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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.



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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,<sup>1</sup> 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*<sup>2</sup> in the proposed standard using the same definition as used in Appendix A of the audit committee communications proposal.<sup>3</sup> 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).

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<sup>1</sup> 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.

<sup>2</sup> 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."

<sup>3</sup> 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.”<sup>4</sup>
- 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.”<sup>5</sup> 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.”<sup>6</sup>
- 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.”<sup>7</sup>
- 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.”<sup>8</sup> 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.”<sup>9</sup>

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

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<sup>4</sup> 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>

<sup>5</sup> 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](http://www3.cfo.com/article/2012/3/compensation_liazos-executive-compensation-audit-pcaob-fas123r)

<sup>6</sup> *Id.*

<sup>7</sup> 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>

<sup>8</sup> 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>

<sup>9</sup> *Id.*





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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.

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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**

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