (Paragraphs 8 and 9 of the Standard in Appendix 1)

Paragraphs 8 and 9 of the standard require the auditor to communicate to engagement team members and, if applicable, other auditors, relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties. A footnote to paragraph 8 states that this communication, which can be more effective when it occurs at an early stage of the audit, complements the discussion among engagement team members regarding risks of material misstatement in accordance with paragraph 49 of Auditing Standard No. 12. That footnote also refers the auditor to paragraph 5 of Auditing Standard No. 10, *Supervision of the Audit Engagement*. If the auditor is using the work of another auditor, paragraph 9 of the standard further requires the auditor to make certain inquiries of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.^{16/}

^{15/} See AU sec. 334.07.

^{16/} The standard does not include a specific requirement for the auditor to make similar inquiries of engagement team members because existing standards already require engagement team members to bring relevant matters to the attention of the audit engagement partner. See, e.g., paragraph 5 of Auditing Standard No. 10.



Communicating information to engagement team members regarding a company's related parties and relationships and transactions with related parties might increase the likelihood that the engagement team will identify related parties or relationships or transactions with related parties previously undisclosed to the auditor by management. Effective communication to engagement team members might also highlight evidence that corroborates or contradicts information provided by management about relationships and transactions with related parties. Additionally, effective communication to engagement team members could enhance the auditor's understanding of the company's relationships and transactions with its related parties.

Examples of matters regarding related parties that the engagement team might discuss include: (i) information that could indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor; (ii) sources of information that could indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor; (iii) how entities controlled by management (e.g., variable interest entities) might be used to facilitate earnings management; and (iv) how transactions between the company and a known business partner of a member of management could be arranged to facilitate fraudulent financial reporting or asset misappropriation.^{17/}

In addition, under PCAOB standards, a principal auditor may use the work and reports of other auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the company's financial statements.^{18/} Exchanging relevant information about related parties with the other auditor can assist the principal auditor in understanding the overall nature of the company's relationships and transactions with related parties and in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor.

AU sec. 334.08 contains audit procedures intended to provide guidance for identifying material transactions that may be indicative of the existence of previously unidentified related party relationships. One such procedure is to provide audit personnel performing segments of the audit, or auditing and reporting separately on the accounts of related components of the reporting entity, with the names of known related

^{17/} See also Section III.B. of this Appendix.

^{18/} See paragraph .01 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.



parties so that they may become aware of transactions with such parties during their audits. Further, AU sec. 334.07.g., suggests a number of audit procedures for determining the existence of related party relationships, including making inquiries of other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions. Finally, paragraph .13 of AU sec. 9334, *Related Parties: Auditing Interpretations of Section 334*, states that the principal auditor and the other auditor should obtain from each other the names of known related parties and that, ordinarily, the exchange should be made at an early stage of the audit. In contrast to the suggested procedures provided in the existing standard, the standard provides specific procedures for the auditor regarding this topic.

Discussion of Comments Received on Paragraphs 3 through 9 of the Reproposed Standard

The Board considered all comments received, including the following significant comments:

Inquiring Regarding "Modifications" to Related Party Transactions: One commenter stated that modifications to transactions with related parties during the period may give rise to a risk of material misstatement. This commenter suggested clarifying the scope of paragraph 5.d. of the reproposed standard by adding the word "modified" after the phrase "the transactions entered into." This change would clarify that the auditor's inquiries regarding the company's related party transactions entered into during the audit period would include inquiries regarding any such transactions that were modified during that period. The Board considered this comment and agreed that this would be a useful change. The Board has made a change to paragraph 5.d. to reflect the commenter's suggestion.

Providing Additional Direction Regarding the Auditor's Inquiries: Two commenters recommended including additional direction regarding the auditor's inquiries. One commenter suggested providing further direction on the nature and extent of the auditor's inquiries. Another commenter suggested that the Board provide examples of others within the company of whom the auditor might inquire to clarify the intent of the requirement in paragraph 6. The Board considered these comments and has added a new footnote to paragraph 6. That new footnote states that examples of "others" within the company who may have such knowledge include: personnel in a position to initiate, process, or record transactions with related parties and those who supervise or monitor such personnel; internal auditors; in-house legal counsel; the chief compliance/ethics officer or person in equivalent position; and the human resources



director or person in equivalent position.^{19/} The Board declined to add more specific requirements because determining the nature and extent of the auditor's inquiries is an area that would benefit from the auditor's consideration of the facts and circumstances of the audit.

Timing of the Auditor's Communications: At the SAG discussion, a suggestion was made to include direction regarding the timing of the auditor's communication to the engagement team. The Board considered this comment, noting that, similar to the approach under the existing standard, this communication would generally occur at an early stage of the audit as it would be performed in conjunction with the risk assessment procedures.^{20/} Further, the proposing release had noted that communicating information about related parties at an early stage of the audit would benefit such discussions and should continue throughout the audit. The Board has revised the footnote to paragraph 8 of the standard to indicate that this communication can be more effective when it occurs at an early stage of the audit.

The Board is adopting paragraphs 3 through 9 of the standard substantially as repropoed, except for, as described above: (i) revising item d. of paragraph 5 to clarify that auditors' inquiries include inquiries regarding any transactions that were modified during the period; (ii) adding a footnote to paragraph 6 that includes examples of others within the company to whom the auditor may address inquiries; and (iii) revising the footnote to paragraph 8 to indicate that the communication can be more effective when it occurs at an early stage of the audit.

^{19/} These examples of "others" had been included in the proposed standard but were removed from the reproposal because the Board did not wish to suggest that the auditor should make inquiries of each of these individuals in all instances. Additionally, one commenter on the proposal observed that some of the "others" might also be members of management in some companies. However, in view of comments indicating that additional examples in the standard would be helpful, the Board believes that these examples could be useful to auditors, and including them in a footnote to the standard should avoid the notion that these examples in and of themselves impose requirements.

^{20/} See AU sec. 9334.13.



D. Identifying and Assessing Risks of Material Misstatement (Paragraph 10 of the Standard in Appendix 1)

Discussion of Paragraph 10 of Auditing Standard No. 18

Paragraph 10 of the standard aligns with the risk assessment requirements contained in Auditing Standard No. 12, which require the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 10 of the standard states that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties. A footnote to paragraph 10 refers the auditor to paragraph 59 of Auditing Standard No. 12.

The clause "including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties" in paragraph 10 is intended to highlight, among other things, that the auditor's assessment of risk includes a focus on risks related to the company's less than complete identification of its related parties or relationships or transactions with related parties. Such a focus helps support the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties.

Due to their nature, transactions with related parties might involve difficult measurement and recognition issues that can lead to errors in financial statements, for example, when terms are not properly considered in accounting determinations. Related parties might also buy or sell goods or services at prices that differ significantly from prevailing market prices or offer unusual rights of return or extended payment terms.

Additionally, as previously discussed, under the risk assessment standards, the auditor is required to determine whether any of the identified and assessed risks of material misstatement are fraud risks or other significant risks.^{21/} The standard does not mandate that all related party transactions be presumed to be or deemed to be significant risks or designated as a fraud risk. Under the risk assessment approach, the auditor's assessment is based on the facts and circumstances of the audit, including the facts and circumstances of a company's relationships and transactions with related

^{21/} See paragraphs 59.f., 70, and 71 of Auditing Standard No. 12.



parties. However, depending on the facts and circumstances, assessed risks of material misstatement associated with related parties and relationships and transactions with related parties might also represent fraud risks or other significant risks. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, provides examples of fraud risk factors, including some concerning related parties.^{22/}

The complexity of a transaction is a factor considered by auditors when assessing risks of material misstatement associated with related party transactions. Further, when the substance of a related party transaction differs materially from its form, or when a company's related parties operate through an extensive and complex range of relationships and structures, heightened scrutiny is warranted. For example, depending upon the facts and circumstances, the creation of a variable interest entity in which the company's economic interest (its obligation to absorb losses or its right to receive benefits) is disproportionately greater than the company's stated power might represent a fraud risk or other significant risk, especially in the presence of other fraud risk factors.^{23/} Examples of fraud risk factors regarding related parties that individually, or in combination with other fraud risk factors, might indicate the existence of a fraud risk, include significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.^{24/}

The existence of dominant influence is another factor considered by auditors when assessing the risks of material misstatement. Related parties, due to their ability to control or significantly influence, may be in a position to prevent a company from pursuing its own separate interests. Identifying the risks of material misstatement associated with dominant influence can assist the auditor's assessment of the risks of material misstatement. AU sec. 316.85 already describes the principle of dominant

^{22/} See AU sec. 316.85.A.2, Section a., under "Opportunities."

^{23/} Paragraph 10 of Auditing Standard No. 12 states that obtaining an understanding of the nature of the company includes understanding the company's significant investments, including equity method investments, joint ventures and variable interest entities.

^{24/} As described in Section III.A. of this Appendix, the amendments regarding significant unusual transactions separate this example into two examples – (i) related party transactions that are also significant unusual transactions and (ii) significant transactions with related parties whose financial statements are not audited or are audited by another firm.



influence in the example of a fraud risk factor by stating that the ineffective monitoring of management as a result of domination of management by a single person or small group, without compensating controls, provides an opportunity for management to engage in fraudulent financial reporting.

Examples of factors that may signal dominant influence exerted by a related party include:

- Significant transactions are referred to the related party for approval;
- There is little or no debate among management and the board of directors regarding business proposals initiated by the related party; or
- The related party played a leading role in starting the company and continues to play a leading role in managing the company, even if the related party is no longer formally part of management or the board of directors.

The existence of dominant influence by itself, or in the presence of other fraud risk factors (e.g., use of an intermediary whose involvement serves no apparent business purpose), might indicate the existence of a fraud risk.

The other amendments to PCAOB auditing standards contained in Appendix 3 complement the requirements of paragraph 10 by amending AU sec. 316.85.A.2 to include the exertion of dominant influence by or over a related party as an example of a fraud risk factor. The other amendment to AU sec. 316.85.A.2 expands that concept to encompass all related parties outside of management of the company. The amendments do not define dominant influence, as doing so might result in some auditors being overly focused on the definition itself, instead of focusing on the red flags associated with dominant influence that might create risks of material misstatement at the financial statement level.

AU sec. 334 does not provide specific guidance for the auditor regarding the identification and assessment of risks of material misstatement associated with related party transactions. In fact, AU sec. 334.06 provides that, in the absence of evidence to



the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business.^{25/}

Discussion of Comments Received on Paragraph 10 of the Reproposed Standard

The Board considered all comments received, including the following significant comments:

Referencing Information Obtained from Past Audits: One commenter recommended requiring the auditor to determine that there were no changed circumstances for material related party transactions previously authorized and approved. Another commenter suggested including a reference to the requirements pertaining to information obtained from past audits contained in the risk assessment standards both to improve the effectiveness of the audit process and to remind auditors of their responsibility regarding the information previously obtained regarding ongoing matters.

The Board considered these comments, noting that paragraph 10 requires that, in identifying and assessing the risks associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4 through 9 and the risk assessment procedures required by Auditing Standard No. 12, which address information obtained from past audits.^{26/} Thus, the auditor is already required to take such information obtained from past audits into account in identifying and assessing risks of material misstatement. Further, the revisions made to item d. of paragraph 5, which require the auditor to inquire of management regarding transactions with related parties modified during the period under audit, should assist the auditor in identifying transactions for which the auditor would not be able to rely on information obtained from past audits.

^{25/} Thus, AU sec. 334.06 could be misunderstood to create a "presumption of validity" for the business purpose of related party transactions in situations where experience suggests a need for heightened scrutiny.

^{26/} Paragraphs 41 through 45 of Auditing Standard No. 12 note that the auditor's risk assessment procedures require the auditor to consider information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements.



The Board is adopting paragraph 10 of the standard as repropoed.

E. Responding to the Risks of Material Misstatement (Paragraphs 11 through 13 of the Standard in Appendix 1)

Discussion of Paragraphs 11 through 13 of Auditing Standard No. 18

Paragraph 11 of the standard aligns with the requirement in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, for the auditor to design and implement audit responses that address the identified and assessed risks of material misstatement. Paragraph 11 states that this includes designing and performing audit procedures that address the risks of material misstatement associated with related parties and relationships and transactions with related parties. Footnotes to paragraph 11 refer the auditor to relevant paragraphs of the risk assessment standards. A note to paragraph 11 refers the auditor to the new requirements in paragraphs .66-.67A of AU sec. 316 for related party transactions that are also significant unusual transactions.

AU sec. 334 also provides guidance to the auditor regarding audit procedures to evaluate identified related party transactions. For example, AU sec. 334.09 provides that, after identifying related party transactions, the auditor should apply the procedures the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient appropriate evidential matter and should extend beyond inquiry of management. AU sec. 334.09 includes procedures that should be considered and footnote 6 of AU sec. 334.09 provides that, until the auditor understands the business sense of material transactions, he cannot complete his audit.^{27/} AU sec. 334.10 includes other procedures that the auditor should consider when the auditor believes it necessary to fully understand a particular transaction, and notes that those procedures might not otherwise be deemed necessary to comply with generally accepted auditing standards.

^{27/} AU sec. 411.06 requires the auditor to consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. Understanding the "business sense" of material transactions is encompassed by this consideration. See also the discussions in Sections II.G. and III.B. of this Appendix.



Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk (Paragraph 12 of the Standard in Appendix 1)

Briefly, paragraph 12 of the standard requires the auditor to perform certain basic procedures (supplemented by more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances) regarding related party transactions that are either required to be disclosed in the financial statements or determined to be a significant risk.^{28/}

Focusing the auditor's attention on related party transactions that are required to be disclosed in the financial statements or determined to be a significant risk is intended to make the auditor's evaluation of whether the company's related party transactions are properly accounted for and disclosed most effective.

One important focus of the procedures required by paragraph 12 is the auditor's evaluation of the business purpose (or the lack thereof) of the related party transactions that are required to be disclosed or determined to be a significant risk. The procedures in paragraph 12 are designed to work with the procedures in paragraphs 3 through 9 to provide the auditor with additional information to understand and assess the business purpose (or the lack thereof) of the targeted related party transactions that are subject to paragraph 12. Understanding the business purpose of related party transactions is an important consideration in assessing and responding to risks of material misstatement and requires the auditor to understand other factors underlying the transaction. For example, although a company may assert that it has utilized a related party transaction to achieve a particular goal, the company may, in fact, have used the transaction for some other purpose.^{29/} Obtaining an understanding of the terms and business purpose of a related party transaction includes understanding why the company entered into the transaction with a related party versus an unrelated party. A business purpose that

^{28/} The SEC expects that auditors will provide "heightened scrutiny" of a company's related party transactions. See SEC Accounting and Auditing Enforcement Release ("AAER") No. 3427, *In the Matter of the Application of Wendy McNeeley, CPA*, at 10–12 (December 13, 2012), which states in part that the SEC and courts have repeatedly held that related party transactions require heightened scrutiny by auditors and notes the importance of the auditor understanding the business purpose of material related party transactions.

^{29/} For example, a broker or dealer might use related party transactions to make the size of their operations appear smaller to avoid regulatory requirements.



appears inconsistent with the nature of the company's business might represent a fraud risk factor.

Performing Basic Procedures: Paragraphs 12.a.-d. contains the basic procedures to be applied to related party transactions that are either required to be disclosed in the financial statements or determined to be a significant risk. Paragraph 12.a. requires the auditor to read the underlying documentation relating to the company's related party transaction(s) and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction. This requirement, together with the other requirements in paragraphs 12.b.-d., require the auditor to evaluate appropriate information regarding the transaction, including, for example, the executed contract, and to consider whether the contract and other underlying documentation is appropriately authorized and approved, and is consistent with explanations from inquiries of management and others. The auditor also considers how that information compares to other available audit evidence. For example, when evaluating the responses to inquiries of management and others, the auditor takes into account information obtained from other sources. Such sources could include, for example, SEC filings that include a description of the registrant's policies and procedures for the review, approval, or ratification of "related person" transactions or that identify any "related person" transaction where such policies and procedures did not require review, approval or ratification or where such policies and procedures were not followed.^{30/}

In particular, paragraph 12.d. of the standard requires the auditor to evaluate the financial capability of the related party with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations. This requirement applies only to items that are individually or collectively significant. Obtaining evidence to evaluate the financial capability of a related party can inform the

^{30/} See Instruction 1 to Item 404(a) of SEC Regulation S-K for the definition of "related person." Disclosure requirements regarding "related persons" in Regulation S-K may differ from "related party" disclosures. See also, Securities Act Release No. 33-8732A, *Executive Compensation and Related Person Disclosure* (August 29, 2006), <http://www.sec.gov/rules/final/2006/33-8732afr.pdf>.



auditor's evaluation of the business purpose (or the lack thereof), including whether the substance of that transaction differs materially from its form.^{31/}

Performing Other Procedures: Paragraph 12.e. requires the auditor to supplement the basic required procedures contained in paragraphs 12.a.-d. with more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. This approach provides the auditor with the opportunity to scale the audit based on the auditor's judgment regarding other procedures that are necessary to address the identified and assessed risks of material misstatement. This requires the auditor to make a determination about what procedures are needed to evaluate the accounting and disclosure of the related party transactions. For example, related party transactions might pose valuation and measurement issues that are not present in arm's-length transactions. Consequently, the auditor's tests regarding valuation of a receivable from an entity under common control might be more extensive than for a trade receivable of the same amount from an unrelated party because the common controlling parties may be motivated to obscure the substance of the transaction.

The procedures contained in paragraph 12.e. are designed to work with other procedures that the auditor performs during the audit to address the relevant assertions associated with each related party transaction that requires disclosure.^{32/} For example,

^{31/} See, e.g., *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005), noting that "among transactions calling for close inspection are related-party transactions, including transactions between a company and its officers or directors. Such dealings are viewed with extreme skepticism in all areas of finance.... The reason for this is apparent: Although in an ordinary arms-length transaction, one may assume that parties will act in their own economic self-interest, this assumption breaks down when the parties are related. A company that would perform a thorough credit-risk assessment before extending a loan might not do so if the loan were to one of its officers or directors."

^{32/} See paragraph 8 of Auditing Standard No. 13, which requires the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure. 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. See also, paragraph 17 of Auditing Standard No. 13, which states that tests of controls must be performed in the audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when



if a company makes a material purchase of property, plant and equipment from an unconsolidated related party, the auditor could inspect the asset to obtain audit evidence that supports management's assertion regarding the existence of the asset. Further, the auditor might examine underlying documents supporting the transfer of title and ownership to obtain audit evidence that supports management's assertion regarding its rights and obligations.

The economic substance of a related party transaction may differ materially from its form. As described in Section II.G. of this Appendix, AU sec. 411.06 requires that the auditor consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. Thus, the procedures performed pursuant to paragraph 12.e. are intended to address the auditor's concerns about whether the substance of a related party transaction differs materially from its form. For example, evaluating the collectability of receivables due from companies owned or controlled by officers of the company under audit might include questions beyond evaluating the financial capability of the related party to pay.

Examples of other procedures that might be appropriate for the auditor to perform pursuant to paragraph 12.e., depending on the nature of the transaction and the risks of material misstatement of the financial statements, include:

- Inquiring directly of the related party regarding the business purpose of the transaction;
- Inspecting information in the possession of the related party or other parties to the transaction, if available;
- Reading public information regarding the related party and the transaction, if any;
- Reading the financial statements or other relevant financial information obtained from the related party, if available, to understand how the related party accounted for the transaction;

necessary to support the auditor's reliance on the accuracy and completeness of financial information used in performing other audit procedures.



- Confirming the terms of the transaction with other parties with knowledge of the transaction (e.g., banks, guarantors, agents, or attorneys), if any;
- Determining whether there are any side agreements or other arrangements (either written or oral) with the related party, including confirming that none exist, if appropriate;
- Evaluating the transferability and value of collateral provided by the related party, if any; and
- Performing procedures at the related party, if possible.

In certain circumstances, an auditor may decide to perform audit procedures at the related party in order to obtain sufficient appropriate audit evidence to support the auditor's opinion. The auditor, however, may not be able to perform procedures at the related party's premises because the related party may not allow the auditor to perform such procedures. However, in all cases the auditing standards require the auditor to obtain sufficient appropriate audit evidence to support his or her audit opinion.^{33/}

Aggregating Transactions for Disclosure: Accounting principles applicable to the company may allow the aggregation of related party transactions that require disclosure (e.g., by type of related party transaction). A note to paragraph 12 of the standard addresses the auditor's responsibility for aggregated related party disclosures. That note states that, 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 in paragraph 12 of the standard for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement. The Board

^{33/} Paragraph 2 of the standard states that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements. As provided by paragraph 14 of the standard, the auditor's evaluation should be supported by auditing procedures and evidence obtained from procedures performed during the audit, including procedures designed to test the accuracy and completeness of the related parties and relationships and transactions with related parties disclosed by the company to the auditor.



notes that a "selection of transactions" could be the selection of one transaction from the aggregation in the appropriate circumstances.

Existing standards require the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.^{34/} AU sec. 334.08-.09 contains procedures that the auditor should consider performing when responding to risks arising from related party relationships and transactions and directs the auditor to apply the procedures the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of identified related party transactions and their effect on the financial statements, noting that those procedures should extend beyond inquiry of management.

Intercompany Accounts (Paragraph 13 of the Standard in Appendix 1)

Paragraph 13 of the standard requires the auditor to perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ. This requirement is based on the procedure in the existing standard, AU sec. 334.09.e., which requires the auditor to consider arranging for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information. Other existing standards also reference the importance of the auditor's review of consolidating accounts.^{35/}

A new note to paragraph 13 states that the procedures performed should address the risks of material misstatement associated with the company's intercompany accounts.

Discussion of the Comments Received on Paragraphs 11 through 13 of Auditing Standard No. 18

The Board considered all comments received, including the following significant comments:

^{34/} See paragraph 8 of Auditing Standard No. 13.

^{35/} See, e.g., paragraph .10 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, and paragraphs .28-.34 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.



Evaluating the Financial Capability of the Related Party. One commenter recommended that the standard should require the auditor to consider evaluating the financial capability of a related party and that the standard should include appropriate alternative procedures if information regarding the related party's financial capability is not readily available. Another commenter stated that the evaluation of the financial capability of the related party should not result in significant additional time by management or the auditor. The Board considered these comments noting that auditors are currently performing procedures to evaluate the financial capability of counterparties in a variety of audit areas today, regardless of whether the counterparty is a related party. For example, auditors might examine the company's support regarding the financial capability of another party as part of evaluating the company's decision to recognize revenue on a particular transaction.

Performing Procedures on Intercompany Balances: Some commenters recommended providing additional direction, including specific procedures that the auditor should perform pursuant to paragraph 13. One commenter recommended requiring the auditor to determine the business purpose for intercompany transactions, and whether the transactions have "economic substance."

The Board considered these comments, noting that the preparation of consolidated financial statements could involve complex matters regarding intercompany transactions. For example, a company could consolidate a subsidiary that has a different year-end. The risks of material misstatement with intercompany transactions could include not only the risks associated with intercompany account balances, but also the resulting effect on the consolidated financial statements, after elimination of such balances. The procedures performed pursuant to paragraph 13 should address the risks of material misstatement. Those procedures could include examining account reconciliations and material transactions, regardless of their timing. The procedures performed pursuant to paragraphs 3 through 9 apply to intercompany transactions and include inquiring of management regarding the business purpose of the transaction and the business purpose for entering into the transaction. Some intercompany transactions might give rise to significant risks of material misstatement that are subject to the procedures in paragraph 12.

The Board considered including additional direction regarding intercompany transactions, but noted that such direction could be viewed as making the requirement unnecessarily prescriptive, which could result in unnecessary costs. However, to remind auditors of the need to address the potential risks of material misstatement, the Board added a note to paragraph 13, which states that the procedures performed should address the risks of material misstatement associated with the company's intercompany



accounts. Further, based on comments received, the header preceding paragraph 13 has been revised to refer to "Intercompany Accounts."

The Board is adopting paragraphs 11 through 13 of the standard, substantially as repropoed, except for changing the header to paragraph 13 and adding a new note to paragraph 13, discussed above.

F. Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14 through 16 and Appendix A of the Standard in Appendix 1)

Discussion of Paragraphs 14 through 16 and Appendix A of Auditing Standard No. 18

Briefly, paragraphs 14 through 16 of the standard address the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties. Appendix A includes examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Paragraph 14 of the standard requires the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Paragraph 14 states that evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. Paragraph 14 also states that this evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, taking into account the information gathered during the audit. Paragraph 14 further requires that, as part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

Paragraph 14 of the standard focuses the auditor on a key aspect of the objective by requiring the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Paragraph 14 recognizes that the company is responsible for the preparation of its financial statements, including, in the first instance, the identification of the company's related parties and relationships and transactions with related parties, and that the auditor begins the audit with information obtained from the company. While paragraph 14 of the standard anticipates that the auditor would start his or her work regarding



related parties with the names of related parties and relationships and transactions with related parties identified by the company, the auditor may not merely rely on management's representations^{36/} as to the accuracy and completeness of the information provided to the auditor. While management has the primary responsibility for preparing the company's financial statements, the auditor should be sensitive throughout the audit to the possibility that management may not have informed the auditor of all related parties or relationships or transactions with related parties.

Paragraph 14 also recognizes that the auditor's procedures to evaluate whether the company has properly identified its related parties should extend beyond the inquiries pursuant to paragraphs 5 through 7 of the standard. Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

A note to paragraph 14 of the standard refers the auditor to Appendix A, which describes examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Many of the examples contained in Appendix A of the standard are contained in AU secs. 334.07-.08. The standard does not require an auditor to perform procedures with respect to each source of information referenced in Appendix A. The information and sources relevant to a particular audit would depend on the facts and circumstances of the audit and, thus, not all of the information or sources of information in Appendix A would need to be considered in every audit. However, other auditing standards, or the performance of auditing procedures in other areas, may impose requirements on the auditor to perform auditing procedures with respect to certain of those sources (for example, reading confirmation responses and responses to inquiries of the company's lawyers).^{37/}

^{36/} To further assist the auditor's efforts in identifying related parties, the other amendments include a complementary provision that expands existing management representations contained in AU sec. 333 to state that the company has provided the names of all related parties and all relationships and transactions with its related parties to the auditor. However, the auditor may not solely rely on management's representations.

^{37/} See, e.g., AU sec. 330, *The Confirmation Process*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.



Appendix A also states that the examples contained in that Appendix are not intended to represent a comprehensive listing.

Paragraph 14 precludes the auditor's reliance on the company's identification of its related parties without the auditor taking additional steps, including following up on possible contradictory information gathered during the audit. Thus, while the standard does not require the auditor to search public information indiscriminately to identify a company's related parties, the standard does anticipate that the auditor will take additional steps, including following up on inconsistencies or red flags that arise during the audit. For example, the auditor might review public documents for information regarding a company's related parties and transactions with related parties, particularly when such information is readily available.^{38/} Additionally, a review of relevant available public information might be appropriate in situations in which information comes to the auditor's attention that suggests that related parties previously undisclosed to the auditor might exist.

In general, the steps performed by the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties include: (i) performing risk assessment 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; (ii) identifying and assessing risks associated with a company's relationships and transactions with its related parties, including whether the company has properly identified its related parties and relationships and transactions with related parties; (iii) designing and performing audit procedures that address and respond to the risks of material misstatement associated with the company's related parties and transactions, including procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company; and (iv) performing specific procedures that address related party relationships or transactions identified by the auditor that were previously undisclosed by company management. Performing these procedures should position the auditor to obtain sufficient evidence to provide reasonable assurance to support the auditor's opinion.

^{38/} Paragraph 11 of Auditing Standard No. 12 requires that as part of obtaining an understanding of the company the auditor should consider reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements.



The approach in paragraph 14 also considers that the auditor's efforts to identify and evaluate a company's significant unusual transactions and obtain an understanding of a company's financial relationships and transactions with its executive officers might assist the auditor in identifying information that might indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Also, as discussed in Section IV.E. of this Appendix, the amendments to AU sec. 560, *Subsequent Events*, require that during the "subsequent period" the auditor inquire regarding whether there have been any changes in the company's related parties and whether the company has entered into any significant new related party transactions. This could inform the auditor's evaluation of the company's identification of its related parties and relationships and transactions with related parties.

Pursuant to paragraph 15 of the standard, if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor then performs the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. The standard requires that these procedures extend beyond inquiry of management.

Pursuant to paragraph 16 of the standard, if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should perform certain procedures targeted at enhancing the auditor's understanding of the previously undisclosed related party or relationship or transaction. The procedures contained in paragraph 16 are intended to focus the auditor on (i) obtaining additional information and evaluating the related party or relationship or transaction with a related party that the auditor has identified, and (ii) assessing the impact of the new information on all aspects of the audit.

Specifically, the procedures contained in paragraph 16 require that if the auditor determines that an undisclosed related party or relationship or transaction exists, the auditor should:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;



- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of the standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;
- f. Perform the following procedures, taking into account the information gathered from performing the procedures in a. through e. above:
 - i. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
 - ii. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
 - iii. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1.

A footnote to paragraph 16 refers the auditor to AU sec. 333.04, which states that, if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified. Another footnote refers the auditor to paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise



the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessment.

As described above, the procedures required by paragraphs 16.a.–e. are performed to obtain the information necessary to evaluate the related party or relationship or transaction with a related party previously undisclosed to the auditor that the auditor has determined exists. Significantly, because of the potential for fraud, paragraph 16.b. of the standard requires the auditor to evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor. If the related party transaction is either required to be disclosed or is determined to be a significant risk, the auditor is required to perform the procedures in paragraph 12 of the standard.

Paragraph 16.f. requires the auditor to take into account the information gathered from the procedures in paragraph 16.a.–e. regarding the relationship or transaction identified by the auditor to assess the impact on the audit. For example, paragraph 16.f.iii. requires the auditor to reassess the implications for the audit if the company's nondisclosure indicates that fraud or an illegal act may have occurred.

Determining that a related party transaction that was previously undisclosed to the auditor exists could have significant implications for the audit. This information contradicts representations made by management to the auditor and may contradict the auditor's preliminary assessment of whether the company has properly identified its related parties and relationships and transactions with related parties. Identifying such contradictory information requires the auditor to reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk.

The auditor takes the information gathered from performing the procedures set forth in paragraph 16 into account when evaluating whether the company has properly identified its related parties and relationships and transactions with related parties pursuant to paragraph 14 of the standard.

In contrast to the approach set forth in paragraphs 14 through 16, the existing standard contains a variety of procedures that are less specific and focused. For example, AU sec. 334.05 alerts the auditor to the fact that business structure and operating style are occasionally deliberately designed to obscure related party transactions. AU sec. 334.05 states that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component to the total entity and should consider controls over management activities,



and the business purpose served by the various components of the entity. AU sec. 334.07 states that determining the existence of transactions with related parties beyond those that are clearly evident requires the application of specific audit procedures and provides examples of such procedures. AU sec. 334.07 further states that the auditor should place emphasis on testing material transactions with parties the auditor knows are related to the reporting entity. AU sec. 334.08 includes procedures that are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships.

Discussion of the Comments Received on Paragraphs 14 through 16 and Appendix A of the Reproposed Standard

The Board considered all comments received, including the following significant comments:

Clarifying the Auditor's Responsibility Regarding Appendix A: Many commenters recommended clarifying the auditor's responsibilities for the examples of information and sources of information contained in Appendix A. Some of the commenters recommended including clarifying language regarding the scope of the auditor's responsibilities with respect to Appendix A; others suggested qualifying language stating that the auditor is not required to perform procedures with respect to each type or source of information referenced in Appendix A.

The Board considered these comments, noting that Appendix A is intended to provide examples of information and sources of information and does not provide a comprehensive or mandatory listing. Further, other auditing standards may impose requirements on the auditor to perform procedures regarding the examples contained in Appendix A. Accordingly, the suggested qualifying language would not be appropriate. The Board, however, made certain revisions intended to clarify the applicability of Appendix A by revising the note in paragraph 14 and similar language in Appendix A to state that Appendix A contains examples of information and sources of information that the auditor may gather during the audit.

Clarifying the Auditor's Responsibility for Evaluating the Company's Identification of Its Related Parties: Many commenters recommended a number of clarifications to paragraph 14 of the repropoed standard. Several commenters recommended incorporating footnote 14 into paragraph 14 of the repropoed standard to clarify that the auditor's evaluation of the company's identification of its related parties and relationships and transactions with related parties requires the auditor to perform procedures to test the accuracy and completeness of the related parties and



relationships and transactions with related parties identified by the company. Other commenters recommended clarification regarding the extent of the auditor's evaluation in paragraph 14 and whether it is based on the information gathered during the audit.

In response to these comments, the Board made a number of clarifications. Specifically, the Board incorporated footnote 14 of the repropoed standard into paragraph 14 to clarify that the auditor's evaluation requires the auditor to perform procedures to test the accuracy and completeness of the company's identification. Additionally, the revisions give more prominence to the requirement and clarify that, in performing the evaluation required by paragraph 14, the auditor takes into account the information gathered during the audit. This revision, in conjunction with the clarifications to the note regarding the examples and sources of information contained in Appendix A (discussed below), is intended to further describe the auditor's responsibilities for evaluating the company's identification of its related parties and relationships and transactions with its related parties.

Examples Included in Appendix A: A few commenters suggested revisions to the examples of information or sources of information contained in Appendix A to the standard. The Board considered these comments, noting that Appendix A contains examples of information and sources of information that the auditor may gather during the audit and does not represent a comprehensive listing. The Board revised Appendix A to include "disclosures contained on the company's website" (in addition to the company's disclosures in SEC filings, which is already included as an example in Appendix A) as another example of a source of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Verifying the Ownership Structure Between the Company and Its Related Parties: One commenter stated that verifying the ownership structure between the company and its related parties may be one of the most difficult aspects of an audit. That commenter recommended that the Board outline procedures for verifying the ownership structure between the company and the related parties disclosed to the auditor by management, including the levels of direct and indirect control, and changes in those levels during the period under audit. The Board considered this comment, noting that determining the procedures for verifying these matters (for example, determining whether the company or its management is able to exercise significant influence over another entity) requires an evaluation of the facts and circumstances. Additionally, in making such a determination, the auditor's response should address the



risks of material misstatement.^{39/} Including additional direction in a context that is so heavily facts and circumstances driven could make the standard unnecessarily complex and prescriptive, making it potentially more difficult to apply.^{40/}

Setting Appropriate Expectations Regarding the Auditor's Responsibilities: Some commenters stated that the extent of the auditor's procedures necessary for evaluating management's identification of its related parties and relationships did not take into account the responsibility of management. One commenter recommended including additional context, similar to that contained in International Standard on Auditing No. 550, *Related Parties*, to recognize that the nature of related party transactions could compromise the auditor's ability to detect material misstatements associated with related parties, even though the audit is properly planned and performed. Another commenter stated that the objective appears to require performance of procedures equivalent to a forensic engagement to uncover all related parties and transactions.

The Board considered these comments and did not agree that additional changes were necessary to address the appropriate expectations for the auditor's responsibilities with respect to identifying related parties and relationships and transactions with related parties.^{41/} Additionally, the Board had already taken note of commenters' requests to clarify its proposal to focus the auditor's attention first on

^{39/} The auditor may also be required to perform procedures on these matters by other auditing standards, such as AU sec. 332.

^{40/} See, e.g., Canadian Public Accountability Board, *Auditing in Foreign Jurisdictions* CPAB Special Report (2012) <http://www.cpab-ccrc.ca/en/topics/PublicSpecialReports/Pages/default.aspx>, which noted that the existence of related parties and transactions are more likely to represent an audit risk for operations in foreign jurisdictions when the legal or regulatory environment requires reliance on complex business structures or when dominant shareholders are involved in the operations of the business. That report also noted that because the identification of related parties may also be more difficult in foreign jurisdictions, it is important that auditors have a heightened sensitivity to possible related-party transactions by performing procedures to determine the ownership and management structure of significant customers and suppliers.

^{41/} For example, the auditor's responsibility to perform procedures to identify related party transactions that are material to the financial statements is reflected in Section 10A(a) of the Securities Exchange Act of 1934 (the "Exchange Act").



information provided by management and is also adopting revisions to AU sec. 333 to provide for additional written representations by management pertaining to its related parties. Moreover, the Board declined to pursue an alternative that would have designated related party transactions as fraud risks, which would have resulted in more forensic-type procedures. Instead, the Board's approach overall to the auditor's responsibility to identify a company's related parties has been targeted and risk-based, requiring heightened scrutiny in areas that have historically represented high risk of material misstatement. The Board believes this approach appropriately recognizes the auditor's existing responsibilities for the identification of related parties and relationships and transactions with related parties in a cost-sensitive way.

Applicability of Paragraph 16 to Related Party Transactions Identified by the Auditor That Are "Clearly Trivial": Several commenters recommended that the procedures required by paragraph 16 should not be required if the related party transaction identified by the auditor is "clearly trivial," as that term is described in Auditing Standard No. 14.^{42/} Those commenters generally noted that such an approach would avoid unnecessary work.

The Board considered these comments, noting that the auditor might not be able to determine if the previously undisclosed transaction identified by the auditor is "clearly trivial" without the information that would be obtained from the procedures in paragraph 16.a.-d. of the repropoed standard." For example, inquiring of management regarding why the transaction was not disclosed to the auditor and evaluating that explanation would be important to determining whether the transaction is "clearly trivial." Further, taking into account information regarding a related party transaction identified by the auditor that is "clearly trivial" generally would not significantly impact the auditor's evaluation of the matters in paragraphs 16.f-h. of the repropoed standard.^{43/}

^{42/} Paragraph 10 of Auditing Standard No. 14 states that "clearly trivial" is not another expression for "not material." Paragraph 10 also states that matters that are clearly trivial will be of a smaller order of magnitude than the materiality level established in accordance with Auditing Standard No. 11, and will be inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature, or circumstances. Paragraph 10 further states that when there is any uncertainty about whether one or more items is clearly trivial, the matter is not considered trivial.

^{43/} Paragraphs 16.f-h. of the repropoed standard are now contained in paragraphs 16.f.i-iii. of the standard.



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The use of the phrase "clearly trivial" could also result in other consequences. For example, providing such an exception could inappropriately focus the auditor's evaluation on quantitative considerations to the detriment of qualitative considerations and might allow management an opportunity to influence the auditor's evaluation. In addition, providing such an exception could create confusion regarding paragraph 16.h. of the repropoed standard (paragraph 16.f.iii of the standard), which refers to Section 10A of the Exchange Act. Section 10A of the Exchange Act applies to information indicating that fraud or another illegal act has or might have occurred, whether or not perceived to have a material effect on the financial statements of the company.

However, after considering these comments, the Board did make revisions to paragraph 16 to clarify that the procedures performed pursuant to paragraph 16 focus the auditor on obtaining additional information both by (i) performing the initial procedures in paragraph 16.a.-e. so that the auditor can evaluate the nature and potential impact of the previously undisclosed related party or relationship or transaction that the auditor has identified, and (ii) performing additional procedures to evaluate the implications for the audit, including the auditor's risk assessment, taking into account the information gathered from performing the procedures in paragraph 16.a.-e. These revisions should clarify the auditor's approach.

The Board also made technical changes to paragraph 16.h. of the repropoed standard to more closely align with the corresponding requirement contained in paragraph 23 of Auditing Standard No. 14. Paragraph 23 of Auditing Standard No. 14 states that if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79-82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Exchange Act, 15 U.S.C. § 78j-1.

As revised, if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor is required to perform certain initial procedures. Those procedures required by paragraphs 16.a.-e. focus the auditor on obtaining additional information and evaluating the related party or relationship or transaction with a related party that the auditor has identified. A footnote to paragraph 16.b. refers the auditor to AU sec. 333.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. After performing the procedures in paragraph 16.a.-e., the auditor performs the procedures in paragraphs 16.f.i-iii. of the standard taking into account the information previously gathered by the auditor, to assess the broader impact of the auditor's findings on the audit.



"Other" Related Parties Previously Undisclosed to the Auditor. One commenter recommended that paragraph 16 be clarified to include that the auditor also inquire of management about the possible existence of transactions with *other* undisclosed related parties. The Board considered this comment, noting that while this inquiry was not explicitly stated, assessing whether there are *other* undisclosed related parties is a component of the auditor's response once a related party or a relationship or transaction with a related party previously undisclosed to the auditor by management has been identified by the auditor.

Inquiring of management regarding the identification of the possible existence of transactions with other undisclosed related parties and relationships and transactions with related parties, including whether there are any *other* undisclosed related parties, would generally be encompassed in the auditor's procedures performed in discharging the auditor's responsibilities once the auditor has determined that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Based on the auditor's reassessment of risk, the auditor performs additional procedures that would include such inquiries, but also would extend beyond inquiring of management.

Significantly, paragraph 16.f.ii. of the standard^{44/} requires the auditor to reassess the risks of material misstatement and perform additional procedures as necessary, if such reassessment results in a higher risk. This would include procedures designed to address the risk of transactions with *other* undisclosed related parties.

To clarify the auditor's responsibilities regarding *other* undisclosed related parties, the Board added a new footnote to paragraph 16 that refers the auditor to paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.

The Board is adopting paragraphs 14 through 16 and Appendix A as repropoed, with the following changes:

^{44/} Paragraph 16.g. of the repropoed standard is now contained in paragraph 16.f.ii. of the standard.



- a. revising paragraph 14 to highlight that the auditor performs procedures to test the accuracy and completeness of management's identification, taking into account information gathered during the audit;
- b. clarifying in the note to paragraph 14 that Appendix A contains examples of information and sources of information that the auditor may gather during the audit;
- c. revising Appendix A to include a new example, "disclosures contained on the company's website";
- d. revising paragraph 16 to clarify that the auditor performs the procedures in 16.f.i.-iii., taking into account the information gathered from performing the procedures in paragraph 16.a.-e.;
- e. adding a new footnote to paragraph 16.f.ii., referring to paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments; and
- f. revising paragraph 16.f.iii. to more closely align with paragraph 23 of Auditing Standard No. 14, which states if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79-82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

G. Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17 and 18 of the Standard in Appendix 1)

Discussion of Paragraphs 17 and 18 of Auditing Standard No. 18

Paragraph 17 of the standard aligns with requirements in Auditing Standard No. 14 to require the auditor to evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. Paragraph 17 states that this includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair



presentation in conformity with the applicable financial reporting framework. A footnote to paragraph 17 refers the auditor to paragraphs 30 and 31 of Auditing Standard No. 14.

The auditor's evaluation of a company's accounting and disclosure of relationships and transactions with related parties is important to the protection of investor interests because the substance of related party transactions might differ materially from their form. Furthermore, related party transactions not only may involve difficult measurement and recognition issues, but may also be used to engage in financial statement fraud and conceal misappropriation of assets.

Paragraph 17 is intended to align the auditor's evaluation with the objective of the standard and to focus the auditor on both the accounting and disclosure of the company's relationships and transactions with related parties. Footnote 1 to paragraph 1 of the standard states that the auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company. Unlike the existing standard, paragraph 17 of the standard does not include a separate requirement to evaluate whether the substance of a related party transaction differs materially from its form because that evaluation is part of the auditor's evaluation of whether the financial statements have been presented fairly in conformity with the applicable financial reporting framework pursuant to AU sec. 411.06.

Consistent with the existing standard, evaluating substance over form does not require the auditor to challenge the appropriateness of the accounting standards. However, financial statements may not be presented fairly if they do not include information about the matters that affect their use, understanding, and interpretation.^{45/} For example, to improve the appearance of its financial condition, a company and a related party could attempt to "dress up" the appearance of the company's balance sheet at period-end. Some period-end "window-dressing" transactions might involve side agreements undisclosed to the auditor, while others might represent transactions that the auditor is aware of, in which management placed more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction.

AU sec. 334 requires the auditor to consider whether sufficient appropriate evidence has been obtained to understand each related party relationship, as well as the effect of each material related party transaction on the financial statements. The existing standard states that the auditor should view related party transactions within the

^{45/} See AU sec. 411.04.



framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure. Further, AU sec. 334.02 states that the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form. Additionally, Auditing Standard No. 14 describes the auditor's responsibility for evaluating the presentation of financial statements, including disclosures, more generally. Auditing Standard No. 14 requires the auditor to evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.^{46/} Furthermore, AU sec. 411.06 requires the auditor to consider whether the substance of transactions or events differs materially from their form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework.

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (Paragraph 18 of the Standard in Appendix 1)

Paragraph 18 of the standard states that if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion.

Financial reporting frameworks permit management to assert that a related party transaction that is required to be disclosed in the financial statements was conducted on terms equivalent to those prevailing on an arm's-length basis only when support for such an assertion exists. Management's refusal to modify such a disclosure when support for that statement does not exist represents a departure from GAAP and IFRS. Such a misstatement would require the auditor to express either a qualified or adverse opinion on the financial statements. A decision by management to remove, at the auditor's request, such an assertion from the financial statements due to management's inability to provide the auditor with sufficient appropriate audit evidence might affect the auditor's assessment of internal control over financial reporting.

The requirements in paragraph 18 of the standard are complemented by the other amendments to AU sec. 333 discussed in Section IV.D. of this Appendix, which require the auditor to obtain written representations from management when

^{46/} See paragraph 30 of Auditing Standard No. 14.



management has asserted that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

AU sec. 334 includes requirements regarding the auditor's evaluation of assertions that related party transactions occurred on terms equivalent to those occurring on an arm's-length basis. AU sec. 334.12 notes the difficulty in substantiating such representations and states that, except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. AU sec. 334 also states that if such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, the auditor should express a qualified or adverse opinion because of a departure from GAAP, depending on materiality.

After considering all comments received, the Board is adopting paragraphs 17 and 18 of the standard as repropoed, except for the addition of a reference to paragraph 30 of Auditing Standard No. 14 in footnote 19 to paragraph 17.

H. Communications with the Audit Committee (Paragraph 19 of the Standard in Appendix 1)

Discussion of Paragraph 19 of Auditing Standard No. 18

Paragraph 19 of the standard requires the auditor to communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with its related parties, as well as other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

Both the auditor and the audit committee benefit from a meaningful exchange of information regarding significant risks of material misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports, including matters arising from a company's relationships and transactions with related parties.

Paragraph 19 of the standard is intended to work in tandem with paragraph 7 of the standard. The inquiries of the audit committee, or its chair, pursuant to paragraph 7, can be more effective when they occur at an earlier point in the audit, when the auditor is obtaining an understanding of the company's relationships and transactions with its related parties. This can avoid situations where the auditor's communications regarding



a company's relationships and transactions with its related parties might first occur at the end of the audit. This is consistent with Auditing Standard No. 16, which anticipates timely and robust communications between the auditor and the audit committee throughout the audit. These communications also provide an opportunity for the auditor to corroborate the information obtained from management regarding the company's relationships and transactions with its related parties.

The communication required by paragraph 19 of the standard provides an opportunity for the auditor to communicate information obtained during the audit relevant to those earlier inquiries pursuant to paragraph 7. For example, the auditor might discuss relationships or transactions with related parties that are significant to the company that were not previously discussed with the audit committee, or its chair. The auditor also would communicate significant matters to the audit committee if the auditor encountered these matters during the review of interim financial information.^{47/}

In all cases, the auditor's communications with the audit committee pursuant to paragraph 19 of the standard would cover all the items listed in paragraphs 19.a.-e., to the extent applicable. Such communications involve matters such as the identification of related parties and relationships and transactions with related parties that were previously undisclosed to the auditor, which, as described in the paragraph below, may be of particular interest and concern to the audit committee. Thus, the auditor's communications pursuant to paragraph 19 are not intended to be done only when an exception is identified by the auditor. Doing so would not provide for the proactive communication that should occur with the audit committee regarding what the auditor found as a result of the auditor's evaluation of the company's identification of, accounting for, and disclosure of, its relationships and transactions with its related parties. Further, these communications cannot be made by management as the communication requirements involve communication of the auditor's evaluation of certain matters and management is not in a position to communicate the auditor's evaluation and views.

As noted in paragraph 19, the auditor's communications to the audit committee may not be limited to only those examples of significant matters included in paragraph 19 of the standard. For example, in evaluating the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, the auditor might identify other significant matters that might be of interest to the audit

^{47/} See paragraph .34 of AU sec. 722, *Interim Financial Information*.



committee, such as concerns over the company's process for identifying related parties and relationships and transactions with related parties.

AU sec. 334 does not include specific requirements regarding the auditor's communication with the audit committee. Other existing auditing standards, however, require that the auditor communicate significant matters to the audit committee, including those encountered during a review of interim financial information.^{48/}

Discussion of the Comments Received on Paragraph 19 of the Reproposed Standard

The Board considered all comments received, including the following significant comments:

Communicating Significant Matters: Many commenters recommended revising paragraph 19.a. of the repropoed standard to allow for additional auditor judgment. Some of these commenters suggested that paragraph 19.a. of the repropoed standard be revised to only require the communication of "significant" related parties or relationship or transactions with related parties that were previously undisclosed to the auditor.

The Board considered these comments and believes that communicating all related party relationships and transactions previously undisclosed to the auditor to the audit committee is beneficial. For example, such communications could inform the audit committee of such matters that management had previously concealed from the audit committee as well as from the auditor. While the auditor determines the impact of the identification of a related party relationship or transaction on the audit, these communications can inform the audit committee of matters that might be important to their oversight of management and the financial reporting process. Further, this communication also serves as an opportunity to corroborate management's explanation regarding why the related party transaction was undisclosed to the auditor.

Form of the Communications: At the SAG discussion, the point was raised as to whether the auditor's communications with the audit committee should be communicated in writing or orally. The Board considered this comment, noting that paragraph 19 of the standard is aligned with the requirements in Auditing Standard No. 16, which includes specific requirements on the nature and timing of auditor

^{48/}

See Auditing Standard No. 16 and AU sec. 722.34.



communications with the audit committee. Paragraph 25 of Auditing Standard No. 16 states that generally the communications can be made orally or in writing.^{49/}

The Board is adopting paragraph 19 of the standard as repropoed.

III. Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions (Appendix 2)

Significant unusual transactions can present increased risks of material misstatement of the financial statements due to fraud or error. The amendments regarding significant unusual transactions being adopted by the Board improve the existing standards regarding the auditor's identification and evaluation of a company's significant unusual transactions.

Many commenters generally supported the Board's efforts to strengthen the existing standards regarding significant unusual transactions. A few commenters noted that the improvements could have a positive impact on audit quality. However, some commenters suggested certain revisions to clarify and refine the repropoed amendments regarding significant unusual transactions.

After considering the comments received, the Board is adopting the amendments regarding significant unusual transactions substantially as repropoed, with certain minor revisions that include:

- *Clarifying the Phrase "Infrequent or Significant Unusual Transactions" in the Amendments to AU sec. 722 (Identifying Significant Unusual Transactions):* The amendments to Appendix B of AU sec. 722 include revisions to clarify that the "occurrence of infrequent transactions" and the "occurrence of significant unusual transactions" are separate examples; and
- *Clarifying the Auditor's Evaluation of Identified Significant Unusual Transactions in the Amendments to Paragraph .67 of AU sec. 316 (Evaluating Significant Unusual Transactions):* The amendments to AU sec. 316.67 include revisions to clarify that, in considering the business

^{49/} Paragraph 25 of Auditing Standard No. 16 also states that the auditor must document the communications in the work papers, whether such communications took place orally or in writing.



purpose (or the lack thereof) of the significant unusual transaction, the auditor should evaluate whether the transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party of the company.

The following sections describe the amendments regarding significant unusual transactions being adopted by the Board and existing requirements, as well as discuss the significant comments received and Board responses, where applicable. The sections are organized by the following topical areas:

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A. Identifying Significant Unusual Transactions (Section A. of the Amendments in Appendix 2)

Discussion of the Amendments Regarding Identifying Significant Unusual Transactions

The amendments regarding identifying significant unusual transactions: (i) align the description of significant unusual transactions in the Board's auditing standards; (ii) enhance the requirements for identifying a company's significant unusual transactions; and (iii) revise and add to the examples of fraud risk factors described in AU sec. 316.

Aligning the Descriptions of Significant Unusual Transactions

Amendments to AU sec. 316.66: The amendments regarding significant unusual transactions revise AU sec. 316.66 to describe significant unusual transactions as 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. This description is consistent with the existing description in paragraph 71.g. of Auditing Standard No. 12. The amendments to AU sec. 316.66 also state that significant unusual transactions may be used to engage in fraudulent financial reporting or conceal misappropriation of assets.

Conforming Amendments: The amendments regarding significant unusual transactions also make conforming changes to introduce a uniform description of



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"significant unusual transaction" throughout the Board's standards. Specifically, the amendments align the terminology in: (i) paragraph 14 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*; (ii) paragraph 12 of Auditing Standard No. 9, *Audit Planning*; (iii) paragraph 13 of Auditing Standard No. 12; (iv) paragraph 15.c. of Auditing Standard No. 13; (v), paragraph .85.A.2 of AU sec. 316; and (vi) AU sec. 722.55.B1.

In general, the description of a significant unusual transaction included in the amendments permits the auditor flexibility in applying the description to different companies of different sizes and in different industries. The description of a significant unusual transaction is designed so that the auditor determines whether a transaction is a significant unusual transaction based on the specific facts and circumstances of the company under audit.

A significant unusual transaction does not necessarily need to occur infrequently. Whether a transaction constitutes a significant unusual transaction should be based upon the specific facts and circumstances. The timing or frequency of transactions is only one element to be considered in determining whether a transaction is a significant unusual transaction.

Enhancing Requirements for Identifying Significant Unusual Transactions

Existing requirements relating to the auditor's consideration of fraud in a financial statement audit recognize that during an audit the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment.^{50/} The risk assessment standards also anticipate that the auditor might come across 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. For example, paragraph 71.g. of Auditing Standard No. 12 states that one factor that should be evaluated for the auditor's determination of which risks are significant risks is whether the risk involves significant transactions outside the normal course of business or that otherwise appear to be unusual due to their timing, size, or nature.

The amendments include changes to existing standards that require the performance of procedures as part of the auditor's risk assessment process to identify

^{50/} See AU secs. 316.66–.67.



significant unusual transactions. As discussed below, these procedures include: (i) inquiring of management and others; (ii) understanding controls relating to significant unusual transactions; and (iii) taking into account other information obtained during the audit.

Inquiring of Management and Others (Paragraphs 56-57 of Auditing Standard No. 12): The amendments regarding significant unusual transactions build on existing requirements in Auditing Standard No. 12 that require the auditor to make inquiries of management and others within the company about the risks of material misstatement.^{51/} Specifically, the amendments regarding significant unusual transactions revise paragraph 56.a. of Auditing Standard No. 12 to require the auditor to inquire of company management regarding whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties. The amendments regarding significant unusual transactions also revise paragraphs 56.b. and 56.c. of Auditing Standard No. 12 to require the auditor to inquire of the audit committee and internal audit personnel (if applicable), respectively, regarding whether the company has entered into any significant unusual transactions.

The amendments regarding significant unusual transactions also amend paragraph 57 of Auditing Standard No. 12, which currently requires that the auditor inquire of others within the company about their views regarding fraud risks and includes the example of employees involved in initiating, recording, or processing complex or unusual transactions. The amendments add significant unusual transactions as an example of a complex or unusual transaction to paragraph 57 of Auditing Standard No. 12.

Inquiring of management and others within the company regarding the existence of significant unusual transactions as part of the auditor's risk assessment procedures is an important step – but not the only step – in the auditor's identification of significant unusual transactions. The auditor might determine that there are significant unusual transactions despite management's assertion that there are no significant unusual transactions (e.g., through other procedures performed during the audit, such as reading minutes of the board of directors meetings and performing journal entry testing).

^{51/}

See paragraphs 56 and 57 of Auditing Standard No. 12.



Understanding Controls Relating to Significant Unusual Transactions (Paragraph 73A of Auditing Standard No. 12): Auditing Standard No. 12 requires that the auditor obtain a sufficient understanding of each component of internal control over financial reporting to: (i) identify the types of potential misstatements; (ii) assess the factors that affect the risks of material misstatement; and (iii) design further audit procedures.^{52/}

The amendments regarding significant unusual transactions build on the risk assessment standards by adding paragraph 73A to Auditing Standard No. 12. That paragraph requires the auditor to obtain an understanding of the controls management has established to identify, authorize and approve, and account for and disclose, significant unusual transactions in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18 through 40, 72, and 73 of Auditing Standard No. 12.

Taking into Account Other Information Obtained During the Audit (AU sec. 316.66): The amendments regarding significant unusual transactions add a note to AU sec. 316.66^{53/} stating that the auditor's identification of significant unusual transactions should take into account information obtained from: (i) the risk assessment procedures required by Auditing Standard No. 12 (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial reporting), and (ii) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

Examples of those procedures include:

- Reading minutes of meetings of the board of directors and its committees;^{54/}
- Reading periodic and current reports, and other relevant company filings with the SEC and other regulatory agencies;^{55/}

^{52/} See paragraph 18 of Auditing Standard No. 12.

^{53/} Section B. of Appendix 2 contains the amendments to AU sec. 316.66.

^{54/} See AU sec. 560.12.c. and AU sec. 722.18.a.

^{55/} See paragraph 11 of Auditing Standard No. 12, which requires the auditor to consider reading public information about the company relevant to the evaluation of



- Inspecting confirmation responses and responses to inquiries of the company's lawyers;^{56/}
- Obtaining an understanding of the company's selection and application of accounting principles, including related disclosures (e.g., reading accounting policy manuals and technical memoranda prepared by or for management);^{57/}
- Performing analytical procedures during the audit;^{58/} and
- Performing journal entry testing, including inquiring of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments as required by existing standards.^{59/}

Also, the auditor might identify significant unusual transactions when examining information gathered during the audit. For example, an auditor might identify a significant unusual transaction by scanning a population of invoices for unusual items when determining a sample of items to be tested. By doing so, the auditor might identify an unusual item in terms of dollar amount, the date on which the item was shipped (e.g., on a Sunday when the shipping department is closed), or an unusually high concentration of transactions during a given time period.

As described in section II.F. of this Appendix, Appendix A to the standard includes examples of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. These examples could also be helpful in identifying significant unusual transactions.

the likelihood of material financial statement misstatements as part of obtaining an understanding of the company.

^{56/} See paragraph .06 of AU sec. 337.

^{57/} See paragraph 7.c. of Auditing Standard No. 12.

^{58/} See paragraphs 46 through 48 of Auditing Standard No. 12.

^{59/} See AU secs. 316.58 through 62.



The amendments add a second note to AU sec. 316.66 that states that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions.

Also, as discussed in Section IV.E. of this Appendix, the amendments to AU sec. 560 require that during the "subsequent period" the auditor inquire regarding whether the company has entered into any significant unusual transactions. This could inform the auditor's identification of a company's significant unusual transactions.

Improving the auditor's identification of significant unusual transactions also can inform the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties, as a significant unusual transaction might also be a related party transaction previously undisclosed to the auditor.

Revising and Adding to the Examples of Fraud Risk Factors

The amendments regarding significant unusual transactions also revise certain examples of fraud risk factors contained in AU sec. 316. For example, AU sec. 316.85A.2 notes that significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm can provide opportunities to engage in fraudulent financial reporting. The amendments regarding significant unusual transactions separate that existing example into two distinct examples, namely: (i) related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business); and (ii) significant transactions with related parties whose financial statements are not audited or are audited by another firm. The amendments also add contractual arrangements lacking a business purpose as an example of a fraud risk factor.

Discussion of the Comments Received on the Reproposed Amendments Regarding Identifying Significant Unusual Transactions

The Board considered all comments received, including the following significant comments:

Identifying Significant Unusual Transactions Is the Auditor's Responsibility. One commenter noted that the repropose procedures for identifying significant unusual transactions (performing inquiries, understanding controls, and taking other information into account) are performed as part of the auditor's risk assessment process rather than



to enable the auditor to perform an initial identification of significant unusual transactions – which, in that commenter's view, is the role of management. That commenter suggested clarifying that management is responsible for identifying the company's significant unusual transactions, consistent with the changes regarding a company's related parties. Another commenter stated that, as the size and complexity of a company increases, the likelihood of an auditor being able to identify significant unusual transactions diminishes proportionately.

The Board considered these comments, noting that the determination of whether a transaction is a significant unusual transaction is the responsibility of the auditor. The auditor takes management's responses to inquiries and other procedures into account when identifying significant unusual transactions. However, the information provided by management is not the sole consideration. The auditor's procedures for identifying significant unusual transactions are performed as part of the auditor's risk assessment, and the auditor's procedures should be sufficient to identify risks of material misstatement of the financial statements, based on the size and complexity of the company.

Clarifying the Phrase "Infrequent or Significant Unusual Transactions" in the Amendments to AU sec. 722: AU sec. 722.55 contains examples of situations about which the auditor would ordinarily inquire of management when conducting a review of interim financial information. A few commenters suggested revisions to clarify the repropoed amendment to the tenth bullet of AU sec. 722.55, which as repropoed stated "the occurrence of infrequent or significant unusual transactions." In response to comments, the Board revised the tenth bullet into two separate items: one bullet relating to the occurrence of infrequent transactions and the other relating to the occurrence of significant unusual transactions.

The Board is adopting the amendments regarding the identification of significant unusual transactions substantially as repropoed, except for the revision to AU sec. 722 discussed above.

B. Evaluating Significant Unusual Transactions (Section B. of the Repropoed Amendments in Appendix 2)

Discussion of the Amendments Regarding Evaluating Significant Unusual Transactions

The amendments regarding the evaluation of significant unusual transactions address the following areas: (i) evaluating the business purpose (or the lack thereof) of significant unusual transactions; (ii) evaluating the accounting and disclosure of



significant unusual transactions; and (iii) other matters regarding significant unusual transactions.

Evaluating the Business Purpose (or the Lack Thereof) of Significant Unusual Transactions

The amendments regarding significant unusual transactions strengthen the auditor's evaluation of whether the business purpose (or the lack thereof) for significant unusual transactions indicates that those transactions were entered into to engage in fraud.

Existing AU sec. 316.66 requires that once an auditor becomes aware of significant unusual transactions, the auditor should gain an understanding of the business rationale for such transactions and whether that rationale (or the lack thereof) suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. Existing AU sec. 316.67 identifies several matters that the auditor should consider in understanding the business rationale for those transactions.

The amendments build on the existing requirements in AU secs. 316.66-.67 and include additional procedures to more specifically focus the auditor's attention on critically evaluating whether the business purpose (or the lack thereof) for significant unusual transactions indicates that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.

Those improvements are accomplished through: (i) revisions to AU sec. 316.66; (ii) adding AU sec. 316.66A; and (iii) revisions to AU sec. 316.67. Each of those amendments is discussed in further detail below.

Revisions to AU sec. 316.66: Because a company might use a significant unusual transaction to engage in fraudulent financial reporting or to obscure the company's financial position or operating results, existing standards require the auditor to perform procedures to evaluate significant unusual transactions identified by the auditor and discuss the auditor's evaluation of such transactions with the audit committee.^{60/} The amendments to AU sec. 316.66 are intended to improve the auditor's evaluation of significant unusual transactions, including the auditor's evaluation of the

^{60/} See AU secs. 316.66–.67 and paragraph 13.d. of Auditing Standard No. 16.



business purpose (or the lack thereof), and whether the transactions have been appropriately accounted for and adequately disclosed in the company's financial statements, by requiring the auditor to perform specific procedures to evaluate significant unusual transactions. Improving the auditor's evaluation of significant unusual transactions should also result in a more meaningful exchange of information between the auditor and the audit committee.

Adding AU sec. 316.66A: The amendments regarding evaluating significant unusual transactions add a new paragraph to AU sec. 316, paragraph AU sec. 316.66A, which requires that the auditor design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. The procedures include:

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

A footnote to item c. of the amendments to AU sec. 316.66A also states that examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

Item d. of the amendments to AU sec. 316.66A provides an opportunity for the auditor to scale the audit by supplementing the basic required procedures with more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. Those procedures should: (i) address the assessed risks of material misstatement; (ii) provide an understanding of the business purpose (or the lack thereof) that is sufficient to evaluate whether the transaction was entered into to commit fraudulent financial reporting or misappropriate assets; and (iii) provide the auditor with



sufficient audit evidence to evaluate whether the financial statement accounting and disclosure requirements have been met.

Examples of other procedures that might be appropriate, depending on the nature of the significant unusual transaction and the risks of material misstatement of the financial statements, include:

- Inquiring directly of the other party regarding the business purpose of the transaction;
- Reading public information regarding the transaction and the parties to the transaction, if available;
- Reading the financial statements or other relevant financial information obtained from other parties involved in the transaction, if available, to understand how the other party accounted for the transaction;
- Evaluating the transferability and value of collateral provided by the other party, if any;
- Confirming the terms of the transaction with other parties with knowledge of the transaction (e.g., banks, guarantors, agents, or attorneys), if any; and
- Confirming whether there are any side agreements or other arrangements (either written or oral) with the other party.

The amendments regarding significant unusual transactions were designed to establish basic procedures for the auditor to identify and evaluate significant unusual transactions and allow the auditor to assess risks and respond to risks based on the facts and circumstances, including the size and complexity of the company and the assessed significance of the identified risks of material misstatement in the financial statements.

Significant unusual transactions, like all transactions, are subject to the requirements contained in AU sec. 411.06, which requires that the auditor consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. That evaluation encompasses an



understanding of the "business sense" of material transactions, which was referred to in footnote 6 of AU sec. 334.^{61/}

Existing standards require that the auditor design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.^{62/} This includes designing and performing audit procedures in a manner that addresses the assessed risks of material misstatement associated with significant unusual transactions. The procedures contained in AU sec. 316.66A work in conjunction with the procedures that the auditor performs during the audit to address the relevant assertions associated with each significant unusual transaction.

Revisions to AU sec. 316.67: The amendments regarding significant unusual transactions also require the auditor to evaluate certain matters when evaluating whether the business purpose (or the lack thereof) of a significant unusual transaction suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. The amendments incorporate the list of matters currently in AU sec. 316.67 and add the following matters:

- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);
- 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 other, more clearly independent, parties on an arm's-length basis;^{63/} and

^{61/} See the discussion in Section II.E. of this Appendix.

^{62/} See also paragraph 8 of Auditing Standard No. 13.

^{63/} See Section II.C. of Securities Act Release No. 33-8056, *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations* (January 22, 2002), <http://www.sec.gov/rules/other/33-8056.htm>.



- The transaction enables the company to achieve certain financial targets.

These additional matters are intended to improve the auditor's evaluation of the business purpose (or the lack thereof) for significant unusual transactions, including whether they may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. For example, considering whether a transaction enables the company to achieve certain financial targets is an important consideration when evaluating whether that transaction has been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. These additional matters also represent areas that may be relevant to the auditor's evaluation of whether the financial statements contain the information regarding the significant unusual transaction essential for a fair presentation in conformity with the applicable financial reporting framework.

Including these additional matters in the auditor's evaluation of a significant unusual transaction can also assist the auditor in the identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor because it focuses the auditor on the substance of the relationship or transaction. For example, relationships such as those with entities managed by former officers, interlocking directors/ownership, significant customers and suppliers, competitors, strategic alliances or partnerships, or collaborative arrangements could represent matters that involve related parties or relationships or transactions with related parties previously undisclosed to the auditor. Further, a related party could be involved in a significant unusual transaction either directly or indirectly, through the use of an intermediary whose involvement in the transaction appears to serve no apparent business purpose.

A footnote to AU sec. 316.67 references the requirement, contained in paragraph 16 of the standard, that the auditor perform certain procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

Evaluating the Accounting and Disclosure of Significant Unusual Transactions

The amendments add a new paragraph to AU sec. 316, paragraph .67A, to require the auditor to evaluate whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements. AU sec. 316.67A further states that this includes evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework. A footnote directs the auditor to paragraphs 30 and 31 of Auditing Standard



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No. 14, which address the auditor's evaluation of the presentation of the financial statements, including the disclosures.

A note to AU sec. 316.67A states that, in evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in accordance with the financial reporting framework, the auditor considers management's disclosure regarding significant unusual transactions in other parts of the company's SEC filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

Other Matters Regarding Significant Unusual Transactions

The amendments regarding significant unusual transactions also make a number of other related amendments, including adding a new paragraph, paragraph 11A, to Auditing Standard No. 13 and making a conforming amendment to Auditing Standard No. 16.

The new paragraph 11A to Auditing Standard No. 13 reminds auditors that significant unusual transactions can affect the risks of material misstatement due to error or fraud, and that the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to the repropoed amendments to AU secs. 316.66-.67A regarding significant unusual transactions.

The amendments regarding significant unusual transactions also amend the auditor communication requirements in Auditing Standard No. 16. The amendments revise paragraph 13.d. of Auditing Standard No. 16 to refer to the "business purpose (or the lack thereof)" instead of the "business rationale" of a significant unusual transaction. In the Board's view improving the auditor's identification and evaluation of significant unusual transactions should enhance the quality of the auditor's discussions with the audit committee.

Discussion of the Comments Received on the Repropoed Amendments Regarding Evaluating Significant Unusual Transactions

The Board considered all comments received, including the following significant comments:

Clarifying the Auditor's Evaluation of Identified Significant Unusual Transactions:
One commenter suggested several clarifying revisions to the factors in AU sec. 316.67



that are relevant to the auditor's evaluation of whether the business purpose (or the lack thereof) of a significant unusual transaction indicates that the transaction may have been entered into to engage in fraud. For example, that commenter suggested revising the fourth bullet to state "the transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party." The Board considered these suggestions and agrees that emphasizing that a related party might be involved in a significant unusual transaction in place of the company is an important clarification, and has revised AU sec. 316.67, accordingly.

Understanding Economic Substance Versus Commercial Substance: One commenter stated that repropounded AU sec. 316.67 did not distinguish "commercial substance" (a term used in connection with accounting for nonmonetary transactions) from "economic substance" (a doctrine governing all transactions). That commenter suggested revising this factor in AU 316.67 so that "commercial substance" is understood to only refer to nonmonetary transactions. The Board considered this comment, noting that the auditor's evaluation does not impose accounting requirements on the auditor as the standard and amendments follow a "framework neutral" approach.

Understanding "Financial Targets": A few commenters suggested improving the auditor's evaluation of whether a significant unusual transaction enables the company to achieve certain financial targets pursuant to AU sec. 316.67, by including required procedures to obtain an understanding of the company's financial targets. The Board considered these comments noting that the auditor's understanding of a company's financial targets is already informed by information obtained during the auditor's risk assessment process.^{64/} The procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers required by the other amendments to Auditing Standard No. 12 further inform the auditor's understanding. The information obtained from such procedures informs the auditor's evaluation of whether a company's significant unusual transaction enables the company to achieve certain financial targets.

The Board is adopting the amendments regarding the evaluation of significant unusual transactions substantially as repropounded, except for the revisions discussed above to AU sec. 316.67 and the addition of a reference to paragraph 30 of Auditing Standard No. 14 in footnote 25B of AU sec. 316.67A.

^{64/}

See paragraphs 16 and 17 of Auditing Standard No. 12.



IV. Other Amendments to PCAOB Auditing Standards (Appendix 3)

The Board is also adopting other amendments to PCAOB auditing standards, including: (i) amendments regarding a company's financial relationships and transactions with its executive officers; (ii) other new requirements that complement the standard and amendments; and (iii) amendments that conform other auditing standards to the standard and amendments being adopted by the Board, including conforming amendments that revise the references to the Board's superseded auditing standard, AU sec. 334.

After considering the comments received, the Board is adopting the other amendments substantially as repropoed. The Board is, however, making a number of minor clarifications in response to comments. These include:

- *Clarifying the Auditor's Inquiries of Management (AU sec. 560)*: The amendments to paragraph 12 of AU sec. 560 include revisions to clarify that the auditor should inquire regarding both whether there have been any changes in the company's related parties and whether there have been any significant new related party transactions; and
- *Revising the First Illustrative Letter in AU sec. 722 (AU sec. 722)*: The amendments to AU sec. 722 include revisions to clarify that the auditor should obtain a representation from management that management has provided "all financial records and related data, including the names of all related parties and all relationship and transactions with related parties" whether the auditor is using the first illustrative letter or the second illustrative letter contained in AU sec. 722.

The following sections describe the other amendments being adopted by the Board and existing requirements, as well as discuss the significant comments received and Board responses, including revisions made, where applicable. The sections are organized by the following areas:

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B. AU sec. 315, <i>Communications Between Predecessor and Successor Auditors</i>	A4-71



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C. AU sec. 316, <i>Consideration of Fraud in a Financial Statement Audit</i>	A4-72
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A. Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (Appendix 3)

Discussion of the Amendments to Auditing Standard Auditing Standard No. 12

In some circumstances, a company's financial relationships and transactions with its executive officers can create risks of material misstatement that relate pervasively to the financial statements. The other amendments to Auditing Standard No. 12 require the auditor to perform specific procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment.

As described in the following sections, the other amendments to Auditing Standard No. 12: (i) add a new paragraph, paragraph 10A, to Auditing Standard No. 12; (ii) revise paragraph 11 of Auditing Standard No. 12; and (iii) make a related conforming amendment to the risk assessment standards.

Paragraph 10A of Auditing Standard No. 12: The other amendments add paragraph 10A to Auditing Standard No. 12 to require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. Paragraph 10A states that those procedures should be designed to identify risks of material misstatement and should include, but not be limited to: (i) reading the employment and compensation contracts between the company and its executive officers; and (ii) reading the proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers. The other amendments are intended to assist the auditor in identifying and assessing risks associated with a company's financial relationships and transactions with its executive officers. The other amendments anticipate that the additional procedures to be performed would contribute to the auditor's consideration of fraud in a financial statement audit pursuant to AU sec.



316, which recognizes certain incentives and pressures on management to commit fraud as examples of fraud risk factors.^{65/}

Performing procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers assists the auditor in understanding whether those relationships and transactions affect the risks of material misstatement.^{66/} For example, the auditor could consider whether the company's internal control over financial reporting is designed and operating to address the risk that management might seek accounting results solely to boost certain executive officers' compensation. This understanding could also assist the auditor in determining areas where management bias might occur (for example, certain accounting estimates, including fair value measurements).

Reading proxy statements and other relevant company filings with the SEC that are available to the auditor can provide the auditor with relevant information regarding a

^{65/} See AU sec. 316.85, which 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: (i) significant financial interests in the entity; (ii) significant portions of their compensation (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 (iii) personal guarantees of debts of the entity.

^{66/} For example, a May 2010 academic study that examined SEC accounting and auditing enforcement releases from 1998 to 2007 noted that the most commonly cited motivations for fraud included the need to: (i) meet external earnings expectations of analysts and others; (ii) meet internally set financial targets or make the company look better; (iii) conceal the company's deteriorating financial condition; (iv) increase the stock price; (v) bolster financial position for pending equity or debt financing; (vi) increase management compensation through achievement of bonus targets and through enhanced stock appreciation; and (vii) cover up assets misappropriated for personal gain. That study indicated that the chief executive officer and/or chief financial officer were named in 89 percent of the cases involving fraudulent financial reporting brought by the SEC during that period. See M. Beasley, J. Carcello, D. Hermanson, and T. Neal, *Fraudulent Financial Reporting 1998–2007: An Analysis of U.S. Public Companies*, Committee of Sponsoring Organizations of the Treadway Commission (May 2010) at 3, http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.



company's financial relationships and transactions with its executive officers that informs the auditor's understanding of the company. In addition, the risk assessment standards require that the auditor consider reading public information about the company, for example, SEC filings.^{67/}

The information obtained regarding a company's financial relationships and transactions with its executive officers, in conjunction with other information obtained during the risk assessment process (e.g., information about company performance measures),^{68/} could be used to identify account balances that are likely to be affected and that could have a significant effect on the financial statements. That information could be used by the auditor to identify and assess risks of material misstatement due to fraud and to design appropriate audit responses. In addition, obtaining an understanding of a company's financial relationships and transactions with its executive officers could identify information that indicates the existence of related party relationships or transactions previously undisclosed to the auditor.

The amendments to paragraph 10A are not intended to call into question the policies and procedures of the company with respect to its compensation arrangements with executive officers, but rather to assist the auditor in identifying and assessing risks of material misstatement associated with those financial relationships and transactions. Such risks could include unrecognized compensation, self-dealing or other conflicts of interest, or possible illegal acts. If present, these conditions may call into question the integrity of management's representations or represent violations of the company's established policies and procedures. In addition, these procedures could identify potential instances of management override of internal controls that could inform the auditor whether others in the company are willing to challenge management or whether management might be dominating others in the company.

The purpose of the procedures in paragraph 10A is to further the auditor's risk assessment rather than to require the auditor to determine the appropriateness of a company's compensation agreements with its executive officers. The amendments would not require the auditor to assess the appropriateness of the compensation of executive officers. The procedures performed are intended to occur in the context of the auditor's process for assessing the risks of material misstatement of the company's financial statements.

^{67/} See paragraph 11 of Auditing Standard No. 12.

^{68/} See paragraphs 16 and 17 of Auditing Standard No. 12.



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The other amendments do not change the existing requirement in paragraph 10 of Auditing Standard No. 12 to consider obtaining an understanding of compensation arrangements with senior management. The population for the procedures required by paragraph 10A of the other amendments is the list of "executive officers," as defined in SEC Rule 3b-7 or included on Schedule A of Form BD,^{69/} while the existing requirement in paragraph 11 of Auditing Standard No. 12 continues to apply to what may be a larger population of a company's management.

The term "senior management" is not a defined term in Auditing Standard No. 12. For certain companies or brokers or dealers, senior management might be the same population as its executive officers. Further, the individuals the company considers to be its "senior management" may differ among issuers and among broker-dealers. The existing standard anticipates that a company's or broker's or dealer's facts and circumstances may affect the composition of its "senior management." The auditor could: (i) gain an understanding of the compensation arrangements with a larger group of "senior management" under Auditing Standard No. 12 in order to obtain an understanding of the company and then (ii) perform the procedures under the other repropoed amendments regarding the financial arrangements with a smaller group of "executive officers."

The other amendments do not require the auditor to evaluate the company's identification of its "executive officers," for SEC filing and other regulatory purposes. In the Board's view, the SEC rules cited in the amendments provide a definition of the term "executive officers" that provides sufficient direction to auditors.^{70/}

Amendments to Paragraph 11: The other amendments also include other changes designed to strengthen the auditor's consideration of the risks of material misstatement associated with financial relationships and transactions with its executive officers.

For example, the amendments to Auditing Standard No. 12 amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider making inquiries regarding

^{69/} See Exchange Act Rule 3b-7, 17 C.F.R. §240.3b-7, and Schedule A of Form BD. See generally Item 401(b) of Regulation S-K, 17 C.F.R. §229.401(b).

^{70/} See Item 401(b) of Regulation S-K, 17 C.F.R. §229.401(b). For a discussion of "executive officer" for foreign private issuers, see the discussion in this section titled "Identifying the Executive Officers of Foreign Private Issuers."



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the structuring of the company's compensation for executive officers to the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company.

An auditor performing this inquiry could take into account other available audit evidence, such as disclosures in SEC filings that: (i) describe the company's compensation policies and practices that present material risks to the company^{71/} and (ii) disclose fees paid to compensation consultants, in certain circumstances.^{72/} An auditor performing this inquiry could inquire of the audit committee, or its chair, regarding its views on executive officer compensation at the same time the auditor makes inquiries regarding how the audit committee exercises oversight of the company's assessment of fraud risks and the establishment of controls to address fraud risks as required by paragraph 56.b.(4) of Auditing Standard No. 12.

In addition, the amendments to paragraph 11 of Auditing Standard No. 12 also require the auditor to consider performing procedures to obtain an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

Based on the auditor's assessment of risk, the auditor might determine that additional procedures are necessary. For example, the auditor might read available reports from the internal audit function that contain an evaluation of the expense report process. In other cases, the auditor might determine that it is necessary to inspect executive officer expense reimbursement documentation for unusual items.

Conforming Amendment to the Risk Assessment Standards: As described in Section II.C. of this Appendix, the other amendments include a conforming amendment to Auditing Standard No. 12. The change aligns Auditing Standard No. 12 with the requirement in paragraph 3 of the standard, which states that the procedures in paragraphs 4 through 9 of the standard are performed in conjunction with the risk assessment procedures required by Auditing Standard No. 12. That amendment removes the note to the final bullet of paragraph 10 of Auditing Standard No. 12.

^{71/} See Securities Act Release No. 33–9089, *Proxy Disclosure Enhancements* (December 16, 2009), <http://www.sec.gov/rules/final/2009/33-9089.pdf>.

^{72/} See Item 407(e)(3)(iii) of Regulation S–K.



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Discussion of the Comments Received on the Reproposed Amendments to Auditing Standard No. 12

The Board considered all comments received, including the following significant comments:

Revisions Included in Paragraph 10A of the Reproposed Amendments: Commenters who commented on the revisions included in paragraph 10A of the repropose amendments to Auditing Standard No. 12 generally were supportive of the revisions to the repropose amendments. Some commenters stated that it is sufficiently clear that the auditor: (i) should obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment; and (ii) is not required to assess the appropriateness of executive officer compensation. One commenter stated that the repropose amendments addressed their concerns regarding the proposed amendments. Another commenter recommended including additional language stating that the amendments are not intended to call into question the policies and procedures of the company. The Board considered these comments and believes that the revisions contained in the repropose amendments sufficiently acknowledge that the auditor is not required to assess the appropriateness or reasonableness of compensation arrangements with executive officers.

Alternatives to Reading Each Compensation Arrangement: One commenter expressed their support for the auditor to obtain an understanding of compensation arrangements with the company's executive officers. That commenter suggested including further clarification to these amendments, including, for example, considering whether such an understanding could be achieved by the auditor assessing the company's internal control over such arrangements as opposed to reading each compensation arrangement. The Board considered this comment, but noted that the purpose of these procedures is to obtain information regarding individuals who perform specific functions at the company, as part of the auditor's risk assessment. Relying on a company's process may not provide the information necessary for the auditor to identify incentives and pressures that may result in risks of material misstatement. Further, reading the documents underlying the financial relationships and transactions with a company's executive officers could identify information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist and also informs the auditor's evaluation of whether a significant unusual transaction enables the company to achieve financial targets as part of the auditors evaluation pursuant to AU sec. 316.67.

Identifying the "Executive Officers" of Foreign Private Issuers: One commenter expressed concern that the auditor would need to determine which individuals fall within



the definition of "executive officers" if foreign private issuers do not identify "executive officers" in their filings with the SEC. The Board considered this comment and determined not to make revisions.

The auditor's risk assessment procedures with respect to a company's financial relationships and transactions with its executive officers begins with the company's identification of its executive officers. These procedures do not require the auditor to evaluate the company's identification of its executive officers for SEC filing or other regulatory purposes. The company's identification of its executive officers is generally available from its SEC filings or other company information.

For example, foreign private issuers might identify their executive officers in their SEC filings:

- Some foreign private issuers currently disclose their "executive officers" in their filings with the SEC (e.g., some foreign private issuers simply disclose "executive officers" in Form 20-F, and some foreign private issuers voluntarily file their annual report on Form 10-K and disclose their executive officers).
- Some home country filing requirements require a foreign company to determine executive officers using a similar definition to Rule 3b-7. For example, in Canada, National Instrument 51-102, *Continuous Disclosure Obligations* states that "executive officer means, for a reporting issuer, an individual who is (a) a chair, vice-chair or president; (b) a vice-president in charge of a principal business unit, division or function including sales, finance or production; or (c) performing a policy-making function in respect of the issuer." Canadian foreign private issuers are also required to disclose such individuals in annual information filings with the SEC.

Further, the individuals comprising a company's "[d]irectors and senior management" determined pursuant to item F. of the General Instructions to Form 20-F would include, among others, those individuals who, on the basis of title or policy making function, qualify as "executive officers" under Rule 3b-7.

In addition, foreign private issuers might identify their executive officers for a number of other reasons, for example:

- If more than 50% of a foreign company's voting securities are held by U.S. residents, the company must determine its eligibility to be a "foreign



private issuer" by considering, among other things, whether the majority of its "executive officers" or directors are U.S. citizens or residents.^{73/}

- A foreign private issuer listed on the New York Stock Exchange ("NYSE") would need to identify its executive officers for purposes of complying with Section 303A.12(b), *Certification Requirements* of the NYSE Listed Company Manual, which requires that each listed company chief executive officer must promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any non-compliance with any applicable provisions of Section 303A of the NYSE Listed Company Manual.

Although the Board did not revise the amendments to Auditing Standard No. 12 for this comment, as described in Section IV.C. of this Appendix, the Board's consideration of this comment did prompt a change to the amendments to AU sec. 316.81A to include a reference to Item 16F of Form 20-F to remind auditors of foreign private issuers of their responsibilities.

Performing Procedures Relating to Individuals Outside of the Company's Executive Officers: Some commenters suggested that the auditor's procedures should not be limited to "executive officers," because compensation arrangements with persons outside the definition of "executive officers" (e.g., the most highly compensated individuals, or individuals holding a material block of stock options that are in a position to influence the company) also might create incentives and pressures that could create risks of material misstatement.

The Board considered these comments, noting that the intent of the amendments was to sharpen the auditor's focus on a company's financial relationships and transactions with individuals that could pose increased risks of material misstatement because of the ability of those individuals to have direct involvement in the company's financial reporting. However, the amendments do not change the existing requirement that the auditor consider obtaining an understanding of the compensation arrangements with what may be a larger group of individuals, a company's senior management. The Board agrees that financial relationships with individuals outside of a company's executive officers also may warrant the auditor's attention. However, obtaining an

^{73/} "Foreign private issuer" is defined in Rule 405 of Regulation C under the Securities Act of 1933 and Rule 3b-4(c) under the Exchange Act.



understanding of the compensation arrangements with individuals outside of management should be based upon the company's facts and circumstances.

Expanding the Examples of Executive Officer Compensation: One commenter suggested including in the amendments a discussion of the basic components of many of today's executive compensation plans and requiring the auditor to read and understand each of the documents underlying those common components. The Board considered this comment but did not make changes, noting that the requirement to obtain an understanding of the company's financial relationships and transactions with its executive officers is intended to provide an overarching requirement for the auditor that can be applied to all companies as part of the auditor's risk assessment procedures and apply to companies of different size and complexity. Additionally, the Board notes that the auditor might have an overall understanding of the issues pertinent to compensation arrangements with the company's executive officers due to the existing responsibility under Auditing Standard No. 12 to consider obtaining an understanding of the compensation arrangements with the company's senior management.

The Board is adopting the amendments to Auditing Standard No. 12 as repropoed.

B. AU sec. 315, *Communications Between Predecessor and Successor Auditors* (Appendix 3)

Discussion of the Amendments to AU sec. 315

The Board is adopting amendments to AU sec. 315, *Communications Between Predecessor and Successor Auditors*. AU sec. 315 provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place, but does not specifically address a company's relationships or transactions with its related parties or its significant unusual transactions. AU sec. 334 notes that determining the existence of relationships with related parties requires the application of audit procedures that may include inquiring of predecessor auditors concerning their knowledge of existing relationships and the extent of management involvement in material transactions.^{74/}

The amendments to AU sec. 315 require the auditor to make inquiries regarding the predecessor auditor's understanding of the company's relationships and

^{74/} See AU sec. 334.07.g. and AU secs. 9334.12–.13.



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transactions with related parties and significant unusual transactions. The amendments also include within the successor auditor's review of the predecessor auditor's working papers any documentation regarding relationships and transactions with related parties and significant unusual transactions.

Inquiring of a predecessor auditor regarding the company's relationships and transactions with related parties and significant unusual transactions can assist the successor auditor in determining whether to accept the engagement. Such inquiries also can benefit the successor auditor in obtaining an understanding of the company's relationships and transactions with its related parties and in identifying significant unusual transactions.

After considering all comments received, the Board is adopting the amendments to AU sec. 315 as reposed.

C. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (Appendix 3)

Discussion of the Amendments to AU sec. 316

The amendments to AU sec. 316 expand the discussion in the standard regarding certain audit requirements contained in Section 10A of the Exchange Act. The amendments emphasize the auditor's responsibility to investigate and disclose possible fraud to management, the audit committee and, upon the satisfaction of certain conditions, the SEC, consistent with the auditor's responsibility under Section 10A of the Exchange Act.

Improving the auditor's identification and evaluation of significant unusual transactions could lead to more instances of auditors becoming aware of indications that fraud or another illegal act has or may have occurred.

In addition, as described in Section II.D. of this Appendix the other amendments to AU sec. 316 also add a new example of a fraud risk factor, the exertion of dominant influence by or over a related party.

As described in Section IV.A. of this Appendix, the Board's consideration of the comments received regarding the amendments to paragraph 10A of Auditing Standard No. 12, regarding the audits of foreign private issuers, prompted a change to the amendments to AU sec. 316.81A. Specifically, to assist auditors of foreign private issuers with their responsibility when there is a change in a registrant's certifying accountants, a reference to Item 16F of Form 20-F in the amendments to AU sec. 316.81A has been included.



After considering all comments received, the Board is adopting the amendments to AU sec. 316 as repropoed, except for adding a reference to Item 16F of Form 20-F to AU sec. 316.81A.

D. AU sec. 333, *Management Representations* (Appendix 3)

Discussion of the Amendments to AU sec. 333

The amendments to AU sec. 333 require that the auditor obtain certain written representations each interim period regarding a company's relationships and transactions with its related parties. AU sec. 333 currently requires auditors to obtain written representations from management for the periods covered by the auditor's report. That standard addresses representations covering financial statements; completeness of information; recognition, measurement, and disclosure; and subsequent events. Additionally, AU sec. 333 currently requires the auditor to obtain a representation regarding the recognition, measurement, and disclosure of related party transactions.

The amendments to AU sec. 333.06 require that the auditor obtain written representations from management indicating that management has disclosed to the auditor the names of all of the company's related parties and all relationships and transactions with related parties. The standard also amends AU sec. 333.06 to require the auditor to obtain a written representation from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor.

Side agreements or other arrangements (either written or oral) undisclosed to the auditor could represent a risk of material misstatement of the financial statements for both related party and significant unusual transactions. For example, the lack of an arm's-length relationship in related party transactions can raise questions about whether all transaction terms have been disclosed to the auditor. Similarly, significant unusual transactions occurring close to the end of the period that pose difficult substance over form questions also could involve side agreements or other arrangements undisclosed to the auditor. The existence of implicit or informal understandings (either written or oral) could have a significant impact on the financial accounting and disclosure of relationships and transactions with related parties and significant unusual transactions.

In addition, the amendments to AU sec. 333 require that the auditor obtain written representations from management in situations in which the financial statements include an assertion by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction. This requirement complements the auditor's evaluation, required by paragraph 18 of the



standard, when management has asserted that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

After considering all comments received, the Board is adopting the amendments to AU sec. 333 as reposed.

E. AU sec. 560, *Subsequent Events* (Appendix 3)

Discussion of the Amendments to AU sec. 560

AU sec. 560 currently requires the auditor to perform auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles.^{75/} AU sec. 560 currently does not require the auditor to inquire regarding the company's relationships and transactions with its related parties and its significant unusual transactions.

The amendments to AU sec. 560.12 require that during the "subsequent period" the auditor inquire regarding related party transactions and significant unusual transactions. Events or transactions that occur subsequent to the balance sheet date, but prior to the issuance of the financial statements, may have a material effect on the financial statements. Making specific inquiries during the "subsequent period" regarding a company's relationships and transactions with its related parties and its significant unusual transactions can benefit the auditor's identification of matters that might require disclosure in the financial statements.

Discussion of the Comments Received on the Reproposed Amendments to AU sec. 560

The Board considered all comments received, including the following significant comment:

Clarifying the Auditor's Inquiries of Management: One commenter recommended revising the inquiry in item v. of the reposed amendments to AU sec. 560.12 to clarify that there are two separate inquiries. The Board considered this comment and in the interest of clarity, revised the reposed amendments to place each inquiry into a separate bullet.

^{75/} See AU sec. 560.12.



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The Board is adopting the amendments to AU sec. 560 substantially as repropoed, with the clarifying change noted above.

F. AU sec. 722, *Interim Financial Information* (Appendix 3)

Discussion of Amendments to Auditing Standard No. 12

AU sec. 722 currently requires the auditor to inquire of management that has responsibility for financial and accounting matters concerning unusual or complex matters that might have an effect on the interim financial information. Generally, the amendments to AU sec. 722 require that the auditor obtain certain written representations each interim period regarding a company's relationships and transactions with its related parties. The other amendments revise AU sec. 722 to be consistent with the amendments to AU sec. 333 that require the auditor to obtain written representations each interim period regarding the company's related parties and the absence of side agreements or other arrangements.

Discussion of the Comments Received on the Repropoed Amendments to AU sec. 722

The Board considered all comments received, including the following significant comment:

Revising the First Illustrative Letter in AU sec. 722: One commenter recommended that a change that had been made in the repropoal to expand item 2.a. of the *second* illustrative letter of AU sec. 722 should also be made to the corresponding item in the *first* illustrative representation letter. That commenter recommended that item 2.a. in the first illustrative letter be revised to state that management has made available to the auditor "all financial records and related data, including the names of all related parties and all relationships and transactions with related parties." The Board considered this comment and made the revisions suggested by the commenter so that the letters were consistent.

The Board is adopting the amendments to AU sec. 722 substantially as repropoed, with the clarification discussed above.

V. Audits of Brokers and Dealers

As described in Section VII. of this release, Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act^{76/} provided the Board with oversight

^{76/} Pub. L. No. 111–203, 124 Stat. 1376 (July 21, 2010).



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authority with respect to audits of brokers and dealers that are registered with the SEC. On July 30, 2013, the SEC adopted amendments to SEC Rule 17a-5 under the Exchange Act to require, among other things, that audits of brokers' and dealers' financial statements be performed in accordance with the standards of the PCAOB for fiscal years ending on or after June 1, 2014.^{77/}

In its reproposal, the Board solicited comment regarding whether there were specific issues relating to audits of brokers and dealers of which the Board should be aware. Commenters did not provide examples of specific audit issues, but did provide views on the applicability of the standard and amendments to audits of brokers and dealers. For example, many commenters stated that the repropose standard and amendments should apply to audits of brokers and dealers and provided various rationales. Some commenters noted that the financial reporting risks that the reproposal is designed to target also exist at these entities and in some cases more prevalently. Other commenters noted that the scalability of the standard and amendments allow the auditor to focus on the specifics of the company, making the standard and amendments appropriate for audits of brokers and dealers.

Further, at the May 17, 2012 SAG meeting, the point was raised that a robust auditing standard on related parties was important for both regulators of brokers and dealers and for users of their financial statements. Several scenarios were discussed by which related party transactions might be improperly used by brokers and dealers, including scenarios where the brokers and dealers could use related party transactions to: (i) overpay for goods and services and disguise capital withdrawals; (ii) avoid the imposition of higher capital requirements and capital charges; (iii) structure a broker's or dealer's business model to appear smaller; and (iv) transfer customer assets to parties that are not approved custodians.

Additionally, the results of the Board's oversight activities regarding audits of brokers and dealers have identified deficiencies regarding the auditor's efforts in the area of related parties, suggesting that this is an area warranting heightened scrutiny.^{78/}

^{77/} See Rule 17a–5, 17 C.F.R. § 240.17a–5 SEC, *Broker–Dealer Reports*, Exchange Act Release No. 34–70073, (July 30, 2013), 78 Federal Register 51910 (August 21, 2013), <http://www.sec.gov/rules/final/2013/34-70073.pdf>.

^{78/} See The Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers (August 20, 2012) and the Second Report on



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The standard and amendments, if approved by the SEC, will be applicable to all audits performed pursuant to PCAOB standards, including audits of brokers and dealers.

VI. Effective Date

As described in Section VIII. of this release, the Board determined that the standard and amendments will be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of interim financial information within those fiscal years.

In determining the effective date, the Board considered the comments received. Many commenters noted that the effective date in the reproposing release was reasonable, if the final standard and amendments were approved three to four months prior to the effective date contemplated in the reproposing release. Those commenters generally indicated that this would have allowed sufficient time for firms to incorporate the new requirements into their methodologies, guidance, audit programs, and staff training. Given the date of the adoption of the standard and amendments, the Board determined that the standard and amendments should be applicable, subject to SEC approval, to audits of financial statements for fiscal years beginning on or after December 15, 2014.

One commenter recommended that the amendments to AU sec. 722 become effective in the first interim period following the first annual period that the standard and amendments are effective. The Board considered this comment but noted that the amendments to AU sec. 722, which encompass inquiries of and representations from management, are designed to complement the standard and amendments. Performing those procedures for reviews of interim financial information during the first year of implementation (the fiscal year beginning on or after December 15, 2014) can inform the auditor's efforts in these critical areas for the audit performed during the first year of implementation.

the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers (August 19, 2013).



APPENDIX 5 – Economic Considerations, Including for Audits of Emerging Growth Companies

I. Introduction and Statutory Background

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is adopting a new auditing standard and amendments to its auditing standards^{1/} to strengthen auditor performance requirements in three areas that historically have represented increased risks of material misstatement in company financial statements: (i) relationships and transactions with related parties; (ii) 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"); and (iii) a company's financial relationships and transactions with its executive officers.^{2/}

This Appendix describes the Board's approach in adopting the standard and amendments as well as the Board's consideration of the economic impacts of the standard and amendments, including economic considerations pertinent to audits of emerging growth companies ("EGCs").^{3/} Additionally, this Appendix summarizes the views of commenters with respect to the economic impacts of the standard and amendments.

^{1/} The Board is adopting the following: (i) an auditing standard, Auditing Standard No. 18, *Related Parties* (the "standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "amendments regarding significant unusual transactions"); and (iii) other amendments to PCAOB auditing standards (the "other amendments"). The amendments regarding significant unusual transactions and the other amendments are collectively referred to as the "amendments."

^{2/} A company's related party transactions, significant unusual transactions, and financial relationships and transactions with its executive officers, are described as, and collectively referred to, as "the critical areas" or "these critical areas" in this Appendix.

^{3/} Section 3(a)(80) of the Securities Exchange Act of 1934 (the "Exchange Act") defines the term "emerging growth company." See footnote 89 of this Appendix for the definition of an EGC.



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The Board is adopting the standard and amendments pursuant to its authority under the Sarbanes-Oxley Act of 2002 (the "Act").^{4/} The standard and amendments must be approved by the U.S. Securities and Exchange Commission ("SEC" or "Commission") before they are effective. Pursuant to Section 107(b)(3) of the Act, the Commission shall approve a proposed standard if it finds that the standard is "consistent with the requirements of [the] Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors."

In the Board's view, the adoption of the standard and amendments is in the public interest and contributes to investor protection by establishing specific auditor performance requirements designed to heighten the auditor's attention to areas associated with risks of fraudulent financial reporting and that may also involve risks of error. New required audit procedures are intended to improve the auditor's identification, understanding, and evaluation of transactions in the critical areas, which can pose difficult measurement, recognition, and disclosure issues due to factors such as transaction structure, complexity, and/or relationship to company financial targets. Additionally, the standard and amendments establish audit committee communication requirements designed to promote and enhance communications and understanding between the auditor and the audit committee.

The auditor's heightened scrutiny of transactions in the critical areas, and the enhanced understanding of such transactions both by the auditor and the audit committee, should improve the quality of the audit and also may result in improvements in companies' accounting and disclosures in these areas. Additionally, the new requirements are aligned with the Board's risk assessment standards^{5/} and reflect a

^{4/} Pub. L. No. 107-204. Pursuant to Section 101 of the Act, the mission of the Board is to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Section 103 of the Act authorizes the Board to adopt auditing standards for use in public company audits "as required by this Act or the rules of the [U.S. Securities and Exchange] Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." In addition, Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") expanded the authority of the PCAOB to oversee the audits of registered brokers and dealers, as defined in the Exchange Act. See Pub. L. No. 111-203.

^{5/} In 2010, the Board adopted eight auditing standards to establish a framework for the auditor's assessment of and response to the risks of material



cohesive audit approach that should improve the auditor's risk-based consideration of the critical areas, as well as provide opportunities for efficient implementation.

The Act was amended by Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act")^{6/} to provide that any additional rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation."^{7/} As a result, if the standard and amendments are approved by the SEC, they will be subject to a separate determination by the SEC regarding their applicability to audits of EGCs.

The Board is recommending that the SEC determine that the standard and amendments should apply to audits of EGCs. To assist the SEC in making this determination, the Board is providing information in this Appendix specifically related to audits of EGCs.

This Appendix includes information regarding: (i) The Need for the Standard and Amendments; (ii) The Baseline (encompassing both existing requirements and audit practices); (iii) The Board's Approach and Consideration of Alternatives; (iv) The Economic Impacts of the Standard and Amendments, including Benefits and Costs; and (v) Economic Considerations Pertaining to Audits of EGCs, including Efficiency, Competition, and Capital Formation.

misstatement in an audit (the "risk assessment standards"), which reflect the Board's view of the auditor's fundamental approach to the audit. The risk assessment standards cover the entire audit process, from initial planning activities to evaluating audit evidence to forming the opinion to be expressed in the auditor's report. See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release 2010–004 (August 5, 2010).

^{6/} Pub. L. No. 112-106 (April 5, 2012).

^{7/} See Section 103(a)(3)(C) of the Act, as added by Section 104 of the JOBS Act.



II. Need for the Standard and Amendments

A. Introduction

Investors are often widely dispersed and significant in number and thus must rely on management to operate and control the company. As a result, investors possess less information about the company than the company's management, a situation that can be described as information asymmetry^{8/} between investors and management. Management prepares the company's financial statements that investors use to evaluate a company's financial performance and management's stewardship of the company. An audit provides investors with independent, reasonable assurance that the company's financial statements are fairly presented, in accordance with the relevant accounting framework, and comply with applicable requirements.

A key objective of PCAOB standards is to improve the likelihood that the auditor will detect material misstatements in company financial statements, whether due to error or fraud.^{9/} The auditor, as a gatekeeper^{10/} in the financial reporting system, can

^{8/} Information asymmetry refers to situations involving two or more parties in a relationship in which one party has more, or better, information than the other party. For more information on matters related to the separation of ownership and control of companies and the implications on financial markets, see, e.g., Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property*, 2 Harcourt, Brace and World, New York *passim* (1967); Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 *Journal of Financial Economics* 305 *passim* (1976); and Paul M. Healy and Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 *Journal of Accounting and Economics* 405 *passim* (2001).

^{9/} Strengthening the requirements for auditing in the critical areas should similarly promote improved performance on audits of broker-dealer financial statements. The approach set forth in the standard should direct auditors to devote more time to areas requiring heightened scrutiny. The auditor's enhanced focus on these areas should improve the reliability of information used in regulatory oversight, which, in turn, should enhance investor protection.

^{10/} According to the SEC:

The federal securities laws, to a significant extent, make independent auditors "gatekeepers" to the public securities markets. These laws



mitigate risks of material misstatement in the financial statements and, thus, risks to investors arising out of their reliance on misstated financial statements, by focusing appropriate auditing effort in areas that warrant heightened scrutiny. Increased attention by the auditor should, in the Board's view, increase the likelihood of the auditor identifying material misstatements.

In considering the need to improve existing auditing standards relating to the critical areas, the Board took into account a variety of factors. Most significantly, the Board considered the need for the standard and amendments against the backdrop of several decades of financial reporting frauds involving related party transactions, significant unusual transactions and financial relationships and transactions with executive officers. Prominent corporate scandals involving these critical areas include many that served as a catalyst for the enactment of the Act.^{11/} The critical areas

require, or permit us to require, financial information filed with us to be certified (or audited) by independent public accountants. Without an opinion from an independent auditor, the company cannot satisfy the statutory and regulatory requirements for audited financial statements and cannot sell its securities to the public. The auditor is the only professional that a company must engage before making a public offering of securities and the only professional charged with the duty to act and report independently from management.

See SEC Securities Act Release No. 33-7870, *Proposed Rule: Revision of the Commission's Auditor Independence Requirements* (June 30, 2000) at Section II.A. See also, SEC Securities Act Release No. 33-7919, *Final Rule: Revision of the Commission's Auditor Independence Requirements* (November 21, 2000) at Section III.A.

^{11/} The following illustrative list provides examples of prominent corporate scandals that involve the critical areas. The following list is not all-inclusive and, in some cases, examples involve more than one critical area: (i) with respect to related party transactions: Hollinger, Inc., see SEC Complaint, *SEC, Plaintiff v. Conrad M. Black, F. David Radler and Hollinger, Inc.* (November 15, 2004); MCA Financial Corporation, see SEC Accounting and Auditing Enforcement Release ("AAER") No. 2076, *In The Matter of Grant Thornton LLP, Doeren Mayhew & Co. P.C., Peter M. Behrens, CPA, Marvin J. Morris, CPA, and Benedict P. Rybicki, CPA, Respondent* (August 5, 2004); and Adelphia Communications Corporation, see SEC AAER No. 1599, *SEC v. Adelphia Communications Corporation, John J. Rigas, Timothy J. Rigas, Michael J. Rigas, James P. Rigas, James R. Brown, and Michael C. Mulcahey, 02 Civ. 5776 (KW) (S.D.N.Y.)*



addressed by the standard and amendments have continued to be contributing factors in more recent enforcement cases.^{12/} These corporate scandals undermine investor confidence and have resulted in significant losses to investors, as well as the loss of many jobs.^{13/} As discussed below, the Board's oversight activities indicate that auditors' scrutiny of these critical areas continues to be an area of concern.

Additionally, the Board considered: (i) input from the Board's Standing Advisory Group ("SAG"); (ii) studies that suggested the need to improve existing auditing standards to address areas that could pose increased risks of material misstatement; (iii) the actions of other standard setters, such as the International Auditing and

(July 24, 2002); (ii) with respect to significant unusual transactions: Enron Corporation, see SEC Spotlight on Enron, <https://www.sec.gov/spotlight/enron.htm>; Refco, Inc., see SEC Complaint, *SEC, Plaintiff, v. Phillip R. Bennett, Defendant* (February 19, 2008); and (iii) with respect to financial relationships and transactions with executive officers: Tyco International, Ltd., see SEC AAER No. 3010, *SEC v. L. Dennis Kozlowski, Mark H. Swartz, and Mark A. Belnick, 02-CV-7312 (RWS) (S.D.N.Y. filed Sept. 12, 2002)* (July 14, 2009); WorldCom, Inc., see *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* (August 2003) at 17-19. Additionally, Section 704 of the Act directed the SEC to study enforcement actions over the five years preceding its enactment "to identify areas of issuer financial reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management" (the "SEC Section 704 Study"). As part of the study, the SEC examined 227 enforcement matters and found that 23 cases included the failure to disclose related party transactions. See *Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002* (January 24, 2003) at 6.

^{12/} See, e.g., SEC AAER No. 3447, *SEC v. Keyuan Petrochemicals, Inc. and Aichun Li* (February 28, 2013), and SEC AAER No. 3385, *SEC v. China Natural Gas, Inc. and Qinan Ji* (May 14, 2012).

^{13/} For example, Enron Corporation was the nation's largest natural gas and electric marketer, with reported annual revenue of more than \$150 billion. When it filed for bankruptcy on December 2, 2001, its stock price had dropped in less than a year from more than \$80 per share to less than \$1. See *SEC Settles Civil Fraud Charges Filed Against Richard A. Causey, Former Enron Chief Accounting Officer; Causey Barred From Acting as an Officer or Director of a Public Company* SEC Litigation Release No. 19996 (February 9, 2007).



Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA"), who had revised their auditing standards in certain analogous areas in 2008 and 2011, respectively; and (iv) information obtained through the Board's oversight activities. The Board also considered input from commenters on its proposal^{14/} and reproposal.^{15/} Commenters were broadly supportive of the Board's standard-setting efforts and generally agreed that improvements to the existing auditing standards were appropriate.^{16/}

^{14/} See *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (the "proposing release" or the "proposal"), PCAOB Release No. 2012–001 (February 28, 2012) http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2012-001_Related_Parties.pdf, which included: (i) an auditing standard, *Related Parties* ("proposed standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions ("proposed amendments regarding significant unusual transactions"); and (iii) other amendments to PCAOB auditing standards ("other proposed amendments"). Collectively, these are referred to as the "proposed standard and amendments."

^{15/} See *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (the "reproposing release" or the "reproposal"), PCAOB Release No. 2013–004 (May 7, 2013) http://pcaobus.org/Rules/Rulemaking/Docket038/Release%202013-004_Related%20Parties.pdf, which included: (i) an auditing standard, *Related Parties* ("reproposed standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions ("reproposed amendments regarding significant unusual transactions"); and (iii) other proposed amendments to PCAOB auditing standards ("other reproposed amendments"). Collectively, these are referred to as the "reproposed standard and amendments."

^{16/} Appendix 4 provides additional discussion of the standard and amendments, as well as discussion of significant comments received and the Board's consideration of such comments.



B. The Need for Improved Requirements in the Critical Areas

The following discussion describes the need for improvements to existing auditing requirements in each critical area. As more fully described below, the Board believes that its existing standards do not contain sufficient required procedures and are not sufficiently risk-based in critical areas that warrant heightened scrutiny. Increased auditor attention to the critical areas should, in the Board's view, increase the likelihood of the auditor identifying material misstatements.

Relationships and Transactions with Related Parties: The auditor's attention to a company's transactions with its related parties is important because the substance of such transactions may differ materially from their form.^{17/} A related party relationship provides the parties with the ability to negotiate transactions on terms that may not be available to other parties on an arm's-length basis. Such non-arm's length transactions potentially provide more of an opportunity for management to act in its own interests,^{18/} rather than in the interests of the company and its investors and, in some instances, such transactions have been used to facilitate financial statement fraud and asset misappropriation.^{19/} Related party transactions also may involve difficult measurement and recognition issues that can lead to errors in financial statements.

^{17/} For example, to improve the appearance of its financial condition, a company and a related party could attempt to "dress up" the appearance of the company's balance sheet at period end by agreeing to have the company temporarily pay down its related party debt prior to the balance sheet date while having an undisclosed side agreement to subsequently borrow the same or a comparable amount shortly after period end. See also, Section II.C. of Appendix 4.

^{18/} See, e.g., paragraph 15 of FASB Statement No. 57, *Related Parties*, which states "[w]ithout disclosure to the contrary, there is a general presumption that transactions reflected in financial statements have been consummated on an arm's-length basis between independent parties. However, that presumption is not justified when related party transactions exist because the requisite conditions of competitive, free-market dealings may not exist. Because it is possible for related party transactions to be arranged to obtain certain results desired by the related parties, the resulting accounting measures may not represent what they usually would be expected to represent."

^{19/} As noted above, the SEC Section 704 Study identified areas of issuer financial reporting that are most susceptible to fraud, inappropriate manipulation or



The importance to investors of the auditing of related party transactions was emphasized by the U.S. Congress in 1995 through the enactment of Section 10A of the Exchange Act, which requires that each audit of financial statements of an issuer include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."^{20/} Additionally, SEC actions have identified related party transactions as warranting heightened scrutiny by auditors.^{21/}

The Board's existing standard for the auditing of related party transactions, AU sec. 334, *Related Parties*,^{22/} was issued in 1983, and has not been substantively revised since then. Among other things, AU sec. 334 has not been revised to align with the Board's risk assessment standards, which provide an overall framework for the auditor's assessment of and response to the risks of material misstatement. Additionally, as discussed below, the existing standard does not reflect an approach that promotes heightened scrutiny by the auditor of a company's relationships and transactions with related parties.

inappropriate earnings management. As part of that study, the SEC examined 227 enforcement matters and found that 23 cases included the failure to disclose related party transactions. See SEC Section 704 Study.

^{20/} Section 10A(a)(2) of the Exchange Act, 15 U.S.C. §78j-1(a)(2).

^{21/} See, e.g., SEC AAER No. 3427, *In the Matter of the Application of Wendy McNeely, CPA*, at 10-12 (December 13, 2012), which states, in part, that the SEC and the courts have repeatedly held that related party transactions require heightened scrutiny by auditors. See also *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005) (citing *Howard v. SEC*, 376 F.3d 1136, 1149 (D.C. Cir. 2004) noting that related-party transactions "are viewed with extreme skepticism in all areas of finance," aff'g James Thomas McCurdy, CPA, 57 S.E.C. 277 (2004)).

^{22/} AU sec. 334 is one of the Board's interim auditing standards. Shortly after the Board's inception, the Board adopted the existing standards of the AICPA, as in existence on April 16, 2003, on an initial, transitional basis. See *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (April 18, 2003).



AU sec. 334 provides guidance for the auditor, rather than explicitly requiring the performance of specific procedures.^{23/} For example, AU sec. 334 includes examples of procedures that the auditor could perform, and indicates that such procedures may not be required in every audit. Such an approach can lead to inadequate auditor effort in an area that historically has posed increased risks of material misstatement. Additionally, the existing standard suggests that related party transactions need not be considered by the auditor as outside the ordinary course of business for a company, unless the auditor is aware of evidence to the contrary. As a result, the auditor may not exercise sufficient professional skepticism in an area that Congress and the SEC have indicated requires heightened scrutiny.

The need to revise and strengthen AU sec. 334 has been supported by a number of prominent studies, including studies conducted by the auditing profession prior to the enactment of SOX and the establishment of the Board. For example, the AICPA recommended, after studying over 200 cases reported by their members in which allegations of an audit failure were made, that "required audit procedures be broadened to help ensure the auditor gains a more complete understanding of related party transactions, including the business aspects of transactions."^{24/}

Additionally, the Board considered a synthesis of the academic literature on auditing related party transactions that states that various high profile frauds demonstrate how related party transactions can be used to mislead users of financial statements.^{25/} The authors find that related party transactions are as common in companies alleged to have committed fraud as in companies in which no fraud has been detected. However, the authors also find that "... when fraud does exist, the presence of related party transactions is one of the top reasons cited for audit

^{23/} See discussion of the Baseline at Section III. of this Appendix for a detailed discussion of the existing requirements applicable to the critical areas.

^{24/} The Quality Control Inquiry Committee of the AICPA's SEC Practice Section issued a report (the "QCIC Report") making this recommendation in 2002. See AICPA SEC Practice Section, Memo To Managing Partners of SECPS Member Firms, "Recommendations for the Profession Based on Lessons Learned from Litigation" (October 2002), which includes the QCIC Report as an attachment.

^{25/} See Elizabeth A. Gordon, Elaine Henry, Timothy J. Louwers, and Brad J. Reed, Auditing Related Party Transactions: A Literature Overview and Research Synthesis, *Accounting Horizons* 21 (1): 81-102 (2007).



failures."^{26/} The authors conclude that the findings in academic literature, combined with the significance of related party transactions in corporate scandals, "are consistent with the PCAOB's reconsideration of auditing of related party transactions."^{27/}

While the Board recognizes that transactions with related parties are also used for legitimate purposes, including the efficient procurement of resources,^{28/} the Board has concluded that the auditing of related party transactions warrants heightened scrutiny. Notably, the Board has observed, through its oversight activities, deficiencies in the auditing of related party transactions, particularly with respect to audits of smaller public companies.^{29/} Additionally, as prominent corporate scandals over the past several decades illustrate, issues involving the scrutiny of related party transactions also arise in the audits of large public companies.

^{26/} Id. at 82.

^{27/} Id. at 81. A subsequent study conducted by the same authors analyzes 43 SEC enforcement actions against auditors related to the examination of related party transactions and identified audit practice issues in that area. The authors found that the majority of this sample involved inadequate examination of the related party transaction by the auditor. Although the authors concluded that the audit failures described in these SEC cases were more likely attributable to a lack of professional skepticism and due professional care than deficiencies in the existing standards, the authors provide suggestions to improve audit practice regarding the auditing of related party transactions. Among other things, the authors suggest that auditors use guidance published by the AICPA in a 2001 "Related Party Transaction Toolkit" that suggests that the auditor should perform many of the procedures described as guidance in AU sec. 334 to determine the existence of related parties and identify transactions with known related parties. See Timothy J. Louwers, Elaine Henry, Brad J. Reed, and Elizabeth A. Gordon, Deficiencies in Auditing Related-Party Transactions: Insights from AAERs, *Current Issues in Auditing* 2 (2): A10-A16 (2008).

^{28/} See Elizabeth A. Gordon, Elaine Henry, and Darius Palia, *Related Party Transactions and Corporate Governance* 9 *Advances in Financial Economics* 1-27, (2004).

^{29/} See Section III.B of this Appendix for a detailed discussion of the deficiencies the Board has observed through its oversight activities related to the auditing of related party transactions.



As a result of these and other considerations discussed throughout this release, the Board has determined that there is a need to improve its existing auditing standard regarding related parties. In the Board's view, AU sec. 334 does not contain sufficient required procedures, is not risk-based, and does not promote the necessary heightened scrutiny of related party transactions.

Significant Unusual Transactions: The identification and evaluation of a company's significant unusual transactions is important to the audit because such transactions can create complex accounting and financial disclosure issues that create risks of error. Additionally, in some cases, significant unusual transactions have been used to engage in fraudulent financial reporting. For example, significant unusual transactions that are close to period end may be entered into to obscure a company's financial position or operating results (e.g., so-called "window-dressing"). Others may involve counterparties that are willing to structure transactions to achieve desired accounting results. In such cases, company management may place more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction.

The Board has considered studies that highlight the risks of material misstatements associated with a company's significant unusual transactions. For example, the *Report Prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs* found that "some U.S. financial institutions and public companies have been misusing structured finance vehicles...to carry out sham transactions that have no legitimate business purpose and mislead investors, analysts, and regulators about companies' activities, tax obligations, and true financial condition."^{30/} Another study attributed an increased risk of financial misstatement to transactions in which the substance of the transactions might differ materially from their form.^{31/}

^{30/} 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), <http://www.gpo.gov/fdsys/pkg/CPRT-107SPRT83559/pdf/CPRT-107SPRT83559.pdf>.

^{31/} See SEC Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 *On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (June 15, 2005), <http://sec.gov/news/studies/soxoffbalancerpt.pdf>.



Additionally, SEC enforcement actions have highlighted the need for the auditor to scrutinize complex unusual transactions, including understanding their underlying economic purpose.^{32/} Other SEC cases have addressed instances in which structured transactions obscured the economic substance of transactions that had a material impact on the company's financial statements.^{33/}

The risk assessment standards require the auditor to consider the risks of material misstatement posed by significant unusual transactions as part of the auditor's risk assessment during the financial statement audit.^{34/} However, the auditing requirements regarding significant unusual transactions are principally contained in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.^{35/} That standard provides that the auditor considers the risks of fraud relating to a significant transaction outside the normal course of business for a company if the auditor "becomes aware" of such a transaction.^{36/} There is no express requirement in AU sec. 316, however, for the auditor to perform specific procedures to identify such transactions or to obtain the information necessary to evaluate the accounting for and disclosure of such transactions, which are key considerations in promoting the auditor's heightened scrutiny of a company's significant unusual transactions.

^{32/} See, e.g., SEC AAER No. 2775, *In the Matter of Michael Lowther, CPA, Respondent* (January 28, 2008), which discusses the 2001 financial reporting fraud at Enron, which included the use of complex structured transactions to obscure the economic substance of certain financing transactions that had a material impact on Enron's financial statements.

^{33/} See, e.g., SEC AAER No. 1631, *In the Matter of Dynegy, Inc., Respondent* (September 24, 2002). In that action, the Commission determined that Dynegy entered into two massive "round-trip" electricity transactions, that is, simultaneous, pre-arranged buy-sell trades at the same price, terms and volume, in which neither Dynegy nor its trading counterparty earned a profit or incurred a loss and that such transactions lacked economic substance.

^{34/} See, e.g., paragraph 71.g. of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

^{35/} See paragraphs .66-.67 of AU sec. 316.

^{36/} See discussion of the Baseline at Section III. of this Appendix for a more detailed discussion of the existing standards applicable to the critical areas.



The Board's staff identified areas of potential weaknesses in the auditor's consideration of significant unusual transactions and in April 2010 issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*.^{37/} That alert discusses a range of auditor practice issues pertaining to significant unusual transactions, including the auditor's understanding of transactions close to period end that pose difficult substance over form issues. Similarly, the IAASB staff issued guidance in August 2010 that addressed the auditing of significant unusual or highly complex transactions.^{38/}

As a result of these and other considerations discussed throughout this release, the Board has determined that there is a need to improve its existing auditing standards regarding significant unusual transactions. In the Board's view, the existing standards in this area do not contain sufficient required procedures to promote the heightened scrutiny necessary for the auditor to identify and evaluate transactions that may be used to intentionally obscure a company's financial results or that may result in erroneous financial reporting.

Financial Relationships and Transactions with Executive Officers: Understanding a company's relationships and transactions with its executive officers^{39/} is important to an auditor because a company's executive officers are generally in a position to determine or influence a company's accounting and disclosures. A company's financial relationships and transactions with its executive officers (e.g., executive compensation) can create incentives and pressures for executive officers to meet financial targets, which can result in risks of material misstatement of a company's financial statements. Additionally, a company's executive officers, because of their role in the financial reporting process, are in a unique position to commit fraud.^{40/}

^{37/} See Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010).

^{38/} See IAASB Staff Questions and Answers, *Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions* (August 2010).

^{39/} See discussion in Section IV.A. of Appendix 4 for a discussion of the applicable definition of "executive officer."

^{40/} See, for example, AU sec. 316.08.



Cases involving fraudulent financial reporting illustrate how a company's financial relationships and transactions with its executive officers can create incentives and pressures that can result in risks of material misstatement, including fraud risks.^{41/} Research that analyzed SEC AAERs from 1998 to 2007 also identified potential motivations for engaging in fraudulent financial reporting that relate to a company's financial targets.^{42/} For example, the study noted that the most commonly cited motivations for fraud included the need to: (i) meet internal or external earnings expectations of analysts and others; (ii) meet internally set financial targets or make the company look better; (iii) conceal the company's deteriorating financial condition; (iv) increase the stock price; (v) bolster financial position for pending equity or debt financing; (vi) increase management compensation through achievement of bonus targets and through enhanced stock appreciation; and (vii) cover up assets misappropriated for personal gain. The cited motivations support a conclusion that a company's financial relationships and transactions with its executive officers can create incentives and pressures that can result in risks of material misstatement to a company's financial statements. That study noted that the chief executive officer and/or the chief financial officer were named in 89 percent of the cases involving fraudulent financial reporting brought by the SEC during that period.

Under the Board's risk assessment standards, the auditor is required to consider obtaining an understanding of compensation arrangements with the company's "senior management" as part of obtaining an understanding of the company.^{43/} In the Board's view this continues to be an important consideration for the auditor during the risk assessment process. However, the Board's risk assessment standards require the

^{41/} For example, over the last decade, the SEC has brought a number of cases where management allegedly manipulated compensation expense recognized in the financial statements, while simultaneously obtaining additional compensation for themselves through options backdating. See SEC Spotlight on Stock Options Backdating, which lists AAERs, Commission speeches and testimony, Commission staff speeches, testimony and letters; and non-SEC documents relating to stock options backdating, <http://www.sec.gov/spotlight/optionsbackdating.htm>.

^{42/} See Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson, and Terry L. Neal, 2010. *Fraudulent Financial Reporting 1998–2007: An Analysis of U.S. Public Companies*, Committee of Sponsoring Organizations of the Treadway Commission (May 2010) at 3, http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.

^{43/} See paragraph 11 of Auditing Standard No. 12.



auditor to "consider" performing procedures to obtain an understanding of certain compensation arrangements as part of "obtaining an understanding of the company" during the auditor's overall risk assessment, but does not require the performance of specific procedures to obtain such an understanding.^{44/} Most significantly, the Board's risk assessment standards do not require the auditor to perform specific procedures to obtain an understanding of financial relationships and transactions with executive officers, which can motivate or affect company accounting or reporting decisions.

As a result of these and other considerations discussed throughout this release, the Board has determined that there is a need to improve its existing risk assessment standards relating to the auditor's consideration of a company's financial relationships and transactions with its executive officers. In the Board's view, its risk assessment standards in this area are not sufficiently targeted to promote heightened scrutiny of potential risks of material misstatement arising from a company's financial relationships and transactions with its executive officers, in view of the unique role played by the company's executive officers in the company's financial reporting process.

C. How the Standard and Amendments Address the Need

The Board has determined to improve its requirements relating to identifying, understanding, and addressing certain areas that are widely acknowledged to represent increased risks of material misstatement in company financial statements. As more fully discussed below, these improvements are intended to strengthen the audit of the company's financial statements by improving the auditor's ability to identify and address such risks. In the Board's view, a more focused approach with specific performance requirements should foster the heightened scrutiny that the Board believes is warranted in the critical areas. Such an approach should help mitigate the information asymmetry between company management and investors.

The following sections describe key aspects of the standard and amendments being adopted by the Board, with a focus on how they address the need for improvement described above.^{45/}

^{44/} See discussion of the Baseline at Section III. of this Appendix for a detailed discussion of the existing standards applicable to the critical areas.

^{45/} A detailed overview of the standard and amendments is contained at Section IV. of the release, and a section-by-section discussion is located in Appendix 4.



Auditing Standard No. 18, Related Parties: The Board is superseding AU sec. 334 and adopting a new standard that establishes specific procedures intended to strengthen auditor performance requirements regarding the auditing of related party transactions. The new requirements establish specific procedures, rather than the approach in the existing standard, which provides guidance and example procedures for the auditor's consideration.

The standard reflects the following key improvements from the existing standard:

- *Adding Basic Requirements:* AU sec. 334 suggests procedures for the auditor's consideration, noting that not all of them may be required in every audit. The standard requires basic procedures for the auditor's response to risks of material misstatement associated with a company's relationships and transactions with its related parties. Specifically, the standard focuses on those related party transactions that require disclosure in the financial statements or that are determined to be a significant risk. The basic procedures are designed to assist the auditor in identifying red flags that indicate potential risks of material misstatement. The standard also requires more in-depth procedures that are designed to be scalable and commensurate with the company's facts and circumstances.
- *Enhancing Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties:* Unlike AU sec. 334, which includes limited direction for obtaining an understanding of the company's relationships and transactions with its related parties, the standard requires the performance of specific procedures in this area, including obtaining an understanding of the terms and business purposes (or the lack thereof) of related party transactions.
- *Aligning with the Risk Assessment Standards:* The standard is designed to align with and build upon the risk assessment standards. The procedures are intended to be performed in conjunction with the procedures performed during the auditor's risk assessment.
- *Improving the Auditor's Focus on Accounting:* AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions. The standard requires that the auditor evaluate both the accounting for, and disclosure of, related party transactions.



- *Emphasizing a Complementary Audit Approach:* The standard specifically requires the auditor to take into account other work performed during the audit, for example, information gathered with respect to significant unusual transactions, when evaluating the company's identification of its related party transactions.
- *Adding Audit Committee Communications:* AU sec. 334 does not mention communications with audit committees regarding related party transactions. The standard being adopted by the Board anticipates two-way communication between the auditor and the audit committee regarding such transactions. This reflects the fact that the new performance requirements contained in the standard and amendments relate to sensitive areas of the audit that potentially involve the interests of company management and, thus, warrant discussion with the audit committee. Specifically, the auditor is required to make inquiries of the audit committee (or its chair) when the auditor is obtaining an understanding of the company, which should occur during the auditor's risk assessment. During these initial communications, the auditor obtains information regarding a company's significant related party transactions and any such relationships or transactions that are of concern to members of the audit committee. The standard further requires that the auditor communicate to the audit committee regarding the auditor's overall evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, including any significant matters the auditor identified during the audit. Among other things, the matters to be communicated related to the auditor's evaluation include the identification of any related parties (or relationships or transactions with related parties) that were previously undisclosed to the auditor.

Amendments Regarding Significant Unusual Transactions: In this area, the Board is: (i) revising AU sec. 316; (ii) making targeted amendments to certain risk assessment standards (e.g., Auditing Standards Nos. 12 and 13); and (iii) making related changes to other PCAOB auditing standards. These amendments include specific procedures designed to improve the auditor's identification and evaluation of a company's significant unusual transactions. Among other things, they require the auditor to perform specific procedures to (i) identify significant unusual transactions and (ii) obtain an understanding of the business purpose (or the lack thereof) of the company's significant unusual transactions, including whether the transaction was entered into to engage in fraud. In the Board's view, adding specific procedures promotes audit quality by providing the auditor with more insight into the nature of a company's significant



unusual transactions, which should enable the auditor to better evaluate whether the financial statements are fairly stated.

The amendments regarding significant unusual transactions are designed to improve existing Board standards in the following key respects:

- *Improving Requirements for Identifying Significant Unusual Transactions:* The amendments regarding significant unusual transactions require the performance of specific procedures intended to improve the auditor's identification of significant unusual transactions, for example, by amending Auditing Standard No. 12 to require the auditor to make inquiries of management and others.
- *Improving the Auditor's Evaluation of Significant Unusual Transactions:* The amendments to AU secs. 316.66-.67A include basic procedures for obtaining information for evaluating significant unusual transactions. The basic procedures include: (i) reading the underlying documentation relating to significant unusual transactions and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction; (ii) determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures; and (iii) evaluating the financial capability of the other parties to the transaction with respect to significant uncollected balances, guarantees, and other obligations.
- *Enhancing Attention to the Business Purpose (or the Lack Thereof) of Significant Unusual Transactions:* The amendments to AU secs. 316.66-.67 enhance the auditor's evaluation of the business purpose of significant unusual transactions by, among other things, expanding the factors considered by the auditor in evaluating whether the business purpose (or the lack thereof) indicates that such transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.
- *Emphasizing Accounting and Disclosure:* The amendments regarding significant unusual transactions to AU sec. 316.67A are intended to heighten the auditor's attention to accounting matters relative to significant unusual transactions by emphasizing that existing requirements include evaluating whether the financial statements contain the information



essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework.

- *Emphasizing a Complementary Audit Approach:* The amendments regarding significant unusual transactions specifically require the auditor to take into account other work performed during the audit, for example, information gathered with respect to related party transactions, when identifying significant unusual transactions.
- *Enhancing Audit Committee Communications:* The amendments regarding significant unusual transactions are intended to improve the quality of the auditor's communications with the audit committee regarding the business purpose (or the lack thereof) of significant unusual transactions.^{46/}
- *Conforming Descriptions of Significant Unusual Transactions:* The amendments introduce a uniform description of "significant unusual transactions" throughout the Board's standards.

Amendments Regarding Financial Relationships and Transactions with Executive Officers: The Board is revising Auditing Standard No. 12 to require the auditor to perform specific procedures during the risk assessment process to obtain an understanding of the company's financial relationships and transactions with its executive officers. In doing so, the auditor would consider, among other things, the potential for increased risks of material misstatement that could arise out of the company's compensation arrangements with its executive officers.^{47/}

The revisions improve the existing audit requirements by requiring the auditor to perform specific procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers, as part of the auditor's risk assessment. Specifically, the amendments revise Auditing Standard No. 12 to state that the auditor "should perform" specified procedures to obtain an understanding of the

^{46/} See, e.g., paragraph 13.d of Auditing Standard No. 16, *Communications with Audit Committees*.

^{47/} The population of the company's "executive officers" is determined by reference to SEC rules and forms. See Section IV.A. of Appendix 4 for a discussion of the applicable definition of the term "executive officer."



company's financial relationships and transactions with its "executive officers" as part of the auditor's risk assessment.

As noted previously, under the existing risk assessment standards, the auditor is required to "consider" obtaining an understanding of compensation arrangements with senior management as part of obtaining an understanding of the company during the auditor's risk assessment.^{48/} The Board's standards currently do not explicitly require that the auditor obtain information regarding incentives or pressures for the company's executive officers to achieve a particular financial position or operating result as a result of performance based compensation arrangements. The Board has determined to supplement its existing requirements, and has determined that the requirement that the auditor "should perform" procedures relating to executive officer compensation arrangements is appropriate to promote heightened scrutiny.

In the Board's view, a focus on the company's executive officers during the risk assessment process is appropriate in that they generally play a key role in the company's accounting decisions and in a company's financial reporting. However, the new required procedures do not require the auditor to make a determination regarding the appropriateness of a company's compensation agreements with its executive officers.

III. The Baseline

To consider the economic impacts (including likely benefits and costs) of the standard and amendments, a "baseline" has been identified that can be used as a benchmark against which the standard and amendments can be compared. The baseline, described below, includes existing requirements and also considers audit practices.

A. Existing Requirements

The auditor's overall responsibility to perform a risk-based audit is contained in the Board's risk assessment standards, Auditing Standards Nos. 8 through 15, which became effective for auditors in December 2010.^{49/} Among other things, the risk

^{48/} See paragraph 11 of Auditing Standard No. 12.

^{49/} See PCAOB Release 2010–004 (August 5, 2010).



assessment standards require the auditor to consider the risks of material misstatement, whether due to error or fraud, throughout the audit.^{50/}

The existing requirements that the Board is strengthening through adoption of the standard and amendments are discussed below.

Relationships and Transactions with Related Parties: The risk assessment standards anticipate that the auditor will consider certain risks inherent in significant transactions with related parties in determining the significant risks of the audit^{51/} and in establishing the materiality level for the audit of the financial statements.^{52/} However, the existing auditing requirements relating to relationships and transactions with related parties are contained primarily in AU sec. 334, one of the Board's interim standards.

AU sec. 334 recognizes that the auditor performs procedures to identify and evaluate a company's relationships and transactions with its related parties as part of performing an audit of financial statements. However, as noted above, it provides guidance and examples of procedures for the auditor's consideration, rather than specific required procedures.

Examples of procedures in AU sec. 334 include: (i) procedures to obtain information from management (such as obtaining the names of all related parties and inquiring whether there were any transactions with these parties during the period); (ii) procedures intended to assist the auditor in identifying related parties that have not been disclosed to the auditor by management (such as reviewing filings with the SEC, reviewing company accounting records and certain invoices, and making inquiries of

^{50/} More generally, auditors are required to comply with all standards of the PCAOB, including existing requirements to perform the audit with due professional care, and to obtain sufficient appropriate audit evidence to support the audit opinion. See, e.g., AU sec. 230, *Due Professional Care in the Performance of Work*, and Auditing Standard No. 15, *Audit Evidence*.

^{51/} See paragraph 71.e. of Auditing Standard No. 12.

^{52/} See paragraph 7 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, which states that lesser amounts of misstatements could influence the judgment of a reasonable investor because of qualitative factors, e.g., because of the sensitivity of circumstances surrounding misstatements, such as conflicts of interest in related party transactions.



other auditors); and (iii) procedures the auditor considers, as necessary, to understand the purpose, nature, and extent of identified related party transactions (such as obtaining an understanding of the business purpose of the transaction). Notably, AU sec. 334 states that not all of the procedures may be required in every audit.

AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions. Significantly, the existing standard also states that, in the absence of evidence to the contrary, related party transactions should not be assumed to be outside the ordinary course of business.^{53/} Thus, AU sec. 334 could be misunderstood to create a "presumption of validity" for the business purpose of related party transactions in situations where experience suggests a need for heightened scrutiny.^{54/}

Significant Unusual Transactions: The risk assessment standards anticipate that the auditor will consider risks of material misstatement in a company's financial statements, including those posed by significant unusual transactions.^{55/} However, the more specific auditing requirements regarding significant unusual transactions are principally contained in AU sec. 316.^{56/} Specifically, AU sec. 316.66 recognizes that during a financial statement audit, the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment. AU sec. 316.66 requires that, if the auditor becomes aware of significant unusual transactions during the course of an audit, the auditor should gain an understanding of the business rationale of such transactions and whether that rationale (or the lack thereof) suggests that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. However, AU sec. 316 does not specify the procedures to perform to identify significant

^{53/} See AU sec. 334.06.

^{54/} This is in contrast to the approach reflected in the standard, which emphasizes the auditor's responsibilities for identifying and assessing risks of material misstatement associated with related parties and relationships and transactions with related parties.

^{55/} See paragraph 71.g. of Auditing Standard No. 12.

^{56/} See AU secs. 316.66–.67.



unusual transactions or to obtain necessary information to understand their business purpose (or the lack thereof).

Financial Relationships and Transactions with Executive Officers: The risk assessment standards require the auditor to consider obtaining an understanding of compensation arrangements with senior management (including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses) as part of obtaining an understanding of the company.^{57/} While this encompasses a company's executive officers, the existing standards do not specifically require the auditor to obtain an understanding of the incentives and pressures posed by executive officer compensation arrangements that can influence a company's accounting and disclosures.

B. Audit Practices

The Board's understanding of audit practices is based on the Board's general knowledge of audit firm practice arising out of information gathered from its oversight activities, including its inspection, enforcement, and standard-setting activities. Additionally, as described in Section II.B., the Board's understanding also has been informed by a range of studies and other materials it considered in determining the need for improvement of its existing standards. Based on this understanding, the Board believes that audit practices associated with the auditor's efforts regarding the critical areas are inconsistent.

The Board is aware that some firms have adopted audit methodologies that require their engagement teams to perform specific procedures regarding related party transactions not currently required by AU sec. 334. This may have occurred for a number of reasons. For example, the analogous standards of the IAASB and ASB require the auditor to inquire of management regarding the entity's related parties.^{58/} Audit practice also may have been impacted by guidance issued by the AICPA encouraging auditors to perform many of the procedures suggested in AU sec. 334 for the auditor's consideration.^{59/} Additionally, some auditors may already perform

^{57/} See paragraph 11 of Auditing Standard No. 12.

^{58/} See paragraph 13 of ISA 550, *Related Parties*, and paragraph 14 of AU-C 550, *Related Parties*.

^{59/} See AICPA Practice Alert No. 95–3, *Auditing Related Parties and Related-Party Transactions*, which indicated the auditor should perform most, if not all, of the



additional procedures arising out of their consideration of the risks of significant transactions with related parties as potential significant risks.^{60/}

Further, some auditors may already perform additional procedures regarding significant unusual transactions as a result of robust risk assessments and as a result of guidance from Board staff and the IAASB.^{61/} Additionally, there has been considerable interest in issues relating to executive compensation, which may have resulted in heightened attention to such issues by some auditors.^{62/}

The Board also is aware through its oversight activities that some firms have exhibited deficient auditing practices with respect to the critical areas. For example, the Board has identified deficiencies regarding the auditing of related party transactions through its triennial inspection program, which focuses on inspections of smaller domestic audit firms. Deficiencies identified include failures to test for undisclosed related parties or transactions with related parties, as well as failures to obtain an understanding of the business purpose of known related party transactions.^{63/}

examples of procedures in AU sec. 334 for determining the existence of related parties and identifying transactions with known related parties, and AICPA Toolkit, *Accounting and Auditing for Related Parties and Related Party Transactions* (2001).

^{60/} See paragraph 71.e. of Auditing Standard No. 12.

^{61/} See Staff Audit Practice Alert No. 5 (April 7, 2010). See also IAASB Staff Questions and Answers, *Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions* (August 2010).

^{62/} See, e.g., Staff Audit Practice Alert No. 1, *Matters Related To Timing And Accounting For Option Grants* (July 28, 2006).

^{63/} See *Report on 2007–2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies*, PCAOB Release No. 2013–001, at 29 (February 25, 2013), http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf, which states, in part:

Inspections staff have observed deficiencies related to firms' failures to test for undisclosed related parties or transactions with undisclosed related parties. Some of those firms failed to identify and address the lack of disclosure of related party transactions in the financial statements.



Additionally, a number of the Board's settled enforcement cases have involved related party transactions.^{64/} Those PCAOB enforcement actions have identified, among other things:

- Failures to perform sufficient procedures for known related party transactions;^{65/}
- Failures to address management's failure to disclose known related party transactions;^{66/} and

Inspections staff have also identified deficiencies relating to the firms' failure to obtain an understanding of the nature and business purpose of transactions with related parties and to evaluate whether the accounting for those transactions reflects their economic substance.

See also, *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms*, PCAOB Release No. 2007–010, at 7 (October 22, 2007), http://pcaobus.org/Inspections/Documents/2007_10-22_4010_Report.pdf.

^{64/} See, e.g., *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of P. Parikh & Associates, Ashok B. Rajagiri, CA, Sandeep P. Parikh, CA, and Sundeep P S G Nair, CA, Respondents*, PCAOB Release No. 105–2013–002 (April 24, 2013); *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Jaspers + Hall, PC, Thomas M. Jaspers, CPA, and Patrick A. Hall, CPA, Respondents*, PCAOB Release No. 105-2008-002 (October 21, 2008); *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Williams & Webster, P.S., Kevin J. Williams, CPA, and John G. Webster, CPA, Respondents*, PCAOB Release No. 105-2007-1 (June 12, 2007); and *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA, Respondents*, PCAOB Release No. 105-2005-022 (November 22, 2005).

^{65/} See *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA, Respondents*, PCAOB Release No. 105-2005-022 (November 22, 2005) and *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Williams & Webster, P.S., Kevin J. Williams, CPA, and John G. Webster, CPA, Respondents*, PCAOB Release No. 105-2007-1 (June 12, 2007).

^{66/} See *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Turner Stone & Company, LLP and Edward*



- Failures to take sufficient steps to determine whether a transaction was a related party transaction, when available information indicated that it was.^{67/}

The types of deficiencies observed by the Board through its oversight activities indicate that auditor practice regarding related parties is inconsistent under the existing auditing framework in a wide range of areas, suggesting that this is a challenging area warranting additional auditor effort and focus.

IV. The Board's Approach and Consideration of Alternatives

During the standard-setting process, the Board considered a number of alternatives and made a number of key policy choices with the goal of improving audit quality in the critical areas, while also providing opportunities for an efficient implementation. The following discussion highlights alternatives and policy choices considered by the Board as part of its economic considerations.

A. Consideration of Alternatives

Prior to the Board's decision to propose the standard and amendments, the Board requested input from its SAG, as early as 2004.^{68/} During these meetings, the Board engaged the SAG in a discussion of issues relating to the auditing of related

Turner, CPA, Respondents, PCAOB Release No. 2006-010 (December 19, 2006) and Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Timothy L. Steers, CPA, LLC, and Timothy L. Steers, CPA, Respondents, PCAOB Release No. 105-2007-004 (November 14, 2007).

^{67/} See Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Cordovano and Honeck, P.C. and Samuel D. Cordovano, CPA, Respondents, PCAOB Release No. 2008-004 (December 18, 2008) and Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Clyde Bailey, P.C., and Clyde B. Bailey, CPA, Respondents, PCAOB Release No. 2005-021 (November 22, 2005).

^{68/} Prior to the issuance of the proposal, the SAG discussed the topic of related parties at meetings on September 8–9, 2004, June 21, 2007, and October 14–15, 2009. See the SAG Meeting Archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>.



party transactions. Additionally, the Board discussed whether and, if so, how, to improve its existing standards in complementary areas that might be considered to pose similar risks of material misstatement.

As part of its standard-setting process, the Board initially considered whether new requirements were necessary. This included a review of the Board's oversight efforts through the Board's inspection and enforcement programs to determine the type, range, and prevalence of audit deficiencies cited. In addition, before issuing its proposal, the Board issued Staff Audit Practice Alert No. 5 in April 2010, which discussed a range of auditor practice issues identified by the PCAOB staff pertaining to significant unusual transactions.^{69/}

Staff Audit Practice Alert No. 5 was issued to remind auditors of the risks associated with significant unusual transactions and to compile selected, relevant requirements from existing PCAOB auditing standards into one document. Given that the alert only highlights circumstances for auditor consideration, it did not alter audit requirements with respect to significant unusual transactions.

In considering whether new requirements were necessary, the Board assessed a range of factors, previously described in Section II., and concluded that it was appropriate to develop standards with more specific requirements to address the critical areas.

As part of its considerations, the Board considered whether AU sec. 334 could be amended to include new specific procedures. The Board determined that the nature and extent of revisions necessary, including changes to align a revised AU sec. 334 with the risk assessment standards, would essentially result in a new standard. Thus, the Board determined that it was appropriate to propose a new standard regarding related parties, rather than amend the existing standard.

In considering how to address the other types of relationships and transactions that the Board had identified as posing similar risks – significant unusual transactions and a company's financial relationships and transactions with executive officers – the Board determined that issuing staff guidance could not make the changes that were necessary to strengthen the existing audit requirements to address the risks that had been identified in these areas. However, the Board determined that new stand-alone

^{69/} See Staff Audit Practice Alert No. 5 (April 7, 2010).



standards were not necessary but that appropriate improvements in audit quality could be achieved by amendments to its existing audit requirements in those areas.

As the Board considered the types and extent of changes to make in its existing standards, it considered several alternatives, including some discussed with its SAG.^{70/} Some alternatives considered included:

Consideration of Related Party Transactions as Fraud Risk: In view of the potential for increased risks of material misstatement arising from these critical areas, the Board considered whether relationships and transactions with related parties should be presumed to be a fraud risk. Under existing auditing standards, this approach would require auditors to devote considerable audit effort to identifying and evaluating relationships and transactions with related parties, in all instances. However, the Board recognizes that many related party transactions might not, in fact, represent fraud risks or other significant risks, a view that was further informed by discussions with the SAG.^{71/} Accordingly, as such an alternative could have resulted in potentially unnecessary audit effort, the Board determined to take a targeted approach that would focus on the auditor obtaining sufficient information to identify, assess, and respond to transactions that pose increased risks of material misstatement, while, at the same time aligning the new requirements with the risk assessment standards.

Consideration of Relationships and Transactions Posing Similar Risks: The Board also considered whether to address relationships and transactions that might fall outside the definition of a "related party" but that might pose similar risks. After obtaining input from the SAG regarding this approach,^{72/} the Board decided that the auditor should consider transactions that might pose similar risks, such as a company's significant unusual transactions, because these transactions not only may involve related parties previously undisclosed to the auditor but also could pose increased risks of material misstatement. Additionally, the Board concluded that linking the auditor's efforts regarding related parties and significant unusual transactions should help auditors "connect the dots" between these areas.

^{70/} See the SAG Meeting Archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>, for the October 14–15, 2009 SAG meeting.

^{71/} See SAG Meeting Archive for the October 14-15, 2009 SAG meeting.

^{72/} *Id.*



B. The Board's Approach and Choices Considered in Developing the Board's Standard and Amendments

The following discussion describes key policy choices considered by the Board as it developed the standard and amendments, and as the Board moved from its proposal to its reproposal and then to the adoption of the standard and amendments. In developing the standard and amendments, the Board determined to develop an audit approach that would promote heightened scrutiny in the critical areas, but that would also provide opportunity for efficient implementation. Key policy choices included:

Aligning with the Risk Assessment Standards: In the Board's view, its overall risk assessment approach promotes a cohesive audit, with opportunities to integrate audit effort where appropriate, and positions the auditor to identify areas in which there may be increased risks of material misstatement in company financial statements. Such an approach could also serve to minimize audit costs. The Board, thus, determined that its new requirements should be explicitly aligned with its risk assessment standards. In response to comments on its proposal, the Board took steps in its reproposal to more closely align the reproposed standard and amendments with its risk assessment standards. Those who commented on this aspect of the reproposal generally agreed that the revisions improved the alignment with the risk assessment standards. This risk assessment focus is retained in the standard and amendments being adopted by the Board.

Providing Opportunity for a Scaled Approach: Similar to the risk assessment standards, the Board determined that the standard should reflect a scaled approach, which establishes basic required procedures that are supplemented by more in-depth procedures that are commensurate with the company's facts and circumstances. Such facts and circumstances may include the size or complexity of the transaction, the nature of the company's relationships or transactions with its related parties, and the related risk of material misstatements in the financial statements.

Most commenters, including several large audit firms, agreed that the reproposed standards and amendments provide a scaled approach, permitting the auditor to vary the level of audit work in proportion to the nature and number of a company's relationships and transactions with related parties and significant unusual transactions. Some of these commenters supported the Board's view that the level of audit effort will vary in proportion to the number and nature of a company's related party relationships and transactions, its significant unusual transactions, its financial relationships and transactions with executive officers, and the company's process to identify such matters. Another commenter stated that an audit approach that begins with basic procedures, and supplements them with more in-depth procedures as needed, is a scalable



approach that allows the auditor to focus on the significant risks, regardless of the size or nature (e.g., broker or dealer or EGC) of the issuer. A few commenters, however, objected to the concept of basic required procedures and advocated for an approach that would leave the determination of the procedures necessary to the auditor's judgment.

The Board considered commenter views and determined that requiring the auditor to perform basic procedures in areas that could pose increased risks of material misstatement would heighten attention by the auditor to such areas and also provide a basis for the auditor to identify red flags that require further attention. However, as discussed below, the Board did revise certain aspects of its proposal to permit additional auditor judgment in certain areas of the audit that it determined appropriate.

Addressing Complementary Audit Areas: The Board determined that the standard and amendments should include linkages that would address risks of material misstatement arising from complementary areas of the audit. For example, the auditor's work in identifying and evaluating significant unusual transactions could assist the auditor in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor by management. This linked approach encourages the auditor to "connect the dots" between different aspects of the audit, which could improve audit effectiveness, as well as provide opportunities for efficient implementation. In its reproposal, the Board made revisions to improve the linkages between the reproposed standard and amendments. This approach is retained in the standard and amendments being adopted by the Board.

Using Existing Concepts and Procedures: The Board determined to include some existing auditing concepts and procedures in its proposal. This approach was intended to permit audit firms to build on existing methodologies and training. Further, this approach could minimize the costs of implementing the standard and amendments. In its reproposal, the Board sought comment on such issues. Several audit firms who commented on the reproposal indicated that they would be able to update their methodologies and train staff to apply the standard and amendments in a short period, suggesting that the implementation of the standard and amendments would not be unduly burdensome.



Additionally, commenters raised a variety of policy choices for consideration by the Board, including the following:^{73/}

Expanding Auditor Judgment. In response to comments, the Board made some changes to allow for additional auditor judgment than originally provided for in the proposal. For example, in its proposal, any related party relationships or transactions not previously disclosed to the auditor would have been considered to be a significant risk and would have required the auditor to perform specific procedures in response. Some commenters stated that an undisclosed related party transaction could be inconsequential in nature and, in such circumstances, treating the transaction as a significant risk and performing all of the procedures set forth in the proposed standard would be unnecessary. Other commenters suggested it might be appropriate to perform some, but not all, of the related procedures in the proposed standard. After consideration of comments, the Board removed the proposed requirement that the auditor always treat undisclosed related party transactions as a significant risk. Instead, the additional procedures would only be required in circumstances where previously undisclosed transactions were determined by the auditor to require disclosure in the financial statements or consideration as a significant risk. This change, which is being retained in the standard being adopted by the Board, could eliminate potentially unnecessary audit work.

Clarifying the Auditor's Responsibilities to Identify a Company's Related Parties: In response to comments, the Board made clarifications to the proposed standard to emphasize that the auditor's efforts to identify a company's related parties and relationships and transactions with its related parties begins with management's work. The clarified approach taken in the Board's reproposal recognizes that the company is responsible, in the first instance, for the preparation of its financial statements, including the identification of the company's related parties, and that the auditor begins the audit with information obtained from the company. This approach has been retained in the standard being adopted by the Board. Additionally, in response to other comments made regarding the repropose standard, several other clarifying changes have been made in this area. Those changes include emphasizing more prominently the auditor's responsibility to perform procedures to test the accuracy and completeness of the company's identification of its related parties, and that in doing so, the auditor takes into account the information gathered during the audit.

^{73/} Additionally, see Appendix 4 of the repropose release for discussion more generally of the Board's response to significant comments received on the Board's February 28, 2012 proposal.



Clarifying the Requirements Regarding a Company's Financial Relationships and Transactions with Its Executive Officers: The Board made two key policy choices relating to the amendments pertaining to a company's financial relationships and transactions with its executive officers: (i) the relationship of the amendments to the risk assessment process; and (ii) the appropriate scope of the population for the auditor's required procedures.

As discussed previously, the Board determined to supplement its existing risk assessment requirements regarding a company's financial relationships and transactions with its executive officers. As proposed, the other amendments provided that the auditor should perform procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers. While some commenters were fully supportive of this requirement and recognized that it did not represent a radical departure from existing standards, other commenters expressed concern that this would require the auditor to make an assessment regarding the appropriateness or reasonableness of executive compensation arrangements. In its reproposal, the Board clarified that these procedures would be performed as part of the risk assessment process and explicitly stated that its amendment does not require the auditor to make any determination regarding the appropriateness or reasonableness of the company's compensation arrangements with its executive officers. Commenters who addressed this area of the Board's reproposal generally indicated that the revisions were appropriate. The amendments being adopted by the Board retain the approach taken in its reproposal.

Additionally, the Board also considered the appropriate population for the auditor's consideration of financial relationships and transactions. The Board determined that the auditor's consideration of a company's financial relationships and transactions need not extend to the company's entire senior management population, but that a focus on a potentially smaller group within that population – executive officers – was appropriate. This focus is appropriate because a company's executive officers generally are in a unique position to determine the company's accounting and financial statement disclosures.

In considering the appropriate population for the auditor's consideration, the Board took note of a range of diverse comments, including those from commenters who advocated that the auditor's procedures should include a broader group than the company's executive officers; others who stated that the auditor's focus on a company's executive officers was the most appropriate group; and another who argued for a narrower group, for example, a company's "named executive officers," ("NEOs"). Under SEC rules, NEOs generally consist of five individuals — the principal executive officer, the principal financial officer, and the next three most highly paid executive officers of a



company as of the end of the most recently completed fiscal year.^{74/} The Board considered the use of the NEO approach, but determined that it might focus the auditor's attention on highly paid individuals (with high compensation due to activity unrelated to financial reporting), rather than individuals with more direct involvement in the financial reporting process.

After considering these comments, the Board determined that a company's executive officers is the most appropriate population for the auditor's efforts.^{75/} In the Board's view, this targeted approach could serve to limit potentially unnecessary audit effort and related costs.

V. The Economic Impacts of the Standard and Amendments, Including Benefits and Costs

This section contains a discussion of the economic impacts considered as the standard and amendments were developed, including consideration of likely benefits and costs.

At present, there is limited data and research available regarding the economic impact of discrete changes to auditing standards.^{76/} As a result, many of the benefits and costs discussed below are difficult to quantify reliably. The resulting benefits to investors, markets, and others from more reliable financial reporting are complex and not capable of reliable quantification at this time. Likewise, limited, if any, public data exists to forecast the costs of performing additional audit procedures in the critical areas

^{74/} See Item 402(a)(3) of Regulation S-K.

^{75/} In considering the appropriate population for the auditor's inquiry, the Board took note of a study that indicated that the median number of "executive officers" for the Standard and Poor's 500 is 8 (the mean is 8.71), and the median number of executive officers for the Russell 2000 is 5 (the mean is 6.12). See Broc Romanek, *Study: Benchmarking the Number of "Executive Officers,"* The Corporate Counsel.net and LogixData (March 2, 2011).

^{76/} The Board established a Center for Economic Analysis to, among other things, promote and encourage academic research relating to the role of the audit in capital formation and investor protection. See *PCAOB Announces Center for Economic Analysis*, (November 6, 2013) http://pcaobus.org/News/Releases/Pages/11062013_CenterEconomicAnalysis.aspx.



or the spillover effect on companies. Therefore, the economic discussion below is qualitative in nature.

The Board's consideration of the impacts of the standard and amendments, as with all aspects of the Board's standard-setting process, takes into account commenters' views.^{77/} As part of the standard-setting process, the Board asked commenters to provide information, as well as empirical data, regarding both benefits and costs, and other effects related to the reposed standard and amendments. In response, commenters provided views regarding whether the standard and amendments would improve audit quality, as well as their views regarding potential audit costs and implementation issues. However, commenters did not provide empirical data.^{78/}

In general, commenters largely supported the Board's standard-setting efforts, and agreed that the existing standards should be improved in the critical areas. Commenters also generally agreed that the standard and amendments could benefit audit quality. Some commenters also noted the standard and amendments could result in improvements in the auditor's: (i) identification of material misstatements; (ii) risk assessment for the audit; and (iii) application of professional skepticism. In addition, benefits noted also included improvements to audit committee communications and company financial statement disclosures.

Commenters who addressed potential costs provided qualitative information that was generally consistent with the discussion of potential costs in the reposing release. While commenters noted that there would be some increased costs, they did not provide data regarding the extent of such costs. However, commenters generally agreed that the standard and amendments were appropriate and should apply to audits of companies of all types and sizes.

Commenters also provided views on issues relating to scalability and costs. For example, one commenter stated that the reposed standard and amendments would not require significant incremental management or auditor resources, but the amount of

^{77/} The comment letters are available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038Comments.aspx>.

^{78/} Additionally, Appendix 4 provides detail regarding the Board's consideration of significant comments received relating to the specific requirements of the standard and amendments.



resources required could be meaningfully greater for companies with a significant number of related party transactions or significant unusual transactions. In general, the Board would not expect there to be significant cost implications for audits of companies that do not have complex or extensive: (i) relationships or transactions with related parties; (ii) significant unusual transactions; or (iii) financial relationships and transactions with the company's executive officers.

The following sections include a description of the Board's consideration of: (A) Benefits; (B) Costs; (C) Smaller Audit Firms and Smaller Companies; and (D) Other Economic Considerations.

A. Benefits

The Board believes that the standard and amendments will benefit investors by requiring auditors to focus appropriate auditing effort on areas that represent increased risks and, thus, warrant heightened scrutiny during the audit. As noted previously, to the extent that the standard and amendments improve the likelihood that the auditor will detect material misstatements in the financial statements, audit quality will be improved in ways that should also improve financial statement accounting and disclosures, which should in turn reduce the information asymmetry between investors and company management.

The standard and amendments take a targeted approach that is intended to focus the auditor's attention on accounting and disclosures relating to potentially complex and risky relationships and transactions that historically have been associated with cases involving fraudulent financial reporting. The magnitude and number of such cases, which have resulted in significant losses to investors, underscore the benefits to investors of strengthening the existing auditing requirements in these areas.^{79/} Increased focus on the critical areas by auditors should increase the probability of auditors detecting potential fraudulent or erroneous financial reporting^{80/} and should also deter fraudulent financial reporting because management will be aware that auditors are likely to expend additional effort assessing the economic substance of transactions in the critical areas.

^{79/} See Section II.A. of this Appendix for a discussion of such cases.

^{80/} See Mark Zimbelman, *The Effects of SAS No. 82 on Auditors Planning Decisions*, 35 *Journal of Accounting Research*, 75 passim (1997).



Existing auditing standards addressing the critical areas largely provide guidance and examples of procedures, rather than requiring specific procedures. This can result in inadequate and inconsistent application of existing standards, as well as the auditor's failure to perform sufficient procedures in the critical areas, which warrant heightened scrutiny. Rather than providing examples of procedures that may not be required in every audit, the standard and amendments require the auditor to perform specific procedures. The new specific requirements in the standard and amendments are designed to assist the auditor in identifying red flags that warrant heightened scrutiny. The performance of basic required procedures should increase the probability of the auditor uncovering events that impact investors, such as fraud and material errors, and provide investors with increased confidence regarding the reliability of the audited financial statements.

Additionally, the standard and amendments take a wholistic view of the audit by requiring the auditor to consider the links and relationships between a company's related party transactions and significant unusual transactions. For example, the auditor's work in identifying and evaluating significant unusual transactions should assist the auditor in identifying and evaluating related parties, or transactions with related parties previously undisclosed to the auditor. Emphasizing the complementary nature of the auditor's efforts regarding these areas should help the auditor to "connect the dots" between different aspects of the audit. The complementary approach is intended to enhance audit efficiency as well as audit effectiveness in that it may increase the probability of the auditor's uncovering potential material fraud or error in a company's financial statements.

Likewise, the standard and amendments are aligned with the Board's risk assessment standards and, thus, should enhance the auditor's overall risk assessment more generally by making the auditor more effective in identifying and assessing risks of material misstatement in the critical areas, and in designing and performing better audit procedures to address such risks. Additionally, the standard and amendments feature a scaled approach that requires the auditor to supplement the basic required procedures with more in-depth procedures in response to risks identified. Alignment with the risk assessment standards and the use of a scaled approach promotes a cohesive audit approach that should contribute to improved audit quality and provide opportunities for efficient implementation.

The auditor's heightened attention to transactions in the critical areas also could result in the auditor obtaining more information about the company's financial position. For example, the standards and amendments emphasize the auditor's understanding of the business purpose (or the lack thereof) of transactions in the critical areas. A better understanding of the business purpose should better position the auditor to understand



and address such transactions, which often pose difficult measurement and recognition issues, due to factors such as transaction structure, complexity, and/or relationship to company financial targets. Such an approach should promote audit quality by providing the auditor with more insight into the nature of transactions in the critical areas, which could allow the auditor to better evaluate whether the financial statements are fairly stated.

The auditor's increased attention to the critical areas also may result in increased attention by companies to their accounting and disclosures, which could result in higher quality financial reporting. Higher quality financial reporting improves the quality of information available to the market and reduces information asymmetry between investors and company management. Improving the quality of financial reporting can reduce investors' uncertainty about the information being provided in company financial statements, foster increased public confidence in the financial markets, and enhance capital formation and the efficiency of capital allocation decisions. Research shows that decreasing the level of information asymmetry reduces the cost of capital for issuers.^{81/} In addition, if management produces more accurate disclosures, research shows that this increased quality of disclosures to financial statement users also reduces the cost of capital.^{82/}

Further, new audit committee communication requirements would promote communications regarding, and improve the auditor's understanding of, the critical areas. For example, the auditor's understanding of related party transactions would be informed by an initial audit committee communication during the risk assessment that is intended to help the auditor identify the company's significant related party transactions, as well as to inform the auditor of any concerns audit committee members may have regarding the company's relationships or transactions with its related parties. Later in the audit, the auditor is required to discuss with the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of, the company's related party transactions, including any that were previously undisclosed to the auditor. In addition, improving the auditor's understanding of: (i) the business purpose (or the lack thereof) of a company's significant unusual transactions and (ii) a

^{81/} See David Easley and Maureen O'Hara, 2004. Information and the Cost of Capital. *The Journal of Finance* 59 (4): 1553-1583.

^{82/} See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, 2012. Information Asymmetry, Information Precision, and the Cost of Capital. *Review of Finance* 16 (1): 1-29.



company's financial relationships and transactions with its executive officers, can enhance already existing required audit committee communications related to significant unusual transactions and significant risks.

These improved communication requirements should result in both auditors and audit committees becoming better informed and thus better equipped to fulfill their respective roles in the company's financial reporting. Through these communications, the auditor becomes better informed about the company, enabling the auditor to be more effective in identifying and addressing risks of material misstatement in the company's financial statements. A better informed audit committee can contribute to management oversight, which may lead management to improve the company's financial reporting. As noted above, research has indicated that improving the quality of financial reporting reduces investors' uncertainty about the information being provided in companies' financial reports and, thus, increases efficiency in capital allocation and fosters capital formation. For example, increased level and/or quality of financial reporting has been found to decrease the cost of equity, decrease the cost of debt, and decrease bid-ask spreads.^{83/}

Commenters largely agreed with the Board that the standard and amendments could improve audit quality. In addition, specific benefits suggested by commenters included: (i) higher quality financial statement disclosures; (ii) improving investors' confidence in audited financial statements; (iii) improving the audit's effectiveness and informational value; (iv) more relevant consideration of issues facing the company; (v) increasing audit committee knowledge; and (vi) improving the audit committees' abilities to fulfill their duties. Additionally, another commenter stated that management may be more attentive to written procedures and responsibilities for related party transactions as a result of the repropoed standard. Specific comments in each area include:

- *Relationships and Transactions with Related Parties:* Many commenters stated that the repropoed standard would improve the auditor's overall understanding of a company's relationships and transactions with its related parties. Some commenters suggested that obtaining such an

^{83/} See Christine A. Botosan, and Marlene A. Plumlee. 2002. *A Re-examination of Disclosure Level and the Expected Cost of Equity Capital*, 40 *Journal of Accounting Research* 21-40, (2002), Partha Sengupta, *Corporate Disclosure Quality and the Cost of Debt.*, 73 *The Accounting Review* 459-474, (1998), and Michael Welker, *Disclosure Policy, Information Asymmetry, and Liquidity in Equity Markets*, 11 *Contemporary Accounting Research* 801-827 (1995), respectively.



understanding would: (i) assist the auditor in obtaining sufficient appropriate audit evidence and increase the likelihood of identifying material misstatements; and (ii) enhance the exercise of professional skepticism in the performance of the audit.

- *Significant Unusual Transactions:* A few commenters suggested that requiring procedures to improve the auditor's identification and evaluation of a company's significant unusual transactions could improve audit quality by: (i) increasing the likelihood of identifying material misstatements; (ii) promoting the exercise of professional skepticism; (iii) improving financial statement disclosures; and (iv) improving audit committees' abilities to fulfill their duties.
- *Financial Relationships and Transactions with Executive Officers:* Commenters providing views on audit quality issues indicated that obtaining an understanding of a company's financial relationships and transactions with its executive officers could improve audit quality by: (i) improving the auditor's identification of risks of material misstatement; (ii) resulting in more relevant audit testing; and (iii) improving the auditor's assessment of fraud risk.

With respect to the baseline, the Board notes that, as described previously, some firms may perform procedures that go beyond existing requirements. Consequently, the application of the standard and amendments should generate greater benefits to audits of companies whose auditors are not currently performing a comprehensive risk-based audit or are performing only the most cursory of procedures under AU sec. 334. Benefits also include promoting consistency in audit practices among audit firms by establishing auditor performance requirements.

B. Costs

In general, the Board recognizes that imposing new requirements will involve some additional audit effort and related costs, both to audit firms and companies.

The Board anticipates costs include direct compliance costs to auditors that will reflect changes necessary to address the introduction of new requirements. The Board anticipates initial and ongoing costs for audit firms will include costs for updating and maintaining methodologies and audit programs, implementation, and staff training. Additionally, depending on the degree of effort currently expended by audit firms, there may be increased costs in terms of incremental audit effort, including increased audit



partner time, and potential costs for the time of specialists to review complex transactions.

The increased audit effort and resulting costs may be limited as the standard and amendments are based on the Board's existing risk assessment standards and retain many existing auditing concepts and procedures that are common in practice today. For example, AU sec. 334 suggests procedures for the auditor's consideration, certain of which have been incorporated into the standard as specific required procedures. To the extent that audit firms have already incorporated these procedures into their current practices, those firms should incur lower costs in updating their methodologies. As a result, costs should be greater where auditors are not currently performing a comprehensive risk-based audit or are performing only the most cursory of procedures under AU sec. 334. In general, audit firms that audit companies of all sizes were supportive of the Board's efforts to improve audit quality in the critical areas and did not raise concerns regarding costs or provide data regarding the extent of such costs for the Board's consideration.

To the extent that there are increased costs for auditors as a result of the application of the standard and amendments, such costs may be passed on, in whole, or part (or not at all), to companies and their investors in the form of higher audit fees.^{84/} The Board is aware, however, that there may be increased costs for companies whose auditors must change their methodologies and practices to address the new requirements. These potential costs to companies include increased audit fees and costs for the additional time and expense of responding to auditor inquiries.

^{84/} It is not clear to what extent the increased auditor performance requirements would result in increased audit fees. The Board is aware of public reports that have analyzed historical and aggregate data on audit fees, and which suggest that audit fees generally have remained stable in recent years, notwithstanding the fact that the Board and other auditing standard-setters have issued new standards during that period. See, e.g., *Audit Analytics Audit Fees and Non-Audit Fees: An Eleven Year Trend* (July 2013). Because amendments to, and adoption of, new Board standards typically involve discrete parts of an audit, which is not accounted for, or priced, on a standard-by-standard basis, it is difficult to obtain data that isolates the costs of particular new audit standards, and that would be comparable between firms. In its reproposal, the Board sought data that might provide information or insight into such costs. As noted above, commenters did not provide data regarding the extent of such costs.



Additionally, other costs could include costs associated with enhanced audit committee communications, to the extent the areas addressed by the standard and amendments are not already discussed. Company audit committees may require additional time and expense to participate in new audit committee communication relating to related party transactions and also may require expanded discussions relating to significant unusual transactions. While companies may need additional time or resources to conduct the new audit committee communications, the standard and amendments build on, and work in concert with, the approach taken in Auditing Standard No. 16. Thus, the new requirements in this area provide additional substance for an integrated meeting with the audit committee. This should not add significantly to the time or resources companies spend with respect to audit committee communications.

The Board also considered potential unintended consequences in conjunction with its consideration of costs. For example, the Board considered whether, to the extent that potential costs stemming from the standard and amendments increase audit costs related to transactions with related parties, this could serve as a deterrent against their use. In such cases, any cost advantage a company may have from engaging in related party transactions during its normal course of operations could be reduced by higher audit-related costs.

Two commenters provided their views that the repropoed standard and amendments could serve as a deterrent against the use of related party transactions. One commenter suggested that requiring auditors to obtain evidence supporting management's arm's-length assertion regarding a related party transaction had corresponding negative economic consequences, such as, management avoiding the use of related party transactions. Another commenter that stated that the increased audit effort will result in a pass through of marginally higher audit costs to companies also noted that there could be changed behavior in structuring transactions so that they are not related party transactions.

The Board considered these comments and acknowledges that, as noted in the reproposal, potential costs stemming from the standard and amendments could increase audit costs related to transactions with related parties, which could conceivably serve as a deterrent against their use. While the Board recognizes this potential, the Board notes that companies are already required to disclose material related party transactions in their financial statements, and auditors already should be performing some procedures, under the existing standards, with respect to these transactions and related disclosures. Additionally, in considering these comments, the Board notes that the requirement in the standard for auditors to obtain evidence supporting management's arm's-length assertion regarding a related party transaction is consistent



with the requirement in AU sec. 334.12, as applicable financial reporting frameworks only permit an arm's-length assertion regarding a related party transaction to be included in the financial statements when supported by evidence.

In general, the Board's assessment of the impact of the adoption of the standard and amendments relative to costs was informed by the fact that commenters did not raise issues regarding costs that were inconsistent with those described by the Board in its reproposal. Additionally, while some commenters noted that there would be some increased costs to audit firms and companies, they did not provide data regarding the extent of such costs. A number of commenters suggested that the costs of the standard and amendments were appropriate. For example, one commenter stated that the benefits of the repropose standard and amendments would outweigh the associated costs. Another commenter stated that the repropose standard and amendments benefit users without placing too high a burden on preparers or auditors. However, a few commenters indicated that the costs associated with the standard and amendments may be difficult to measure prior to implementation.

One commenter stated that the repropose standard and amendments would not require significant incremental management or auditor resources, but resources required could be meaningfully greater for companies with a significant number of related party transactions or significant unusual transactions. Several other commenters also indicated that smaller audit firms might be disproportionately impacted by the Board's reproposal. However, commenters in general noted that the standard and amendments were appropriate for, and should apply to, audits of companies of all types and sizes, including broker-dealers and EGCs. As noted above, the Board received comments from a wide spectrum of commenters, including firms that audit companies of various sizes. Further discussion of the potential impact on smaller audit firms and smaller companies is discussed in Section C below.

C. Smaller Audit Firms and Smaller Companies

The Board recognizes that the adoption of the standard and amendments may impose disproportionately greater costs on smaller audit firms than on larger audit firms. For example, the one-time costs to update audit methodologies and training may represent a relatively larger share of audit costs for smaller audit firms compared to larger audit firms. Further, to the extent that a smaller audit firm has not already incorporated procedures suggested by AU sec. 334 into its current practices, such a firm would likely incur higher incremental costs to comply with the standard and amendments.



As described above, the costs incurred by the auditor to comply with the standard and amendments may be passed on, in whole, or in part (or not at all), to companies and their investors in the form of increased audit fees. To the extent this occurs, it may particularly affect smaller companies that rely on related party transactions as part of their business model. This point also was asserted by some commenters on the proposal and reproposal, many of whom also noted the particular risks posed by related party transactions engaged in by smaller companies. Increasing the costs of audits for smaller companies could negatively impact their profitability.

In considering this potential impact, the Board also has taken note of its oversight findings, which indicate that the audits of smaller companies are more frequently the subject of inspection findings and enforcement actions that involve related party transactions. Additionally, the Board notes that there is likely less information available regarding smaller companies (e.g., they have fewer brokerage research analysts, and less press coverage). Thus, while there is the potential for greater cost impact on smaller companies arising from the standard and amendments, there is also the potential that investors in such companies would accrue relatively larger benefits from the standard and amendments, such as a lower cost of capital.

As noted above, the Board believes that any additional audit costs would likely vary based on the size and complexity of the company's transactions in the critical areas, and would be commensurate with the risk of material misstatement arising out of such transactions. As noted in the reproposing release, a company that has extensive relationships and transactions with related parties or significant unusual transactions, or that has financial relationships and transactions with executive officers that give rise to risks of material misstatement, could anticipate a greater increase in audit-related costs than a company without such relationships or transactions.^{85/} Thus, the Board would not expect there to be a significant increase in audit fees for a company that does not have complex or extensive: (i) relationships or transactions with related parties; (ii) significant unusual transactions; or (iii) financial relationships and transactions with the company's executive officers. In addition, to the extent that some auditors are already performing procedures similar to those in the standard and amendments, there would be a lesser impact. However, if the auditor identifies related parties or relationships or transactions with related parties that were previously undisclosed to the auditor, there would be incremental costs, as well as benefits, associated with the auditor's response to the increased risks of material misstatement.

^{85/} See page A4-97 of the reproposing release.



D. Other Economic Considerations

As noted above, commenters generally supported the Board's efforts to promote audit quality in the areas addressed by the standard and amendments. However, a few expressed concerns. For example, one commenter acknowledged that the Board had repropoed the standard and amendments to obtain more information regarding economic considerations generally, but the commenter was nonetheless critical of the Board's economic analysis in its reproposal. This commenter stated that the Board had failed to provide adequate specifics in its reproposal supporting the need for the standard and stated that the reproposal did not adequately address potential alternatives to the proposed requirements, including any rationale for not choosing to converge with the IAASB and ASB standards, which, in that commenter's view, introduced unnecessary complexity and cost. This same commenter also asked why the Board thought it necessary to adopt new requirements after the issuance of Staff Audit Practice Alert No. 5.

The Board considered the issues raised by this commenter and believes that the need for the standard and amendments, and the alternatives considered by the Board, have been fully described in the Board's proposals and throughout this release, including in this Appendix. The standards and amendments being adopted represent a targeted approach that appropriately responds to areas of the audit that have historically represented risks of material misstatement in company financial statements. In the Board's view, the need to improve the Board's existing standards addressing the critical areas, including alignment with the Board's risk assessment standards, cannot be adequately addressed through staff interpretations of existing standards. More specific requirements are warranted to promote heightened scrutiny in the critical areas. While the new auditor performance requirements will involve some additional effort and related costs in some cases, to avoid unnecessary audit efforts and costs, the Board developed the standard to align with existing audit procedures that the auditor already is required to perform as part of the auditor's risk assessment and requires the auditor to perform procedures that are commensurate with the risks of material misstatement.

The Board also considered the comment that the Board did not set forth a rationale for not choosing to converge the proposed auditing requirements with the standards of the IAASB and the ASB. As a matter of practice, the Board regularly considers the work of other standard-setters, such as the IAASB and the ASB, for insights as it develops its standards. In developing the standard and amendments, the Board considered the analogous standards of the IAASB and the ASB and incorporated



a number of similar audit procedures and requirements that the Board believed were useful and appropriate.^{86/}

The Board, however, has determined that the critical areas require heightened scrutiny and, thus, the standard and amendments contain auditing requirements that are not reflected in the analogous standards of the IAASB and the ASB. For example, the standard and amendments contain requirements for the auditor to focus heightened audit attention on the business purpose (or the lack thereof) of a company's related party transactions.^{87/} Also, in view of the importance of the audit committee's role in the oversight of the company's financial reporting, the standard requires the auditor to make inquiries of the audit committee (or its chair) regarding the audit committee's understanding of the company's related parties and transactions, as well as regarding whether any member of the audit committee has concerns regarding such matters. Additionally, the other amendments require the auditor to perform risk assessment procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers. Appendix 6 compares certain significant differences between the objective and certain key requirements of the standard and amendments and analogous standards of the IAASB and the ASB.

Two commenters raised concerns regarding economic considerations of a more general nature, suggesting that the Board develop a specific framework for considering costs and benefits more generally. The Board has addressed these matters separately.^{88/}

^{86/} For example, paragraph 5 of the standard being adopted by the Board contains similar requirements to paragraph 13 of ISA 550 (and paragraph 14 of AU-C 550), which require the auditor to inquire of management regarding: the identity of the entity's related parties, including changes from the prior period; the nature of the relationships between the entity and these related parties; and whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

^{87/} See, e.g., paragraphs 5.d., 12.a., and 19.e. of the standard in Appendix 1.

^{88/} See, e.g., *PCAOB Strategic Plan: Improving the Quality of the Audit for the Protection and Benefit of Investors 2013 – 2017* (November 26, 2103) at 5 and 13, and *PCAOB Releases Staff Guidance on Economic Analysis in PCAOB Standard Setting* (May 15, 2014)
http://pcaobus.org/News/Releases/Pages/05152014_Economic_Analysis.aspx.



Finally, in its reproposal, the Board specifically asked for comment regarding any considerations relating to efficiency, competition and capital formation that the Board should take into account with respect to the reproposed standard and amendments. Other than the general comments described above, the Board did not receive comments noting specific concerns regarding efficiency, competition and capital formation in response to its request.

In summary, after considering these factors and public comments, the Board believes that its new requirements reflect a reasoned approach that considers and is intended to limit unnecessary audit effort and related costs.

VI. Economic Considerations Pertaining to Audits of EGCs, Including Efficiency, Competition, and Capital Formation

The PCAOB has been monitoring implementation of the JOBS Act in order to understand the characteristics of EGCs^{89/} and inform the Board's considerations regarding whether it should recommend that the SEC apply the standard and amendments to audits of EGCs. To assist the SEC, the Board is providing the following information regarding EGCs that it has compiled from public sources.^{90/}

^{89/} Pursuant to the JOBS Act, an EGC is defined in Section 3(a)(80) of the Exchange Act. In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than \$1 billion during its most recently completed fiscal year (and its first sale of common equity securities pursuant to an effective Securities Act of 1933 (the "Securities Act") registration statement did not occur on or before December 8, 2011). See JOBS Act Section 101(a), (b), and (d). Once an issuer is an EGC, the entity retains its EGC status until the earliest of: (i) the first year after it has total annual gross revenue of \$1 billion or more (as indexed for inflation every five years by the SEC); (ii) the end of the fiscal year after the fifth anniversary of its first sale of common equity securities under an effective Securities Act registration statement; (iii) the date on which the company issues more than \$1 billion in non-convertible debt during the prior three year period; or (iv) the date on which it is deemed to be a "large accelerated filer" under the Exchange Act (generally, an entity that has been public for at least one year and has an equity float of at least \$700 million).

^{90/} To obtain data regarding EGCs, the PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and November 20, 2013, for disclosures by entities related to their EGC status. Only those entities that have voluntarily disclosed



A. Characteristics of Self-Identified EGCs

As of November 20, 2013, based on the PCAOB's research, 1,227 SEC registrants had identified themselves as EGCs in SEC filings. These companies operate in diverse industries. The five most common Standard Industrial Classification ("SIC") codes applicable to these companies are codes for: (i) blank check companies; (ii) pharmaceutical preparations; (iii) real estate investment trusts; (iv) prepackaged software services; and (v) computer processing/data preparations services.

The five SIC codes with the highest total assets as a percentage of the total assets of the population of EGCs are codes for: (i) federally chartered savings institutions; (ii) real estate investment trusts; (iii) national commercial banks; (iv) state commercial banks; and (v) crude petroleum or natural gas. Total assets of EGCs in these five SIC codes represent approximately 35% of the total assets of the population of EGCs. EGCs in three of these five SIC codes (federally chartered savings institutions, national commercial banks, and state commercial banks) represent financial institutions and the total assets for these three SIC codes represent approximately 22% of the total assets of the population of EGCs.

Approximately 19% of the EGCs identified themselves in registration statements and were not previously reporting under the Exchange Act as of November 20, 2013. Approximately 64% of the companies that have identified themselves as EGCs began reporting under the Exchange Act in 2012 or later. The remaining 17% of these companies have been reporting under the Exchange Act since 2011 or earlier. Accordingly, a majority of the companies that have identified themselves as EGCs began reporting information under the securities laws since 2012.

Approximately 63% of the companies that have identified themselves as EGCs and filed an Exchange Act filing with information on smaller reporting company status indicated that they were smaller reporting companies.^{91/}

their EGC status have been identified. The PCAOB has not validated these entities' self-identification as EGCs. The information presented also does not include data for entities that have filed confidential registration statements and have not subsequently made a public filing.

^{91/} The SEC adopted its current smaller reporting company rules in *Smaller Reporting Company Regulatory Relief and Simplification*, Securities Act Release No. 33-8876 (December 19, 2007). Generally, companies qualify to be smaller reporting



Approximately 32% of the companies that have identified themselves as EGCs provided a management report on internal control over financial reporting. Of those companies that provided a report, approximately 46% stated in the report that the company's internal control over financial reporting was not effective.^{92/}

Audited financial statements were available for nearly all of the companies that identified themselves as EGCs.^{93/} For those companies for which audited financial statements were available and based on information included in the most recent audited financial statements filed as of November 20, 2013:

companies ("SRCs") and, therefore, have scaled disclosure requirements if they have less than \$75 million in public equity float. Companies without a calculable public equity float will qualify if their revenues were below \$50 million in the previous year. Scaled disclosure requirements generally reduce the compliance burden of SRCs compared to other issuers. Notably, the only area in which SRC requirements may be more extensive than requirements for other issuers is with respect to the disclosure of related party transactions. The SEC justified this difference in treatment based on the importance of disclosing related party transactions, particularly for issuers with lower materiality thresholds.

^{92/} For purposes of comparison, the PCAOB compared the data compiled with respect to the population of companies that identified themselves as EGCs with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The Russell 3000 was chosen for comparative purposes because it is intended to measure the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market (as marketed on the Russell website). To contrast, approximately 95% of the companies in the Russell 3000 Index provided a management report on internal control over financial reporting. Of those companies that provided a management report, approximately 4% stated in the report that the company's internal control over financial reporting was not effective.

^{93/} Audited financial statements were available for 1,216 of the 1,227 self-identified EGCs. Audited financial statements were not available for some EGCs that had filed registration statements that had not been declared effective by the SEC.



- The reported assets ranged from zero to approximately \$18.2 billion. The average and median reported assets were approximately \$184.4 million and \$0.4 million, respectively.^{94/}
- The reported revenue ranged from zero to approximately \$962.9 million. The average and median reported revenue were approximately \$59.6 million and \$3 thousand, respectively.
- The average and median reported assets among companies that reported revenue greater than zero were approximately \$359.5 million and \$68.1 million, respectively. The average and median reported revenue among these companies that reported revenue greater than zero were approximately \$116.2 million and \$20.7 million, respectively.
- Approximately 49% identified themselves as "development stage entities" in their financial statements.^{95/}
- Approximately 54% had an explanatory paragraph included in the auditor's report describing that there is substantial doubt about the company's ability to continue as a going concern.^{96/}

^{94/} As noted above, for purposes of comparison, the PCAOB compared the data compiled with respect to the population of companies that identified themselves as EGCs with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The average and median reported assets of issuers in the Russell 3000 were approximately \$12.2 billion and approximately \$1.6 billion, respectively. The average and median reported revenue from the most recent audited financial statements filed as of November 20, 2013 of issuers in the Russell 3000 were approximately \$4.6 billion and \$725.8 million, respectively.

^{95/} According to the Financial Accounting Standards Board ("FASB") standards, development stage entities are entities devoting substantially all of their efforts to establishing a new business and for which either of the following conditions exists: (i) planned principal operations have not commenced or (ii) planned principal operations have commenced, but there has been no significant revenue from operations. See FASB Accounting Standards Codification Subtopic 915-10, *Development Stage Entities—Overall*.

^{96/} Approximately 1% of the population of companies in the Russell 3000 Index have an explanatory paragraph describing that there is substantial doubt about the company's ability to continue as a going concern.



- Approximately 38% were audited by firms that are annually inspected by the PCAOB (that is, firms that have issued auditor's reports for more than 100 public company audit clients in a given year) or are affiliates of annually inspected firms. Approximately 62% were audited by triennially inspected firms (that is, firms that have issued auditor's reports for 100 or fewer public company audit clients in a given year) that are not affiliates of annually inspected firms.

The PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and November 20, 2013, for related party disclosures by EGCs. An analysis of 1,103 of the most recent audited financial statements filed through November 20, 2013 of the 1,227 self-identified EGCs indicates that approximately 68% of these companies disclosed at least one related party relationship or transaction.^{97/}

B. Economic Considerations Pertaining to Audits of EGCs, Including Comments Received

The Board's analysis of the potential economic impacts on EGCs is based on the EGC data described above, which has been collected and analyzed by the Board's staff. The Board's analysis is also informed by the Board's oversight activities, as well as by the other considerations described in this Appendix and the release more generally. Additionally, the Board's analysis has been informed by information provided by commenters. The Board's discussion of potential economic impacts on EGCs follows.

Based on the data outlined above, a majority of EGCs are smaller public companies. EGCs also appear to be companies that are relatively new to the SEC reporting process. This indicates that there is less information available to investors regarding such companies relative to the broader population of public companies. It is generally acknowledged that investors are less informed about companies that are smaller and newer, suggesting there is a higher degree of information asymmetry for smaller and newer companies.

^{97/} A similar analysis of SEC filings for the population of companies in the Russell 3000 Index found that approximately 45% of those companies have disclosed at least one related party relationship or transaction.



As noted in Section VI.A. above, self-identified EGCs disclosed related party relationships or transactions at a significantly higher rate as compared to companies in the Russell 3000 Index. The data also suggests that EGCs are more likely than the population of companies in the Russell 3000 Index to have a management report on internal control over financial reporting stating that the company's internal control over financial reporting was not effective. The higher propensity of EGCs to engage in related party transactions coupled with an increased likelihood for control deficiencies suggests that applying the standard in audits of EGCs is particularly relevant.

Given the characteristics of EGCs as newer and smaller companies, some might assume that EGCs would have operations that are less complex. However, this may not be true for many EGCs. Audits of EGCs appear to reflect a wide range of complexity and risk. For example, 580 of the 1,227 companies that have identified themselves as EGCs did not recognize revenue in the most recently filed financial statements. As noted in Section VI.A., financial institutions represent at least 22% of the total assets of EGCs. Given the nature of the operations of financial institutions, these EGCs could engage in transactions that involve complex accounting and financial statement disclosure issues.

Further, the data presented in Section VI.A., indicates that for 54% of the EGCs the auditor's report on the most recent audited financial statements includes an explanatory paragraph describing that there is substantial doubt about the company's ability to continue as a going concern, as compared to 1% for the population of companies in the Russell 3000 Index.

Thus, applying the standard and amendments to the audits of EGCs may be particularly pertinent because of the characteristics of EGCs described above (e.g., potential for higher rates of material weaknesses in internal control, use of related party transactions, and substantial doubt about the company's ability to continue as a going concern).

In the reproposal, the Board specifically sought comment on the application of the repropounded standard and amendments to audits of EGCs. Commenters generally considered the requirements of the standard to be applicable and appropriate to companies of varying sizes and industries. All those who commented on the applicability of the standard and amendments to EGCs stated that the repropounded standard and amendments should be applicable to audits of EGCs. Those commenters provided various reasons, including that the risks regarding related parties, significant unusual transactions and financial relationships and transactions with executive officers are the same, if not greater at EGCs and that EGCs may enter into such matters more frequently than non-EGCs.



No commenters stated that the repropoed standard and amendments should not apply to audits of EGCs. One commenter, however, was concerned that the repropoal did not contain a substantive analysis of the economic impacts of the propoed requirements on EGCs. This commenter acknowledged, however, that after the enactment of the JOBS Act, the Board repropoed the standard and amendments to seek comment and obtain additional information regarding the economic impacts on EGCs.

Some commenters stated that the repropoed standard is scalable for application to audits of EGCs. One commenter stated that firm implementation costs should not differ when implementing the repropoed standard for audits of EGCs or other issuers; however, increased recurring costs may fall relatively disproportionately on EGCs. One commenter stated that the implementation and training costs that a firm would incur would not depend upon whether the repropoed standard is applicable to EGCs and there should be little or no additional costs to apply the repropoed standard to EGCs. Another commenter noted that although smaller companies (some of which may be EGCs) may engage in more related party transactions compared to other companies, which will result in higher audit costs, the costs are commensurate with the risks of material misstatement.

Some commenters noted that regardless of the applicability to audits of EGCs, firms would perform the same procedures for all audits. One commenter suggested that it would be more costly not to apply the repropoed standard and amendments to audits of EGCs as this would, in the commenter's view, require firms to maintain two methodologies. One commenter stated that it would perform the same procedures for audits of EGCs, regardless of the applicability of the repropoed standard and amendments to audits of EGCs, as the cost to develop and maintain two separate methodologies and the related training would be cost-prohibitive. One commenter, representing a committee, stated that the standard should be applicable to audits of EGCs. However, that commenter also noted that its committee members had a mixed response; some believed the standard ought to be universally applicable, as a "carve-out" for EGCs would be more costly, but a minority believed that a carve out would be easy to implement. One commenter suggested that applying different rules to financial statement audits performed in accordance with PCAOB standards could be confusing to investors and other stakeholders.

The standard and amendments are designed to improve the auditor's efforts regarding a company's relationships and transactions with its related parties, significant unusual transactions and financial relationships and transactions with its executive officers. As previously discussed, a significant number of the Board's oversight findings



from its inspections and enforcement programs regarding related party transactions involve smaller public companies, which have characteristics that are similar to EGCs.

Thus, enhanced auditor consideration of the areas addressed in the standard and amendments may be particularly important to investors in EGCs given that: (i) information asymmetry may be more pronounced at EGCs; (ii) there is the potential for greater reliance by EGCs on related party transactions; and (iii) there is a significant number of findings regarding related party transactions in audits of financial statements of smaller companies identified through PCAOB oversight activities.

As described more fully in Section V.A. of this Appendix, improving the auditor's efforts in the areas addressed in the standard and amendments should promote audit quality in ways that also should improve financial statement accounting and disclosure, which in turn should improve financial reporting, reduce information asymmetry, and reduce the company's cost of capital. These benefits should accrue to all types of companies, including EGCs.

EGCs will incur some incremental costs in connection with auditor compliance with the standard and amendments. As noted earlier, these costs may be disproportionately higher for smaller companies, including EGCs, relative to the broader population of public companies. The additional audit-related costs, as discussed above, could conceivably serve as a deterrent against the use of related party transactions by EGCs. Likewise, additional audit-related costs may deter certain EGCs from entering public markets, if those costs weigh heavily on their potential profitability. To the extent that EGCs tend to be smaller and newer companies, the enhanced audit performance requirements may place a disproportionately higher burden on them, which may impact their profitability and competitiveness. As noted above, however, no commenter stated that the repropoed standard and amendments should not apply to audits of EGCs and no commenter discussed the impact on competitiveness of EGCs.

The standard and amendments are designed to mitigate cost impacts by aligning the auditor's efforts with the risk assessment standards and providing opportunities for a scaled approach. This allows auditors to integrate the audit to avoid unnecessary audit effort.

Additionally, in its reproposal, the Board specifically asked for comment regarding any considerations regarding efficiency, competition and capital formation that the Board should take into account when determining whether to recommend to the SEC the application of the repropoed standard and amendments to audits of EGCs. No commenter expressed concerns regarding efficiency, competition and capital



formation with respect to the application of the repropoed standard and amendments to audits of EGCs.

C. Recommendation

The Board believes that the standard and amendments will advance investor protection and promote audit quality. In addition, more effective audits and more informed communications between the auditor and the audit committee should enhance the quality of a company's financial reporting.

Additionally, the Board believes that its new requirements reflect a reasoned approach to considering and limiting unnecessary audit effort and related costs. Many commenters agreed that the repropoed standard and amendments would lead to improvements in audit quality, with many commenters stating that the requirements of the repropoed standard and amendments should be applicable to, and were appropriate for, companies of different sizes and industries.

The JOBS Act was enacted after the Board issued its proposing release. Subsequently, the Board issued a reproposal, in part to request comment specifically on matters relating to the application of the standard and amendments to audits of EGCs. A variety of commenters noted particular risks posed by related party transactions pertinent to small companies, including EGCs. In addition, all those commenters who commented with respect to the applicability of the standard and amendments to EGCs stated that the standard and amendments should be applicable to audits of EGCs.

Based on data available to the Board regarding EGCs, it appears that a wide range of entities, of differing sizes and industries, identify themselves as EGCs. One key difference between EGCs and the broader population of public companies would appear to be the length of time that EGCs have been subject to Exchange Act reporting requirements. Based on the information available to the Board, while there may be additional costs and potential competitive impacts on EGCs, there also may be additional benefits from enhanced scrutiny in the areas addressed by the standard and amendments. Given these considerations, there does not appear to be a compelling reason to treat audits of EGCs differently from the audits of other companies.

For the reasons explained above, the Board believes that the standard and amendments are in the public interest and, after considering the protection of investors and the promotion of efficiency, competition, and capital formation, recommends that the standard and amendments should apply to audits of EGCs. Accordingly, the Board recommends that the Commission determine that it is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will



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promote efficiency, competition, and capital formation, to apply the standard and amendments to audits of EGCs. The Board stands ready to assist the Commission in considering any comments the Commission receives on these matters during the Commission's public comment process.



APPENDIX 6 – Comparison of the Objective and Key Requirements of the Standard and Amendments with the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

I. Introduction

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is adopting: (i) Auditing Standard No. 18, *Related Parties* (the "standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "amendments regarding significant unusual transactions"); and (iii) other amendments to PCAOB auditing standards (the "other amendments").^{1/}

This Appendix 6, which was prepared for informational purposes only, compares certain significant differences between the objective and certain key requirements of the standard and amendments with the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA").

This Appendix is not a summary of, or a substitute for, the standard in Appendix 1 or the amendments in Appendices 2 and 3. This comparison may not represent the views of the IAASB or the ASB regarding the interpretations of their standards.

The analogous standards of the IAASB discussed in this comparison include:

- International Standard on Auditing 550, *Related Parties* ("ISA 550");
- International Standard on Auditing 210, *Agreeing the Terms of Audit Engagements* ("ISA 210");
- International Standard on Auditing 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* ("ISA 240");
- International Standard on Auditing 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* ("ISA 315");

^{1/} The amendments regarding significant unusual transactions and the other amendments are collectively referred to as the "amendments." The standard and amendments are collectively referred to as the "standard and amendments."



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- International Standard on Auditing 510, *Initial Audit Engagements—Opening Balances* ("ISA 510");
- International Standard on Auditing 560, *Subsequent Events* ("ISA 560");
- International Standard on Auditing 580, *Written Representations* ("ISA 580");
- International Standard on Auditing 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* ("ISA 600"); and
- International Standard on Review Engagements 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*, ("ISRE 2410").

The analogous standards of the ASB discussed in this comparison include:

- AU-C Section 550, *Related Parties* ("AU-C Section 550");
- AU-C Section 210, *Terms of Engagement* ("AU-C Section 210");
- AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit* ("AU-C Section 240");
- AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* ("AU-C Section 315");
- AU-C Section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements* ("AU-C Section 510");
- AU-C Section 560, *Subsequent Events and Subsequently Discovered Facts* ("AU-C Section 560");
- AU-C Section 580, *Written Representations* ("AU-C Section 580");
- AU-C Section 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* ("AU-C Section 600"); and



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- AU-C Section 930, *Interim Financial Information* ("AU-C Section 930").^{2/}

This comparison is organized in the following sections: (II.) the auditing standard; (III.) the amendments regarding significant unusual transactions; and (IV.) the other amendments to PCAOB auditing standards.^{3/} This comparison does not cover the application and explanatory material in the analogous standards of the IAASB or ASB.^{4/}

II. **Auditing Standard, Related Parties (Appendix 1)**

A. **Introduction (Paragraph 1 of the Standard in Appendix 1)**

PCAOB

The standard refers auditors to the requirements of the U.S. Securities and Exchange Commission ("SEC") for the company under audit with respect to the

^{2/} These AU–C sections are contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification* ("SAS No. 122"). In October 2011, the ASB adopted SAS No. 122, which contains 39 clarified SASs with "AU–C" section numbers for each clarified SAS. The "AU–C" is a temporary identifier to avoid confusion with references to existing "AU" sections in AICPA Professional Standards.

^{3/} This comparison does not cover the requirements contained in the risk assessment standards. Appendix 11 of PCAOB Release No. 2010–004, *Auditing Standards Related to Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, contains a comparison of the objectives and requirements of those standards with the analogous standards of the IAASB and the ASB.

^{4/} Paragraph A59 of International Standard on Auditing 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, states that the Application and Other Explanatory Material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of AU–C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU–C section."



accounting principles applicable to that company, including the definition of the term "related parties," and the financial statement disclosure requirements with respect to related parties. The standard does not include a definition for an arm's-length transaction.

IAASB

Paragraph 10(b) of ISA 550 defines a related party as a party that is either:

- i. A related party as defined in the applicable financial reporting framework;
or
- ii. Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - c. Another entity that is under common control with the reporting entity through having:
 - (i) Common controlling ownership;
 - (ii) Owners who are close family members; or
 - (iii) Common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

ISA 550 also defines an arm's-length transaction as a transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.



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ASB

AU-C Section 550 defines a related party as that term is defined in generally accepted accounting principles. AU-C Section 550 also contains a definition of arm's-length transaction that is similar to the definition in ISA 550.

B. Objective (Paragraph 2 of the Standard in Appendix 1)

PCAOB

Paragraph 2 of the standard states that the auditor's objective is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

IAASB

Paragraph 9 of ISA 550 states that the objectives of the auditor are:

- (a) Irrespective of whether the applicable financial reporting framework establishes related party requirements to obtain an understanding of related party relationships and transactions sufficient to be able:
 - i. To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
 - ii. To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:
 - a. Achieve fair presentation (for fair presentation frameworks); or
 - b. Are not misleading (for compliance frameworks); and
- (b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.



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ASB

Paragraph 9 of AU-C Section 550 contains a similar objective to the objective in ISA 550 for fair presentation frameworks.

C. Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 – 9 of the Standard in Appendix 1)

PCAOB

Paragraph 3 of the standard requires that the auditor 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 in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Paragraph 3 of the standard states that the procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company's process (paragraph 4);
- b. Performing inquiries (paragraphs 5-7); and
- c. Communicating with the audit engagement team and other auditors (paragraphs 8-9).

A note to paragraph 3 of the standard states that 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.

Another note to paragraph 3 of the standard states that performing the risk assessment procedures described in paragraphs 4-9 of the 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 related parties and relationships and transactions with related parties.



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IAASB

Paragraph 11 of ISA 550 states that as part of the risk assessment procedures and related activities required by ISA 315 and ISA 240, the auditor shall perform the audit procedures and related activities set out in paragraphs 12-17 of ISA 550 to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Obtaining an Understanding of the Company's Process (Paragraph 4 of the Standard in Appendix 1)

PCAOB

Paragraph 4 of the standard requires that in conjunction with obtaining an understanding of internal control over financial reporting, the auditor obtain an understanding of the company's process for:

- a. Identifying related parties and relationships and transactions with related parties;
- b. Authorizing and approving transactions with related parties; and
- c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

IAASB

Paragraph 14 of ISA 550 requires that the auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to:

- a. Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
- b. Authorize and approve significant transactions and arrangements with related parties; and



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- c. Authorize and approve significant transactions and arrangements outside the normal course of business.

ASB

Paragraph 15 of AU-C Section 550 contains similar requirements to those in ISA 550.

Performing Inquiries (Paragraphs 5 – 7 of the Standard in Appendix 1)

PCAOB

Paragraph 5 of the standard requires the auditor to inquire of management regarding:

- a. The names of the company's related parties during the period under audit, including changes from the prior period;
- b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);
- c. The nature of any relationships, including ownership structure, between the company and its related parties;
- d. The transactions entered into, modified, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;
- e. The business purpose for entering into a transaction with a related party versus an unrelated party;
- f. 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; and
- g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

Paragraph 6 of the standard requires the auditor to inquire of others within the company regarding their knowledge of the matters in paragraph 5 of the standard.



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Paragraph 6 also requires the auditor to identify others within the company to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding:

- a. The company's related parties or relationships or transactions with related parties;
- b. The company's controls over relationships or transactions with related parties; and
- c. The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Paragraph 7 of the standard requires the auditor to inquire of the audit committee, or its chair, regarding:

- a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
- b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties, and, if so, the substance of those concerns.

IAASB

Paragraph 13 of ISA 550 requires the auditor to inquire of management regarding:

- a. The identity of the entity's related parties, including changes from the prior period;
- b. The nature of the relationships between the entity and these related parties; and
- c. Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

ASB

Paragraph 14 of AU-C Section 550 contains similar requirements to those in ISA 550.



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D. Identifying and Assessing Risks of Material Misstatement (Paragraph 10 of the Standard in Appendix 1)

PCAOB

Paragraph 10 of the standard aligns with the existing requirements for the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 10 states that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties or relationships or transactions with related parties. Paragraph 59 of Auditing Standard No. 12 requires that the auditor identify which risks are significant risks. Further, paragraph 71 of Auditing Standard No. 12 provides factors that the auditor should evaluate in determining which risks are significant risks. Those factors include: (i) whether the risk involves significant transactions with related parties; (ii) whether the risk involves significant transactions that are outside the normal course of business; and (iii) whether the risk is a fraud risk. The amendments regarding significant unusual transactions revise paragraph .85A.2 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, to state that a related party transaction that is also a significant unusual transaction (e.g., a significant related party transaction outside the normal course of business) is an example of a fraud risk factor.

A note to paragraph 10 of the standard states that, in identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4-9 of the standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

IAASB and ASB

Paragraph 18 of ISA 550 and paragraph 19 of AU-C Section 550 require that the auditor identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. ISA 550 and AU-C Section 550 require the auditor to treat identified significant related party transactions outside the normal course of business as giving rise to significant risks.



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E. Responding to the Risks of Material Misstatement (Paragraphs 11-13 of the Standard in Appendix 1)

PCAOB

Paragraph 11 of the standard aligns with existing requirements that the auditor design and implement audit responses that address the identified and assessed risks of material misstatement. Paragraph 11 of the standard states that this includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.

A note to paragraph 11 of the standard states that the auditor should look to the requirements of AU secs. 316.66-.67A for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). That note further states that for such related party transactions, AU sec. 316.67 requires 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.

IAASB

Paragraph 20 of ISA 550 requires that the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21-24 of ISA 550.

ASB

Paragraph 21 of AU-C Section 550 contains similar requirements to those in ISA 550.

Transactions with Related Parties Required to Be Disclosed in the Financial Statements or Determined to Be a Significant Risk (Paragraph 12 of the Standard in Appendix 1)

PCAOB

Paragraph 12 of the standard requires that for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:



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- a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. 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;
- c. Determine whether any exceptions to the company's established policies or procedures were granted;
- d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
- e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

A note to paragraph 12 of the standard states that 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 in paragraph 12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

IAASB

Paragraph 23 of ISA 550 requires that for identified significant related party transactions outside the entity's normal course of business, the auditor shall:

- a. Inspect the underlying contracts or agreements, if any, and evaluate whether:
 - i. The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;



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- ii. The terms of the transactions are consistent with management's explanations; and
 - iii. The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- b. Obtain audit evidence that the transactions have been appropriately authorized and approved.

ASB

Paragraph 24 of AU-C Section 550 contains similar requirements to those in ISA 550.

F. Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14-16 of the Standard in Appendix 1)

PCAOB

Paragraph 14 of the standard requires that the auditor evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, taking into account information gathered during the audit. Paragraph 14 requires that as part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

A note to paragraph 14 of the standard states that Appendix A contains examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

As described in Section II.F. of Appendix 4, other PCAOB auditing standards might impose requirements relating to the sources of information that could indicate that related parties or relationships or transactions with related parties previously



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undisclosed to the auditor might exist (e.g., reading confirmation responses and responses to inquiries of the company's lawyers).^{5/}

Paragraph 15 of the standard requires that if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Paragraph 15 also states that those procedures should extend beyond inquiry of management.

Paragraph 16 of the standard describes the procedures that the auditor is required to perform if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Paragraph 16 of the standard requires that the auditor:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of the standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;

^{5/} See, e.g., AU sec. 330, *The Confirmation Process*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.



- f. Perform the following procedures, taking into account the information gathered from performing the procedures in a. through e. above:
- (i) Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
 - (ii) Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
 - (iii) Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1.

IAASB and ASB

Paragraph 15 of ISA 550 requires the auditor to remain alert, during the audit, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. Paragraph 15 of ISA 550 further requires that, in particular, the auditor inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- (a) Bank and legal confirmations obtained as part of the auditor's procedures;
- (b) Minutes of meetings of shareholders and of those charged with governance; and
- (c) Such other records and documents as the auditor considers necessary in the circumstances of the entity.

Paragraph 21 of ISA 550 requires that if the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall



determine whether the underlying circumstances confirm the existence of those relationships and transactions.

Paragraph 22 of ISA 550 requires that if the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

- a. Promptly communicate the relevant information to the other members of the engagement team;
- b. Where the applicable financial reporting framework establishes related party requirements;
 - (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation;
 - (ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
- c. Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions;
- d. Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor and perform additional audit procedures as necessary; and
- e. If the nondisclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.



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G. Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17–18 of the Standard in Appendix 1)

PCAOB

Paragraph 17 of the standard aligns with the existing requirement that the auditor evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. Paragraph 17 states that this includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.

IAASB

Paragraph 25 of ISA 550 requires that in forming an opinion on the financial statements, the auditor shall evaluate:

- a. Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- b. Whether the effects of the related party relationships and transactions:
 - (i) Prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or
 - (ii) Cause the financial statements to be misleading (for compliance frameworks).

ASB

Paragraph 26 of AU-C Section 550 contains similar requirements to the requirements in ISA 550 for fair presentation frameworks.

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (Paragraph 18 of the Standard in Appendix 1)

PCAOB

Paragraph 18 of the standard requires that if the financial statements include a statement by management that transactions with related parties were conducted on



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terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.

A note to paragraph 18 of the standard further states that a preface to a statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

IAASB

Paragraph 24 of ISA 550 states that if management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion.

ASB

Paragraph 25 of AU-C Section 550 contains similar requirements to those in ISA 550.

H. Communications with the Audit Committee (Paragraph 19 of the Standard in Appendix 1)

PCAOB

Paragraph 19 of the standard requires that the auditor communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. Paragraph 19 of the standard also requires that the auditor communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

- a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;



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- c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and
- e. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

IAASB

Paragraph 27 of ISA 550 requires that the auditor communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

ASB

Paragraph 27 of AU-C Section 550 contains similar requirements to those in ISA 550.

III. Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions (Appendix 2)

A. Identifying Significant Unusual Transactions (Section A of the Amendments in Appendix 2)

PCAOB

The amendments to paragraph 56.a. of Auditing Standard No. 12 require the auditor to inquire of management regarding whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involve related parties. The amendments regarding significant unusual transactions to paragraph 56.b. of Auditing Standard No. 12 require that the auditor inquire of the audit committee or equivalent, or its chair, regarding whether the company has entered into any significant unusual transactions. The amendments regarding significant unusual transactions to paragraph 56.c. of Auditing Standard No. 12 require similar inquiries of internal audit personnel.



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A note to AU sec. 316.66 states that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions.^{6/} That note refers the auditor to paragraphs 14-16 of Auditing Standard No. 18. That note further states that Appendix A of the standard includes examples of such information and examples of sources of such information.

IAASB and ASB

ISA 315, ISA 550, AU-C Section 315, and AU-C Section 550 do not contain similar requirements for the auditor to those in the PCAOB's amendments described above.

B. Evaluating Significant Unusual Transactions (Section B of the Reproposed Amendments in Appendix 2)

PCAOB

The amendments regarding significant unusual transactions add paragraph .66A to AU sec. 316. That paragraph requires the auditor to design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. AU sec. 316.66A requires that those procedures include the following:

- a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
- b. Determining whether the transaction has been appropriately authorized and approved in accordance with the company's established policies and procedures;
- c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and

^{6/} Section B. of Appendix 2 contains the amendments to AU sec. 316.66.



- d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

The amendments to AU sec. 316.67 require that the auditor evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. The amendments require that, in making that evaluation, the auditor evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);
- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor;
- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party of the company;
- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);
- 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 other, more clearly independent, parties on an arm's-length basis;
- The transaction enables the company to achieve certain financial targets;
- 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); and



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- Management has discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Further, the amendments add paragraph 11A to Auditing Standard No. 13. That paragraph requires that because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-.67A.

The amendments to AU sec. 316.67A require that the auditor evaluate whether significant unusual transactions identified by the auditor have been properly accounted for and disclosed in the financial statements.

IAASB

Paragraph 16 of ISA 550 requires that if the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required by paragraph 15 or through other audit procedures, the auditor shall inquire of management about:

- (a) The nature of these transactions; and
- (b) Whether related parties could be involved.

Paragraph 32(c) of ISA 240 requires the auditor to evaluate whether the business rationale (or the lack thereof) of a significant transaction outside the normal course of business suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. As discussed in Section II.E. of this Appendix, paragraph 23 of ISA 550 requires the auditor to perform certain procedures for identified significant related party transactions outside the entity's normal course of business.

ASB

AU-C Section 550 and AU-C Section 240 contain similar requirements to those in ISA 550 and ISA 240.



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IV. Other Amendments to PCAOB Auditing Standards (Appendix 3)

A. Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (Appendix 3)

PCAOB

The other amendments to paragraph 10A of Auditing Standard No. 12 require that to assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers. The other amendments to Auditing Standard No. 12 also include a definition of executive officer that aligns with definitions used in SEC filings.

In addition, the other amendments amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider:

- Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and
- Obtaining an understanding of the company's established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

IAASB and ASB

ISA 315 and AU-C Section 315 do not contain similar requirements for the auditor to those in the PCAOB's amendments described above.



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B. AU sec. 315, *Communications Between Predecessor and Successor Auditors* (Appendix 3)

PCAOB

The other amendments to other PCAOB Auditing Standards amend AU sec. 315, *Communications Between Predecessor and Successor Auditors*, to require the auditor to inquire of the predecessor auditor regarding the predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions. The other amendments also require the successor auditor to review documentation regarding related parties and significant unusual transactions.

IAASB and ASB

Neither ISA 210 and ISA 510, nor AU-C Section 210 and AU-C Section 510 contain similar requirements to those in the PCAOB's amendments described above.

C. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (Appendix 3)

PCAOB

The other amendments to AU sec. 316.81A describe the auditor's responsibility, under certain conditions, to disclose possible fraud to the SEC to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change on Form 8-K and the fraud or related risk factors constitute a *reportable event* or are the source of a *disagreement*, as these terms are defined in Item 304 of Regulation S-K and Item 16F of Form 20-F. These requirements also include reports that may be required pursuant to Section 10A(b) of the Securities Exchange Act of 1934 (the "Exchange Act") relating to an illegal act that the auditor concludes has a material effect on the financial statements.

IAASB and ASB

ISA 240 and AU-C Section 240 do not inform the auditor of certain obligations under Section 10A of the Exchange Act, which is applicable to auditors of U.S. public companies registered with the PCAOB.



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D. AU sec. 333, *Management Representations* (Appendix 3)

PCAOB

The other amendments to AU sec. 333, *Management Representations*, require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The other amendments to AU sec. 333 also require the auditor to obtain written representation from management if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction.

IAASB and ASB

Neither ISA 580 and ISRE 2410, nor AU-C Section 580, and AU-C Section 930 contain similar requirements to those in the PCAOB's amendments described above.

E. AU sec. 560, *Subsequent Events* (Appendix 3)

PCAOB

The other amendments amend paragraph .12 of AU sec. 560, *Subsequent Events*, to require that during the "subsequent period" the auditor inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:

- Whether there have been any changes in the company's related parties;
- Whether there have been any significant new related party transactions;
and
- Whether the company has entered into any significant unusual transactions.

IAASB and ASB

ISA 560 and AU-C Section 560 do not contain similar requirements to those in the PCAOB's amendments described above.



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F. AU sec. 722, *Interim Financial Information* (Appendix 3)

PCAOB

The other amendments to AU sec. 722, *Interim Financial Information*, require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The other amendments to AU sec. 722 also require the auditor to obtain written representations from management when management has made an assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in arm's-length transactions.

IAASB

ISA 550 and ISRE 2410 do not contain similar requirements to those in the PCAOB's amendments described above.

ASB

AU-C Section 550 and AU-C Section 930 do not contain similar requirements to those in the PCAOB's amendments described above.