



May 25, 2012

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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:

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