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.

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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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THURSDAY
MAY 17, 2012

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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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MR. BAUMANN: The next subject on our agenda is a recently proposed standard on related parties, which included certain amendments to other standards pertaining to significant unusual transactions. We first turn it over to Jay Hanson for some brief comments on this matter.

MR. HANSON: Thanks, Marty. It's been a long day, and we've got a lot of road to cover in the next 55 minutes, and so I'll be brief. The related party standard we're about to talk about we issued as a proposal in February, and the original comment period has ended but we're extending it a few more weeks in light of this discussion today. I personally think it's a really important standard for investor protection. In my career, I have been involved with actually detecting a fraud through diligent questioning of related party transactions, and I understand the importance of this. And many of the things that we put into this proposed standard I believe are just common sense and things that are being done today in practice.

And so I'm hoping that we get good feedback today from all of you on this project, and I hope we get good feedback in the comment letters. So far, we've only received less than ten or so comment letters as of this morning.

And as Marty had mentioned earlier in the day, there was initially, when we put this out in February, some reports in the press of concern about the executive compensation portion of this proposal, and I was surprised by that. And we have received a few comment letters that amplify those concerns that were in the press. And one of the comments said that our particular requirement that we're about to consider could constitute an unwarranted check on management's prerogative to structure executive compensation in a manner that is in the best interest of shareholders. And as we will explain a little bit, that is not what was intended. And today auditors already need to look at executive compensation arrangements because things like accruals for bonuses and stock options and things like that, you can't audit those without looking at those arrangements. And so this is just a natural extension of considering the risk effect of those arrangements.

So with that, I will turn it over to Greg Scates and the rest of the staff to talk about this.

MR. SCATES: All right. Thank you, Jay. This proposal includes three principal elements. It's a new standard on related parties which would supersede the existing standard, our AU Section 334. 334 has been around a while, and it's aged quite a bit over the years, and it needed to, we needed to make some enhancements to it. And so we took that opportunity to not only make enhancements to this standard on related parties but also to take a look at another important area of the audit, and that has to do with the significant unusual transactions.

And so we took that opportunity to enhance those paragraphs, particularly paragraphs 66 and 67 of AU 316, the fraud standard, to improve, we thought that there were some improvements that we could make there. We wanted to make those improvements because, oftentimes, when you have related party transactions, they may involve a significant unusual transaction and vice versa. So as you'll see, as you noted in the proposal, in the proposed standard itself, in the language, you'll see that we referred to 316, paragraphs 66 and 67, the new amended ones we're proposing, in the related party standard that the auditor needs to be cognizant of that fact that you could have significant unusual transactions in this area, and those transactions need to be evaluated similarly to the related party transactions in that the auditor needs to understand the business rationale behind those transactions.

Also, as Jay mentioned, as was mentioned by Marty this morning, we did also propose an amendment to Auditing Standard Number 12 with respect to the auditor's responsibility to gain an understanding of the compensation arrangements and any relationships with its executive officers. The executive officers of a company are related parties, and we think it's important that we put that language in the risk assessment standards itself so the auditor can carry out an appropriate risk assessment process in order to gain an understanding of any relationships that are going on with its executive officers and make sure that there are appropriate disclosures in that area.

As Jay also mentioned, in light of the discussion today, we did extend the comment period from May 15th to May 31.

What I'd like to do now is to go ahead and open the discussion up to you this afternoon, the remaining minutes we have, and we can start with any of the areas. We can start with related parties or, if you'd prefer, we can go in to significant unusual transactions and then also we can touch on, if you'd like to, talk about the amendment to the risk assessment standards on the executive compensation and the auditor's responsibility to understand those relationships.

So I'll open the floor up if we'd like to go ahead and start talking about any particular of those areas. I see one tent card up. Jamie Miller?

MS. MILLER: Yes. My comments relate to the related parties proposal. And I think the standard as written or the proposal as written appears to be okay. But given the press that we've seen, and, Jay, I appreciate your comments that that wasn't necessarily the intent or how the standards should be read, but it may be important to clarify the words in the standard to make it more clear that this is sort of a risk assessment process, as opposed to an audit or some other deeper, you know, sort of assurance around the exec comp structure and that there isn't an expectation that auditors are engaged in the compensation committee process or in an audit of that process. So just a thought that, you know, given the misunderstandings that are out there, maybe we want to re-read the proposal in that light.

MR. SCATES: Jamie, thank you for your comment. That clearly was not our intent at all is to get into the executive compensation arena. I mean, that clearly resides with the board and with the compensation committee. This is purely from a risk assessment perspective so the auditor can appropriately carry out his or her procedures in this area. And based on the comments we receive on this, if we need to make some, we'll certainly make some clarification in that area because we certainly want to make sure that it's focused only on risk assessment and then how the auditor then responds to that risk assessment.

Oh, Susan DeMando Scott? Susan, your mic.

MS. SCOTT: Thank you. Thank you very much. I'd like to comment on the related parties standard. Primarily, I'd like to talk about it with respect to broker/dealers. I know we've talked a lot today about issuers and, obviously, being from FINRA, I have an interest as to how these standards might apply to audits of broker/dealers.

Just by way of very brief background, FINRA is the largest independent regulator of securities firms that operate in the United States. We oversee the activities of approximately 629,000 registered representatives and 4400 broker/dealers. I work in the Risk Oversight and Operational Regulation Department. What that means is we focus on broker/dealers' compliance with Net Capital Rule, Customer Protection Rule with respect to safeguarding customers' cash and securities, and also the Books and Records Rules. As part of our work, we look at over 30,000 unaudited financial filings a year and also the audited financials for each of our 4400 members. And I want to say that we consider them a very important tool as part of our regulatory program, and, certainly, robust standards with respect to related party transactions are very important.

I just want to mention briefly, because I think when one thinks of related party transactions with respect to issuers, they take on a very different flavor then what one would see in the broker/dealer world. So just very briefly, I want to talk about five high-level scenarios, and there could be more, but I will limit it to that where we see related party transactions.

The first has to do with the use of expense sharing agreements or management services agreements. These are used by broker/dealers to, many times, overpay for goods or services that are provided to the broker/dealer by an affiliated party. The transactions can be used to disguise capital withdrawals from the broker/dealer. Capital withdrawals, for the most part, have to be reported to the SEC. And in many cases, FINRA and the SEC will actually limit capital withdrawals or require that we provide approval before the broker/dealer can withdraw capital.

Related party transactions can also be structured in an attempt to avoid the imposition of higher capital requirements. A lot of people don't understand that the capital rule is not static. The capital rule imposes requirements based on the activity that a broker/dealer is actually engaged in, so there are times when arrangements are entered into so that a broker/dealer with a lower capital requirement will not be subject to, so that the regulators won't know really that their activity should require the imposition of a higher standard.

Related party transactions also can be structured in an attempt to avoid various capital charges. That means that the broker/dealers' financial statements may look better than they actually are. This is usually done via parking securities with an affiliated entity.

There are two more scenarios that I'd like to mention briefly. One has to do with a broker/dealer structuring their business model to look smaller than it is. In this way, FINRA may not know the true extent of the firm's operations, which means that firm is more than likely to be on a more extended examination cycle than if we were fully aware of all of its operations.

Also, often our members operate pursuant to a membership agreement. This is a permission slip, if you will, where FINRA and the broker/dealer kind of, FINRA approves and the broker/dealer agrees to operate within certain constructs. When a broker/dealer's business is larger than it is and when we don't realize that because of related party transactions, that means the broker/dealer may be failing to apply to us for the expanded business model and we may not be able to conduct our due diligence with respect to the proposed activities and whether or not we would actually approve them.

And, finally, to the extent that related party transactions are used to put a customer's assets in inappropriate locations, locations that are not approved pursuant to the SEC's Customer Protection Rule, then those assets may be at risk.

I wanted to mention just briefly how we see related party transactions. Again, there are other examples that I won't go into over time. I will say that the common theme is that the related party transactions that I've talked about today are noted across broker/dealers of size and business model.

One final point just to make in terms of the statistics. I think we tend to think of broker/dealers as either clearing and carrying firms, those that settle trades and hold custody, or the introducing firms that act as agent and execute those trades. Somewhere between, I don't have exact numbers with me today, but probably somewhere between one out of eight I'm going to just say for now operate businesses that are totally unrelated to either the clearing and carrying firm or the introducing firm model, and the preponderance of those other firms are engaged almost exclusively in the sale of unregistered securities.

So, consequently, I think these proposals are very important. The audits, again, are important tools to FINRA. We use them. And I think most importantly, they're important tools to investors who can go into the SEC's website and look at the audited statement of financial condition of broker/dealers. So thank you.

MR. SCATES: Thank you, Susan. Thank you for those comments. Joe Carcello?

MR. CARCELLO: Thanks, Greg. I really liked your proposed rule, and I just want to make a few comments. These are relatively granular comments. On page A4-15, you ask if there are 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 an RPT is a fraud risk. I didn't see, Greg, where there had been any discussion, and maybe I missed it, but transactions at year-end, transactions that help the entity hit an earnings target, particularly if it's processed outside normal processing channels. So you might want to consider that.

Also on page A4-15, you reference footnote six of AU Section 334.09, and I'm quoting, "Until the auditor understands the business sense of material transactions, he cannot complete his audit," and my question is has this language been removed from the proposed standard? I didn't see it if it was still there. This is strong language and language that affects people's behavior, so I would consider adding it back.

On page A4-34, you talk about performing journal entry testing, including inquiring of individuals involved in the financial reporting process, about inappropriate or unusual activity related to the processing of journal entries. And that's fine, but what about testing for topside adjustments, adjustments that bypass the general ledger and, hence, require no entry, no journal entry and go directly to the trial balance or the financial statements? I didn't see any discussion of that.

And then the last thing is on page A4-43. You talk about the auditor could take into account other available audit evidence, such as disclosures and SEC filings that describe the company's compensation policies and practices that present material risks to the company and disclose fees paid to compensation consultants in certain circumstances. So my reaction to that is why could and not should since these SEC disclosures are supposed to address how compensation plans might increase risk? It's just hard for me to understand why the auditor would not just automatically look at that.

MR. SCATES: Joe, just a follow-up on one of the items there. On the journal entry testing, do you think the journal entry testing is sufficient that we have already in 316, or do you think we should consider taking another look at that?

MR. CARCELLO: Greg, I didn't re-read 316 as I was reading this, so I'd have to look at 316.

MR. SCATES: Okay. That's fine. Okay. Roman Weil?

MR. WEIL: Here I don't have anything to add except seeking clarity. I figure if I don't understand something there might be somebody else who doesn't, as well. So this is a really dense document, and the way I think about this is like a taxonomy of three things. One, what is a related party transaction? I don't think there's an attempt here to redefine what that is. Number two, how do we spot them? And, number three, once we've spotted one, is it a risk? What should we do about it?

Now, the way I read this document, and this is where I want clarification if I’m wrong, this is mostly about number three. They're not new definitions and no new attempts to figure out where management is hiding them. That's like finding the side letters. If you can figure out how to find them when they're trying to hide them, then we ought to be writing a side letter revenue recognition fraud one, too.

So if it is just about number three, I'd just like you to somehow for this document to make clear that that's what it's about. I think that's what I get out of it. Not a new definition, not new help in finding them, but once you've found them how to evaluate them; is that right?

MR. SCATES: Well, the related parties themselves are defined by the applicable framework. Related parties are defined in IFRS, as well as in US GAAP. The standard itself indicates what the auditor should do in order to identify related parties and transactions or relationships with those related parties, and then once they're aware, which management, when they inquire of management, management should obviously inform the auditor of all the related parties and the transactions they have with those related parties, and then the auditor is required then to audit those transactions that are required to be disclosed in the financial statements or they are a significant risk. And so those procedures are outlined in the standard.

But in addition, the auditor, though, is required to, if they become aware of any transactions, any related parties or transactions or relationships with related parties that were not disclosed to the auditor, then the auditor has an additional responsibility to then audit those particular items. And then, of course, it's a huge red flag, and then they need to bring that to the attention of the audit committee. So the standard is about identifying and evaluating those transactions with related parties.

MR. BAUMANN: Greg, to Roman's question, the standard does go further, this proposed standard goes further than 334 in connection with your number two. Number two was largely in 334, I don't want to say exactly, but it was inquire of management about related parties and obtain a list from management of related parties primarily. This still acknowledges to do that step, but it tells the auditor to do more and it spells out a number of other sources where the auditor might find indications that there are related parties that were previously unidentified. So it does attempt to do more with respect to the second point you made about how to spot those related parties that were not previously identified to the auditor.

MR. SCATES: Lynn Turner?

MR. TURNER: Marty, just back to the comment you just made and maybe I had, as I went through it, I had some of the same thoughts as Roman did. But when I went through, for example, in paragraph four up-front where it talks about identifying related party transactions, and I started looking through it and noticed, chewing on through four, five, six, it's got the auditor should inquire in paragraph six, paragraph seven the auditor should inquire. I got to paragraph eight, the auditor should inquire. And I started to get this feeling that this was an audit by inquiry, and if people are doing bad things with related party, because there are legitimate related party transactions and there are illegitimate related party transactions.

But when there's been a problem inquiry has turned out to be a woefully, if not totally, ineffective procedure. And so I think you've got to come back in and do something other than inquiry. I agree with you this an improvement over 334. I think this is headed in the right direction. But to Joe's point, for example, related party transactions have shown up in quarterly or year-end closing entries and were done to make the earnings, and we created the related party just to do that. It seems to me you've got to, part of this has got to be, you've got to do more than just ask people about it. You've got to look at those transactions, you've got to look for transactions in the general ledger that may raise questions about things, you need to look at transaction where there's no fee, which would raise the question why are you doing this for free, those type of things.

So I think you've got to go beyond the inquiry, and maybe I just didn't study it enough before, but I came back away from reading that section that this is going to be an audit by inquiry. And in this area, that's never proved to solve the problem.

MR. SCATES: Lynn, I agree with your point about the inquiry. But in the standard itself, though, particularly paragraph 11, refers the auditor to the appendix, to the standards at Appendix A where the auditor is cognizant or should be cognizant of the information coming to his or her attention, sources of information throughout the audit. And once that information comes to the auditor's attention, the auditor cannot just sit on it. The auditor then has to react to that information when it indicates that there are transactions with these type of parties.

MR. TURNER: I think that's a fundamental problem where we're finding problems with audits. And back to the point that Brian has made at times, how that we don't necessarily agree on it all the time, when you look at these that have popped up, auditors missed it because the information didn't come to their attention. In audits today, all too often we get a set of numbers and we go audit those numbers and we audit for information to support those numbers. What the Muddy Waters and hedge funds and research firms are doing is going beyond that and looking for information that says those numbers may be wrong, and fundamentally, we don't do that in an audit. I think we should. I think just doing an audit tells you you should do that. You can't just look for supporting, you've got to look for contrary type information. And certainly that's true with respect to related parties, and I think, unless you tell the auditors you've got to go look for information that may be available on a public domain that you haven't been provided that may raise questions with related parties, then you're not done yet. And I think that's the piece that's seriously missing here.

Now, I'll go back through it and maybe I misread, you know. Maybe it's better than what I think. But I think that's the piece that's missing here, and until you put that piece in you'll never solve the problem with related parties, to Brian's point, and it won't get you there. I think you ought to go back and look at some examples where we had serious related parties, be it Enron or, you know, who's a classic case, or some of the others, and see if this would have actually been using these procedures that would have turned around and should have resulted in the auditor detecting the issue. And I just don't know that it does at this point in time.

MR. BAUMANN: Lynn, those are really valuable comments. I mean, one of the very important things we struggled with in this proposal and, clearly, as you said, it does go further than existing 334, and paragraph 11 tells the auditor to, aside from the additional inquiries, tells the auditor to evaluate information that comes to their attention as part of the audit and directs them to Appendix A, which is a whole long list there.

But having said all of that, your reading of it, you're saying is that enough and should the auditor do even more to identify undisclosed related party transactions? And that's an important comment for us to take back and consider and think about are there other ways that the auditor should go about doing that. And, again, we thought about that and we thought about how far do we want to have an auditor go and what's the appropriate extent of those procedures of digging a needle in a haystack kind of thing but performing more procedures.

So I think your comment is I think right on point with one of the critical issues of this standard, and that is how deep should we make the procedures, to what Roman brought up, and you're bringing up identifying undisclosed related parties.

MR. TURNER: Don't get me wrong because I think you've got a very good start here, Marty, and I think it is a good improvement. I'm still not convinced, to Brian's point, though, that it's actually going to solve the problem, and I think that's really what you want to do at the end of the day is make sure you solve the problem with this standard and we aren't back here in ten years at the table.

But I think the other piece of that that I go with is as the information comes to you and you start to see more and more question marks, I think I'd make it very clear you've got to go further because we've always held in the auditing profession that we're not responsible for and we don't have to go audit the related party. And in court cases, the firms have always argued that under 334, you know, you make sure the disclosure is okay, but you don't have to go audit the related party. I would tell you that's, you know, as you dig down and you find more and more trouble, that you need to make it clear then to the auditor that mere disclosure doesn't resolve the issue, that if, in fact, as you dig down, you start to find more information that raises a question about the business nature of the transaction or the purpose or why we're doing this that you may have to go further and it could ultimately, if it's really an ugly thing, you may actually have to go down to where you actually audit down to the related party. I think that wouldn't be the case in most cases, but certainly one could argue that in the Enron case perhaps the auditors, the standards should have said if it's that type of situation and that bad you need to go audit the Raptors. And unless you can audit and get your hands around what was going on with the Raptors, you couldn't issue an opinion on Enron.

And so I think it’s not only do you have to look at information that might not have come to your attention, you have to make a positive search for information on related parties. But then also, as you dig down and it becomes more and more questionable, then you've got to keep digging down, and disclosure alone won't solve that problem.

MR. BAUMANN: Again, sorry, Greg, but I think you've gone to the heart of the key question in this proposal, and that is have we gone far enough? And you're suggesting think about going further and how to do that. So thanks for those comments.

MR. SCATES: One thing I would add, Lynn, to the comment about the disclosure, you're right with respect to the existing standard today. But under this new proposal, when there is a disclosure of related party transactions, it's mandatory, that's going to have to be audited today. That transaction is going to have to be audited, and the auditor is going to have to understand the business rationale behind the transaction and read the arrangements or contracts in place with respect to those transactions. So that one, I think we took care of that area with respect to the disclosure. It's now going to be audited, all that information, and supported with the relevant audit evidence.

MR. DEGANO: One other thing to consider is that the additional procedures that are being proposed for significant unusual transactions would also be helpful in identifying previously undisclosed related parties. Significant unusual transactions could end up being an undisclosed related party transaction, so by improving the auditor's identification of significant unusual transactions and their evaluation of the business purpose of those transactions, that could also help to inform the auditor's consideration of whether there's previously undisclosed related parties.

In the evaluation section, like Greg was mentioning, the auditor is going to be asked to look at each related party transaction or type of transaction that requires disclosures. And part of the proposed standard reminds the auditor that they should be performing other procedures, as appropriate, depending on the nature of the related party transaction and the related risk of material misstatement to meet the objective of the standard. And in the release, in the appendix, which goes into more detail, it gives examples of additional procedures which might be necessary that the auditor could consider. And one of those would be performing other procedures at the related party, if possible.

So the release gives more information to the auditor about what they might do, depending on the nature of the risks that they're seeing, and tries to put them in a better position to think about what they might need to do to meet the objective of the standard.

MR. SCATES: Okay. We have some more tent cards up. Jeff Mahoney?

MR. MAHONEY: Thank you. I'll be brief. The Council did submit a letter in response. I hope you received it. I hope I hit the right button when I sent it. We focused on your proposed enhancements to Auditing Standard 12, and we support those. Executive compensation is obviously a key element of corporate governance. And when it's poorly structured, it can result in a number of risks, as was evidenced in the financial crisis. So certainly it makes sense to us that looking at executive compensation can help an auditor assess a risk of material misstatement, as well as fraud risk.

With respect to Jamie's earlier comment about clarification, I don't have any objection to that. I understood it when I read it, but maybe others didn't. But my experience from reading a lot of comment letters in my prior job led me to conclude that, in some cases, commentators don't read the proposal, and maybe that's the case here. So when you clarify, you have to take into account the fact that some commentators don't read.

MR. SCATES: Scott Showalter?

MR. SHOWALTER: Thanks. Hopefully I read. So your question, two, Greg, asked about the objective stated in the standard. By the way, I think that's great. I would encourage you to do that. I think it helps the auditors, as they go in the standard, to understand why they're there. And my comment is going to actually going to tie back to what Lynn just talked about and that this is a chance to educate a little bit along the way to the practitioner as they read this. And if you read this, you could do what Lynn just said. You could stop by identifying accounting for and disclosing without going to that next step that we had that conversation was how are you going to extend your audit procedures because of what you found?

So if you just read that the way you said it, I could stop with disclosure. So I would encourage you to think about adding on to that sentence a little bit about any other impact it may have on the remaining audit procedures because you reference it all through the document, so it's there in the footnotes. But this is a chance for you to kind of communicate it right up-front. And, again, it's tying back into Lynn's comment, but I liked the objective.

MR. SCATES: Thank you, Scott. I appreciate that comment. Denny Beresford?

MR. BERESFORD: It's certainly appropriate to ask whether this has gone far enough. It's also, I think, appropriate to ask whether it's gone too far in certain respects. As Roman pointed out, this is a pretty complicated document, and the inspection group will be following up with accounting firms to challenge aspects of it.

From an audit committee perspective, I'm a little concerned about two aspects. One of them is the paragraph 10A of the proposed amendments to Auditing Standard Number 12, which would require the auditor to obtain an understanding of the company's financial relationships and transactions with its executive officers, requiring reading of employment and compensation contracts, reading proxy statements and other relevant company filings, and then a related reference to officers' expense accounts. And as a general comment, I think that's all well and good. My concern is how much detail that involves. Certainly, audit committees often ask internal auditors and sometimes external auditors to take a look at officers' expense accounts, particularly if there's some issues, like the Best Buy situation recently. But as a general matter, these are not material to the overall financial statements. And I'm a little concerned, again, coupled with the inspection results, that if it results in lots of detailed procedures and if the outside auditors believe that they will be challenged if they don't go through and look at every employment contract and do a test of all of the officers' expense accounts they're going to be challenged that this is going to be busy work that's really not contributing to the representation or the fair presentation of the financial statements.

The other point I wanted to make is related to the report to the audit committee. Again, I think it's a question of keeping things in balance. Certainly, audit committees would like to know about things that haven't been brought to their attention previously, unusual things and so forth. And I recognize that the wording of the document is emphasizing those, but it starts off by talking about reporting about the procedures that have been followed and so forth, and I think it's very important, Marty, to emphasize that we're talking about exception reporting there. As I indicated in my comments about the auditors' report to the audit committee, I am very concerned and I know a lot of the letters were concerned about that becoming more and more boilerplate, that, as we have a checklist of 27 or 37 or 370 items that have to be reported to audit committees, it loses its meaningfulness and the communications just don't become really that communicative I guess is the best way of putting it. And this is just one more item that possibly could have caused the trees to lose the focus of the forest.

MR. SCATES: Denny, one comment I'd like to make. With respect to the, you mentioned about the officers and reading the contracts and reviewing the proxy information statement and reviewing the expense accounts. Remember, this proposal, though, is confined, though, only to the executive officers. So this is a much smaller population than in a lot of the issuers today.

I'll give you an example. If you look at, like if you look at GE's 10-k, they have ten executive officers. Xerox has nine. So, I mean, it's a very small population, so it's not like the auditor is going to be required to do an enormous amount of work in this area. The population is well defined, and it's a pretty small population. So I don't think we're really going out on a limb here requiring the auditor to do an extra amount of work here in this area because the population, like I said, is well defined and it's a relatively small population and number of people in these companies.

And the next one, Gail Hanson?

MS. HANSON: I'd just like to point out in your paper you talk about looking at the procedures and seeing if the related party transactions are consistent with the procedures and their approval levels. I would suggest that a good audit would be to go look at the internal controls over related party transactions. I would presume in a number of these cases where there have been issues, that controls were not adequate, so there weren't written procedures, it wasn't taken to the audit committee or to a committee of the board to vet. I know in certain cases they were, but that would be a good place to start.

MR. SCATES: Thank you, Gail. And Steve Rafferty?

MR. RAFFERTY: Maybe to Lynn's point, I would perhaps suggest, before you get too far into what procedures you might want to add to identify related parties, you go back to the source of this issue and ask yourself what was the primary problem? Is it identifying the related parties, or is it how do you deal with them once you identify them? And my experience in my own career has been the more difficult issue is do you deal with them correctly once you identify them. I know there are probably circumstances where auditors fail to identify the related parties, but there's no end to the things you could do to go on a witch hunt and look for those, as well, and you have to find an appropriate balance here.

My take was that, you know, this was, in general, this is an important issue for the PCAOB to address, and I personally thought it was pretty well done.

MR. SCATES: Thank you, Steve. And you are right, we're trying to find the right balance here, as we are obviously with a lot of our standards because you don't want anyone going on some wild fishing expedition. Arnie Hanish?

MR. HANISH: Greg, I think you're trying to achieve the right balance. But to maybe build upon Denny's point, while it may be a small population, I think in our case it might be about 12 or 13 executive officers, maybe 14, I don't know, but every little bit of incremental work adds up and you still have to focus on, in my view, the material issues, the material risk. And so I'd just, I don't personally want you to dismiss what Denny was trying to communicate because I think what we hear all the time from our auditors, when you try to push back on certain things, well, it's not material or it's not a lot of work, it's not a lot of incremental work, but it all adds up when you're really trying to focus on things that create a material misstatement or create awareness where there could be a material misstatement. And maybe there's other procedures or processes, as opposed to trying to insist that -- and if you're insisting that they look at all these documents for all the executive officers, I mean, I could see a junior auditor or a senior auditor spending however many hours. And then you've got your manager that has to review it and your senior manager that has to review it, your partner that has to review the documents. You add all those incremental hours up for documentation purposes to meet your inspection requirements, you're talking about potentially a lot of hours.

MR. SCATES: Thanks, Arnie. And we do take those comments and Denny's very seriously, and we're going to look and see what comments come in on this area and see if we need to have some further clarification or further amendments to this particular area. Walter Ricciardi?

MR. RICCIARDI: Thanks. I notice that if management makes representations that the terms are consistent with arms length then there is a requirement to see if that's justified. If there is no such representation, is there any suggestion that the auditor should still look at whether it appears to be consistent with arms length?

The reason why I ask is, in my experience, a number of times the problem was you found related party and the auditors took that statement in the current literature, I think it's consistent with current literature, to mean, well, not my job to look at whether a price is right or not. But, often, it's the mismatching the price which is used to hide a fraud, so it's something to consider.

MR. SCATES: Well, under the proposal, the auditor must have sufficient appropriate audit evidence to support an assertion, if management is going to make an assertion, that the transactions were at arms length or similar to an arms length transaction. Then the auditor has to obtain that evidence to support that assertion.

MR. RICCIARDI: But what I've seen is management carefully does not make such a representation, and then the auditor then feels like, well, they haven't made a representation that it's equivalent to arms length, so I don't need to even look at whether it was or not. For example, one where two related companies, one was non-profit and one was profitable, and the rates are regulated at the non-profit and they were selling things to the non-profit and jacking up the price, and it was sucking money out of the non-profit to avoid the regulatory issue on the pricing is a big fraud, and the auditors just felt, well, they disclosed, I don't need to look at whether prices are reasonable, and they were pointing to that language. And had there been some suggestion that maybe, in determining whether there's earmarks of fraud, one thing to look at may be whether the price appears to be -- and, often, that's very difficult to assess, but one thing to look at is perhaps the price is not arms length and that's evidence that could be indicative of impropriety.

MR. SCATES: No, I agree. I appreciate what you're saying, Walter, because the auditor, at the end of the day, when you've got a transaction like you described, has to understand the business rationale, and that business rationale has to go to the elements of the transaction and it has to be, you know, was it at a reasonable price between the parties? And if not, then you need to dig deeper, the auditor should be digging deeper and has to because they've got to, at the end of the day, understand and be able to be satisfied that it was a transaction and it makes business sense to the parties that are involved in the transaction. And that's in the proposal today.

MR. BAUMANN: I think it's another good point to take another look at in terms of addressing, you know, have we appropriately advised the auditor that even if management isn't making such an assertion about the importance of understanding the transaction, whatever the pricing might be, understand it anyway and what the impact of that might be on the financial statement. So your point is well made, and we'll think about that.

MR. SCATES: Thank you, Walter. Jay Hanson?

MR. HANSON: I just wanted to, further to Walter's comments, which I think are good, the other thing to mention is, Greg, you mentioned that part of the requirement is understand the business purpose of the transaction, but another part is understanding why the transaction was entered into with a related party. And so I guess, thinking about that one broadly, I would hope that considerations about under- or over-market pricing would come into that if the auditor was trying to pull that thread about why, why, why did you do this with a related party? But your points are well taken.

MR. SCATES: Thanks, Jay. Lisa Lindsley?

MS. LINDSLEY: Thank you. We are finalizing our comment letter, so we'll be submitting it shortly. And, you know, we're very pleased that the PCAOB has taken up the issue of understanding the relationship between executive compensation and risk of misstatement, and there are a number of academic studies supporting this.

We also don't think that it will add to the cost of an audit because, as you know I'm not an auditor, but I understand that Auditing Standard Number 12 requires or provides that an auditor will "obtain an understanding of compensation arrangements with senior management, including incentive compensation arrangements and other aspects of compensation." So it seems like the proposal just clarifies and makes more specific the understanding that the auditor will have.

MR. SCATES: Thank you, Lisa. Jerry De St. Paer?

MR. DE ST. PAER: Thank you. I just wanted to take the point that you've given that you're only dealing with executive officers, and I think, consistent with the point that Lisa just made, having been a chief financial officer of a public company for a long time, my own view always was that it was prudent to, in fact, to review the expense account on an annual basis of those people, including myself at that time, because even whether or not it demonstrated a possible risk, it demonstrates that there's no independence problem, that the views of the executive officers of the company are, indeed, you can see the compensation and you can understand the risk factors that are embedded in that.

What I want to give is an example that, hopefully, would lead you to think that maybe there should be some additional wording. I want to go to AIG. I think what I'm going to say is a matter of the public record. There were two very significant compensation structures at AIG before the company encountered its difficulty. One was the Financial Products Group, and the other was the Aircraft Leasing Company. In both of those cases, the individuals in question were receiving annual compensation in excess of $100 million. That should be a number, even in the size of the numbers of AIG, that would attract some attention.

In the one case of the Aircraft Leasing Company, that was because the company was hugely successful, had a dominant position. They were not taking unusual risks, but, in fact, when somebody is making $100 million it's probably worthwhile to at least take a review to understand that there is not some untoward risk involved. And I believe that it would have been fairly quick to determine that wasn't the case.

In the other case, in Financial Products, that's also a matter of public record, and, indeed, it was indicative that there was an incentive that, if one had dug just a little bit deeper into what that was leading to do to put volume on the books, it might well have created the opportunity to understand the concentration of risk that was being created as a result in part of that compensation structure. They were incented to put that business on the books.

So I just want to flag that just the executive officers are not the only place. In a very, very large company, there are often many people below the executive officers who make more than the executive officers and have production-related compensation structures that could well indicate risk.

So I laud you in response to Denny's comment about let's not make sure this doesn't go too far. I think your idea of restricting it to executive officers is very good. But I would suggest that there should be some judgment aspect applied, especially if when in a company you can have a couple of people making $100 million a year. Maybe somebody ought to understand what the risks could be contingent with that compensation structure.

MR. SCATES: Thank you, Jerry. There were other tent cards up. Joe, did you want -- okay. Any other comments? If not, just a reminder that our comment period is coming up. We extended it to May 31, and we're looking forward to getting the comment letters in as we move forward on this project.