

July 3, 2013

Via e-mail: comments@pcaobus.org

Office of the Secretary
PCAOB
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

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 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 entity's decision makers should know when they are dealing with a related party.

6. **Does the repropoed standard appropriately allow for the use of auditor judgment? Why or why not?**

The Committee believes the repropoed 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 repropoed standard clear? (b) Are there other examples that should be included in the repropoed standard?**

(a) Yes; (b) no

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?**

Please refer to the Committee's response to question #6 above.

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?**

Yes.

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?**

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 repropoed 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 repropoed 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 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?

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 repropoed 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 repropose 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 repropose 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 repropose 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 repropose standard vs. an established issuer. All will benefit from the repropose 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 repropose 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 repropoed standard for audits of EGCs or established issuers, as firms would apply the repropoed 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 repropoed 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 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?

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 repropoed 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 repropoed 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 repropoed standard and amendments to audits of EGCs?

No.

45. Are the repropoed standard and repropoed 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 propoed 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