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PROPOSED AUDITING STANDARD – RELATED PARTIES PROPOSED AMENDMENTS TO CERTAIN PCAOB AUDITING STANDARDS REGARDING SIGNIFICANT UNUSUAL TRANSACTIONS AND OTHER PROPOSED AMENDMENTS TO PCAOB AUDITING STANDARDS	PCAOB Release No. 2013-004 May 7, 2013 PCAOB Rulemaking Docket Matter No. 038

Summary: The Public Company Accounting Oversight Board is reproposing: (i) an auditing standard, *Related Parties*; (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions; and (iii) other amendments to PCAOB auditing standards. The proposed auditing standard would supersede the Board's auditing standard AU sec. 334, *Related Parties*.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 038 in the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on July 8, 2013.

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I. Introduction

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is reproposing a new auditing standard, *Related Parties* (the "reproposed standard");

amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "reproposed amendments regarding significant unusual transactions"); and other amendments to PCAOB auditing standards (the "other reproposed amendments").[1/] The reproposed standard would supersede the Board's existing auditing standard on related parties, AU sec. 334, *Related Parties* (the "existing standard").

Related party transactions have been contributing factors in numerous prominent financial reporting frauds over the last few decades.[2/] Financial reporting frauds also have involved significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature ("significant unusual transactions"); and a company's financial relationships and transactions with its executive officers. Corporate scandals involving these areas, such as financial reporting frauds at Enron Corporation, Tyco International, Ltd., Refco, Inc., and WorldCom, Inc., undermined investor confidence, resulted in significant losses for investors, as well as the loss of many jobs for employees. These critical areas have continued to be a contributing factor in more recent cases.[3/] The reproposed standard and amendments would update and strengthen auditor performance requirements in these critical areas, which could pose significant risks of material misstatement in company financial statements. The critical areas addressed by the reproposed standard and amendments include:

[1/] The reproposed amendments regarding significant unusual transactions and the other reproposed amendments are collectively referred to in this release as the "reproposed amendments." In addition, all the Board's reproposals contained in this release may be referred to globally as the "reproposed standard and amendments" or as the Board's "reproposal."

[2/] *See Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2012-001 (Feb. 28, 2012), (the "proposing release"), available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx for a discussion of these financial reporting frauds.

[3/] *See e.g.,* Securities and Exchange Commission ("SEC") v. Keyuan Petrochemicals, Inc. and Aichun Li, SEC Accounting and Auditing Enforcement Release ("AAER") No. 3447 (Feb. 28, 2013), and SEC v. China Natural Gas, Inc. and Qinan Ji, AAER No. 3385 (May 14, 2012).

Relationships and Transactions with Related Parties: Relationships and transactions with related parties can pose increased risks of material misstatement, as their substance might differ materially from their form. Related party transactions also may involve difficult measurement and recognition issues that can lead to errors in financial statements. Moreover, in some instances, related party transactions have been used to engage in fraudulent financial reporting and to conceal misappropriation of assets – misstatements that are relevant to the auditor's consideration of fraud.[4/] The importance to investors of auditing related party transactions is recognized by Section 10A of the Securities and Exchange Act of 1934 ("Exchange Act"), which requires each audit of financial statements of an issuer to include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."[5/]

The reproposed standard would strengthen existing audit performance requirements by setting forth new, specific audit procedures that would include: (i) obtaining an understanding of the company's relationships and transactions with its related parties; (ii) performing specific procedures for related party transactions that require disclosure in the financial statements or that are determined to be a significant risk; (iii) evaluating whether the company has properly identified its related parties and relationships and transactions with related parties; and (iv) communicating with the audit committee. The reproposed standard would supersede the existing auditing standard, AU sec. 334.

[4/] *See* paragraph .06 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, which states that two types of misstatements are relevant to the auditor's consideration of fraud – misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. Misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the financial statements not to be presented, in all material respects, in conformity with generally accepted accounting principles ("GAAP"). Misstatements arising from misappropriation of assets (sometimes referred to as theft or defalcation) involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented, in all material respects, in conformity with GAAP.

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

Significant Unusual Transactions: A company's significant unusual transactions can create complex accounting and financial statement disclosure issues posing increased risks of material misstatement. In some instances, significant unusual transactions have been used to engage in fraudulent financial reporting. For example, significant unusual transactions, especially those close to period end that pose difficult "substance-over-form" questions, may have been entered into to obscure a company's financial position or operating results.[6/] In such cases, management may place more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction. Existing auditing standards relating to significant unusual transactions are principally contained in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.* The reproposed amendments regarding significant unusual transactions are designed to focus the auditor's identification and evaluation of a company's significant unusual transactions, and, among other things, enhance the auditor's evaluation of (i) whether such transactions have been appropriately accounted for and adequately disclosed in company financial statements; and (ii) whether the lack of a business purpose indicates that they may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

Financial Relationships and Transactions with Executive Officers: A company's executive officers are in a unique position to influence a company's accounting and disclosures. A company's financial relationships and transactions with its executive officers (as one example, executive compensation) can create incentives and pressures for executive officers to meet financial targets, which can result in risks of material misstatement to a company's financial statements. Other reproposed amendments would modify Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* to require the auditor to perform specific procedures to obtain an understanding of the potential risks of material misstatement posed by incentives and pressures arising from a company's financial relationships and transactions with its executive officers. For issuers, the term "executive officer" is the definition contained in Rule 3b-7 under the Exchange Act, while for brokers and dealers, the term "executive officer" is based on a list in Schedule A of Form BD (as required by Item 2(a) of the schedule). In response to comments, the reproposed amendments have been revised to clarify that the auditor's procedures in this area would be performed as part of the auditor's risk assessment process[7/] and would not require the auditor to make any

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[6/] *See, e.g., In the Matter of Dynegy Inc.*, AAER No. 1631 (Sept. 24, 2002), and *In the Matter of Michael Lowther*, *CPA* AAER No. 2775 (Jan. 28, 2008).

[7/] In 2010, the Board adopted Auditing Standards Nos. 8-15 on assessing and responding to risk in an audit (the "risk assessment standards"), which cover the entire audit process, from initial planning activities to evaluating audit evidence to

determination regarding the reasonableness of compensation arrangements or recommendations regarding compensation arrangements.

The Board notes that the existing auditing requirements that address these critical areas warrant updating. Since the issuance of the existing standard, AU sec. 334, significant financial reporting frauds involving related party transactions have occurred.[8/] The need to update AU sec. 334 has been supported by a number of prominent studies, including one produced by the auditing profession.[9/] Moreover, the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the AICPA ("ASB") revised their auditing standards on related parties in 2008 and 2011, respectively. In addition, AU sec. 334 does not reflect the enactment in 2010 of the risk assessment standards, which provide an overall

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forming the opinion to be expressed in the auditor's report. *See Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release No. 2010-004 (Aug. 5, 2010).

[8/] In 1983, AU sec. 334 replaced AU sec. 335, *Related Party Transactions,* which was issued in July 1975. AU sec. 334 removed guidance in AU sec. 335 relating to accounting considerations and disclosure standards for related parties (in response to the issuance of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*) and included other related technical changes. Thus, the nature and extent of the auditor's responsibilities and procedures pertaining to related parties reflected in AU sec. 334 have not changed since 1975.

[9/] *See* the Report of the Quality Control Inquiry Committee ("QCIC") of the AICPA's SEC Practice Section ("SECPS"), which analyzed more than 200 alleged audit failures from December 1997 to October 2002 and recommended that, among other things, "required audit procedures be broadened to help ensure the auditor gains a more complete understanding of related-party transactions, including the business aspects of the transactions." *See*, AICPA SEC Practice Section, Memo to Managing Partners of SECPS Member Firms, "Recommendations for the Profession Based on Lessons Learned from Litigation" (Oct. 2002). The QCIC report and other reports and studies supporting the need for improvements to existing auditing standards in these three critical areas are discussed in the proposing release. *See* PCAOB Release No. 2012-001.

framework for the auditor's assessment of and response to the risk of material misstatement.[10/]

The Board is proposing changes in these three critical areas contemporaneously because it believes that the auditor's efforts in these areas complement each other. For example, focusing the auditor's identification and evaluation of significant unusual transactions might assist the auditor in identifying related parties or relationships or transactions with related parties that management has not previously disclosed to the auditor. Similarly, performing procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers might provide the auditor with information that indicates the existence of related party relationships or transactions previously undisclosed to the auditor. Both the auditor and the investor benefit from a comprehensive and consistent examination of these areas, not only because of the risk of material misstatement due to fraud, but also because these transactions, due to their nature, pose a risk of material misstatement due to error.

The reproposed standard and amendments would update the Board's standards and focus the auditor's efforts on these critical areas that could pose significant risks of material misstatement to company financial statements. In the Board's view, this update is particularly appropriate due to the number and magnitude of financial reporting frauds, and resulting investor losses, associated with these areas.

II. Background and Considerations in Developing the Reproposed Auditing Standard and Amendments

On February 28, 2012,[11/] the Board proposed an auditing standard, *Related Parties* (the "proposed standard"), proposed amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "proposed amendments regarding significant unusual transactions"), and other proposed amendments to PCAOB auditing standards (the "other proposed amendments").[12/]

[10/] *See* PCAOB Release No. 2010-004.

[11/] *See* PCAOB Release No. 2012-001.

[12/] The proposed amendments regarding significant unusual transactions and the other proposed amendments are collectively referred to in this release as the "proposed amendments." In addition, the proposed standard and proposed amendments may be globally referred to as the "proposed standard and amendments" or as the Board's "proposal."

The Board's proposal reflected several years of careful consideration. For example, the issue of related parties was discussed with the Board's Standing Advisory Group ("SAG") on several occasions prior to the Board's decision to issue the proposed standard.[13/] The Board discussed with its SAG a variety of issues and alternative approaches relevant to developing the proposed standard and proposed amendments.

The Board developed its proposed standard and amendments after receiving input from its SAG and considering current audit requirements and developments, including the work of other standard setters and international developments.[14/] In addition, the Board took note of observations from the PCAOB's oversight activities, including that the facts underlying a significant number of the Board's settled disciplinary actions to date involved auditors' failures to perform sufficient procedures regarding related party transactions. These observations from the PCAOB's oversight activities primarily relate to audits of financial statements performed by triennially-inspected firms.[15/]

The Board's goal – both in developing its proposal as well as its reproposal – has been to develop an approach that promotes audit quality and investor protection, while at the same time considering economic considerations, including avoiding unnecessary costs and implementation issues. Before developing its proposal, the Board considered whether it could achieve sufficient improvements in audit quality through its inspection and enforcement programs without amending its standards and requirements.[16/]

[13/] The SAG discussed the topic of related parties at a number of its meetings prior to the issuance of the Board's proposal, including at meetings occurring on: October 14-15, 2009; June 21, 2007; and September 8-9, 2004. See the SAG meeting archive at http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx.

[14/] These matters are discussed in detail in Section III. of the proposing release. *See* PCAOB Release No. 2012-001.

[15/] *See, e.g., Report On 2007-2010 Inspections Of Domestic Firms That Audit 100 Or Fewer Public Companies* PCAOB Release No. 2013-001, (Feb. 25, 2013) at 29, available at: http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf.

[16/] For example, before deciding to issue its proposal, the Board issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010), available at http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf, which discusses a range of auditor practice issues identified by the PCAOB staff pertaining to significant unusual transactions.

However, the existing standards allow the auditor significant latitude in auditing these critical areas. Thus, since the nature and extent of audit procedures can vary widely, the Board concluded that new requirements were appropriate as these critical areas could pose significant risks of material misstatement. The Board also concluded that it was appropriate to propose a new auditing standard regarding related parties rather than to amend the existing standard because of, among other things, the nature and extent of changes necessary to align the existing standard with the risk assessment standards. On the other hand, the Board concluded that appropriate improvements in audit quality could be achieved by amending its existing requirements regarding significant unusual transactions as opposed to issuing a new separate standard.

As noted above, the Board issued the proposed standard and amendments for public comment on February 28, 2012.[17/] The Board received 37 comment letters on the proposal.[18/] In addition, the Board discussed the proposed standard and amendments with its SAG at a May 17, 2012 meeting.[19/] The comment period was extended to May 31, 2012 to allow commenters an opportunity to consider the SAG's discussion. Comments received from the SAG members were considered together with the comment letters received. The Board took all comments received (from both comment letters and the SAG discussion) into consideration in developing the reproposed standard and amendments.

In general, commenters were supportive of the Board's efforts to enhance the auditor's efforts regarding related party and significant unusual transactions and agreed that improvements to the auditing standards were appropriate at this time. While the proposed changes regarding financial relationships with a company's executive officers drew support from a range of commenters, some commenters raised concerns that performing such procedures could have unintended consequences, including impacting the design of compensation arrangements. Commenters also identified a number of areas in which the proposed standard and amendments could be clarified or improved.

[17/] *See* PCAOB Release No. 2012-001.

[18/] The comment letters are available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx.

[19/] The transcript of the SAG's discussion of the proposed standard and proposed amendments is available at http://pcaobus.org/Rules/Rulemaking/Docket038/2012-05-17_Transcript-Related_Parties.pdf.

In response, the Board has revised its proposal and is now seeking comment on a reproposed standard and amendments. Although the overall approach and many of the performance requirements remain the same in the reproposed standard and amendments, the Board is proposing certain changes to align more closely with the risk assessment standards and to respond to some commenters' suggestions. The Board is issuing the reproposed standard and amendments to provide an opportunity for commenters to provide input on the changes reflected in the reproposal.

The Board also is requesting comments on the potential economic implications of the reproposed standard and amendments. In addition, subsequent to the publication of the Board's proposal, the Jumpstart Our Business Startups Act ("JOBS Act") was enacted.[20/] The Board therefore is specifically requesting comments on considerations raised by the JOBS Act, including the application of the reproposed standard and amendments to audits of emerging growth companies ("EGCs").

Appendix 4 of this release describes the Board's consideration of significant comments received as well as changes reflected in the reproposed standard and amendments. Appendix 4 also contains questions for commenters related to specific aspects of the reproposed standard and amendments.

The Board's Approach for Promoting Audit Quality in These Critical Areas

In developing its approach to promote audit quality, the Board made a number of key decisions to make its auditing standards in these critical areas more effective. The Board also was mindful of the need for standards that can be implemented efficiently. The following discussion summarizes the Board's approach and highlights its considerations in the choices made and alternatives considered, both in crafting its proposal as well as its reproposal.

Overall Approach: The reproposed standard and amendments would establish new requirements designed to sharpen the auditor's focus on critical areas prone to material misstatements of the financial statements, including material misstatements associated with fraudulent financial reporting, with the goal of promoting the auditor's ability to identify, assess, and respond to such risks. Thus, the performance requirements could improve audit quality, help protect the interests of investors, and

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[20/] Pub. L. No. 112-106 (April 5, 2012). *See* Section 103(a)(3)(C) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. §7213(a)(3)), as added by Section 104 of the JOBS Act.

further the public interest in the preparation of informative, accurate, and independent audit reports.

Opportunity for Scalability: The reproposed standard and amendments would establish basic required procedures that would be supplemented by more in-depth procedures, as needed, commensurate with the auditor's evaluation of the risks posed by the company's facts and circumstances. Relevant facts and circumstances include the nature, size, or complexity of the transaction and the related risk of material misstatement in the financial statements. This provides the opportunity for the auditor to scale the audit and focus his or her attention on the most critical aspects of the audit.

Alignment with the Risk Assessment Standards: The reproposed standard and amendments have been designed to align with and build upon the requirements in the risk assessment standards.[21/] The reproposed standard would require the auditor to perform specific risk assessment procedures to obtain an understanding of the company's relationships and transactions with its related parties. Performing these risk assessment procedures required by the reproposed standard in conjunction with the auditor's risk assessment procedures is intended to provide the auditor with a basis for identifying and assessing risks of material misstatement associated with related parties and related party transactions. This cohesive approach would provide opportunities to integrate audit effort, where appropriate, and, at the same time, position the auditor to identify areas in which there may be increased risks of material misstatement of financial statements posed by a company's related party relationships and transactions. Similarly, the reproposed amendments also would include amendments to the Board's existing standards intended to focus the auditor's attention, in a targeted way, on potential issues associated with a company's significant unusual transactions and its financial relationships and transactions with its executive officers as part of the auditor's risk assessment process.

Complementary Audit Areas: The reproposed standard and amendments are complementary and offer opportunities for efficient implementation as well as more effective audits. For example, obtaining an understanding of financial relationships and transactions with executive officers can help the auditor identify incentives and pressures that could cause management to use related party or significant unusual transactions to meet financial goals.

[21/] The risk assessment standards include a focus on the auditor's responsibilities to consider the risks of, and possibilities for, material misstatement, whether due to error or fraud, throughout the entire audit process. *See* PCAOB Release No. 2010-004.

Retaining Existing Concepts and Procedures: The reproposed standard and amendments would incorporate, and where appropriate, strengthen many of the audit procedures rooted in existing auditing standards and common in practice today. For example, the reproposed standard would include as new requirements certain procedures that are included in AU sec. 334 as procedures for the auditor to consider, such as obtaining an understanding of the business purpose of the transaction and reading the underlying documentation. This approach would permit auditors that have such procedures as part of their existing methodologies to build upon their existing knowledge and training. As a result, this approach could minimize their incremental costs of implementing the reproposed standard and amendments.

Improving the Auditor's Communication with the Audit Committee: The reproposed standard and amendments would establish new requirements relating to the auditor's communications with the company's audit committee regarding related parties. The communications requirements in the reproposed standard would work in concert with Auditing Standard No. 16, *Communications with Audit Committees,* to ensure that the auditor has a forum to discuss the auditor's evaluations regarding the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. In addition, the reproposed amendments regarding significant unusual transactions would complement the recently enacted auditor communication requirements regarding significant unusual transactions in Auditing Standard No. 16.

III. Overview of Reproposal and Improvements from Existing Standards

This section provides an overview of the reproposed standard and amendments, and key proposed improvements from existing standards. This section also summarizes certain changes from the proposed standard and amendments based upon comments received. Appendix 4 of this release contains a more detailed discussion of these matters.

Relationships and Transactions with Related Parties

Overview of the Reproposed Standard: The reproposed standard would strengthen existing auditing procedures associated with identifying, assessing, and responding to the risks of material misstatement associated with a company's relationships and transactions with its related parties. Among other things, the reproposed standard would require the auditor to:

- Perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties, including obtaining an understanding of the nature of the relationships between the company and its related parties and of the terms and business purposes (or the lack thereof) of

transactions involving related parties. The new procedures are intended to be performed in conjunction with the auditor's risk assessment procedures pursuant to Auditing Standard No. 12.

- Evaluate whether the company has properly identified its related parties and its relationships and transactions with related parties. In making that evaluation, the auditor should take into account information gathered during the audit. As part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. If the auditor identifies information that indicates that related parties or relationships or transactions with a related party previously undisclosed to the auditor might exist, the auditor would perform procedures necessary to determine whether undisclosed relationships or transactions with related parties, in fact, exist.

- Perform specific procedures if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists.

- Perform specific procedures regarding each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk. Focusing the auditor's attention on these transactions is intended to enhance the effectiveness of the auditor's evaluation of whether the company's related party transactions are properly accounted for and disclosed.

- Communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, and other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

The Existing Standard: As previously noted, the existing requirements for auditing relationships and transactions with related parties are contained primarily in AU sec. 334.

AU sec. 334 recognizes that the auditor performs procedures to identify and evaluate a company's relationships and transactions with its related parties as part of performing an audit of financial statements. In doing so, AU sec. 334 provides "guidance" and examples of procedures, for the auditor's consideration for identifying and evaluating related party transactions. Examples of procedures in AU sec. 334

include procedures to obtain information from management (such as obtaining the names of all related parties and inquiring whether there were any transactions with these parties during the period) as well procedures intended to assist the auditor in identifying related parties that have not been disclosed to the auditor by management (such as reviewing filings with the Securities and Exchange Commission ("SEC"), reviewing company accounting records and certain invoices, and making inquiries of other auditors). Notably, AU sec. 334 provides that the procedures set forth in AU sec. 334 should not be considered all-inclusive and that not all of them may be required in every audit. Further, AU sec. 334 states that, in the absence of evidence to the contrary, related party transactions should not be assumed to be outside the ordinary course of business.[22/] Finally, AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions.

Key Improvements from the Existing Standard: The reproposed standard retains certain concepts and procedures from AU sec. 334 that relate to identifying and evaluating related parties and related party transactions**.** However, the reproposed standard differs from AU sec. 334 in a number of key respects.

- *Enhanced Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties:* Unlike AU sec. 334 which includes limited direction for obtaining an understanding of the company's relationships and transactions with its related parties (e.g., AU sec. 334.05), the reproposed standard would require the performance of specific procedures in this area, including obtaining an understanding of the terms and business purposes (or the lack thereof) of related party transactions.

- *Alignment with the Risk Assessment Standards:* Since the adoption of AU sec. 334, the Board has adopted and amended several auditing standards, including its risk assessment standards. The reproposed standard would align with and build upon the risk assessment framework. This alignment could provide an opportunity for efficient implementation. For example, the auditor could perform the inquiries that would be required by the reproposed standard contemporaneously with inquiries required by the risk assessment standards.

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

- *Addition of Basic Requirements:* AU sec. 334 suggests procedures for the auditor's consideration, noting that the suggested procedures should not be considered all-inclusive and not all of them may be required in every audit. As noted above, the reproposed standard would require basic procedures for the auditor's assessment of and response to risks of material misstatement. The reproposed standard also would require more in-depth procedures commensurate with the auditor's assessment of the risks posed by the company's facts and circumstances.

- *Broader Focus on Accounting:* As noted above, AU sec. 334.02 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions. The reproposed standard would require that the auditor evaluate the accounting for and disclosure of related party transactions.

Key Changes from the Proposed Standard: The reproposed standard reflects clarifying changes and improvements in response to comments received. Some of the changes address the following:

- *Clarifying the Relationship between the Reproposed Standard and the Risk Assessment Standards:* In response to requests to clarify the relationship between the proposed standard and the risk assessment standards, the Board made several revisions to better integrate the proposed requirements with those standards. For example, the revisions would clarify, among other things, that the risk assessment procedures performed to obtain an understanding of the company's relationships and transactions with its related parties are performed in conjunction with the risk assessment procedures performed pursuant to Auditing Standard No. 12. In addition, the reproposed standard would add a number of references to other auditing standards that may be relevant to the auditor's consideration of related parties and related party transactions.

- *Responsibility of the Auditor to Evaluate the Company's Identification of Related Parties:* Some commenters suggested that the Board clarify the auditor's responsibility to perform procedures to identify the company's related parties. In response, the reproposed standard has been revised to focus more directly on a key aspect of the audit objective, that is, whether relationships and transactions with related parties have been properly identified by the company under audit.

  As reproposed, the standard would include a new requirement for the auditor to evaluate whether the company has properly identified its related parties.

Evaluating whether a company has properly identified its related parties involves more than assessing the process used by the company to identify its related parties. The new evaluation contained in the reproposed standard would require the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company. The reproposed standard would include focused audit procedures intended to support the auditor's required evaluation. Such steps, which closely mirror the auditor's risk assessment process, would include: (i) performing risk assessment procedures to obtain an understanding of the company's relationships and transactions with its related parties; (ii) identifying and assessing risks relating to a company's relationships and transactions with its related parties, including whether the company has properly identified its related parties; (iii) designing and performing audit procedures that address and respond to the risks of material misstatement associated with the company's related parties and transactions; and (iv) performing enhanced procedures that address related party relationships or transactions identified by the auditor that were previously undisclosed by company management.

In the Board's view, the clarifications in the reproposed standard represent a more effective audit approach that recognizes that the company is responsible for the preparation of its financial statements, including, in the first instance, the identification of the company's related parties, and that the auditor begins the audit with information obtained from the company.[23/]

- *Requests for Additional Auditor Judgment:* Several commenters suggested that the proposed standard allow more room for the use of auditor judgment.

[23/] To further assist the auditor's efforts in identifying related parties, the reproposed other amendments include a complementary provision that would expand existing management representations contained in AU sec. 333, *Management Representations,* to state that the company has provided the names of all related parties and all relationships and transactions with its related parties to the auditor. However, the auditor may not rely solely on management's representations. Representations from management are not a substitute for the application of those audit procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit. The auditor's new required evaluation should be supported by auditing procedures and evidence obtained from procedures designed to test the accuracy and completeness of the related parties and transactions disclosed by the company to the auditor.

In response, the Board has revised a number of the requirements, including: (i) clarifying that the auditor exercises discretion in making inquiries of certain individuals within the company regarding the company's relationships and transactions with its related parties and (ii) removing the requirement that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk.

The Board is seeking comment on whether the reproposed standard is appropriate, including proposed revisions that have been made, and has included specific questions for respondents at the end of Section I. of Appendix 4 to this release.

Significant Unusual Transactions

Overview of the Reproposed Amendments Regarding Significant Unusual Transactions: The reproposed amendments regarding significant unusual transactions would revise AU sec. 316 and other PCAOB auditing standards to strengthen the auditor's identification and evaluation of significant unusual transactions.

Among other things, the reproposed amendments regarding significant unusual transactions would:

- Require the auditor to perform procedures to identify significant unusual transactions;

- Require the auditor to perform procedures to obtain an understanding of, and evaluate, the business purpose (or the lack thereof) of identified significant unusual transactions; and

- Add factors for the auditor to consider in evaluating whether significant unusual transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

The reproposed amendments regarding significant unusual transactions would include substantive enhancements to AU sec. 316, as well as amendments to Auditing Standard Nos. 12 and 13. The reproposed amendments regarding significant unusual transactions also would include conforming changes to other Board auditing standards to provide for consistency in the use of the term "significant unusual transactions" throughout the Board's standards.

Existing Standards Regarding Significant Unusual Transactions: Existing auditing requirements regarding significant unusual transactions are principally contained in AU

sec. 316.[24/] Specifically, AU sec. 316.66 recognizes that during a financial statement audit, the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment. AU sec. 316.66 also requires that, if the auditor becomes aware of significant unusual transactions during the course of an audit, the auditor should gain an understanding of the business rationale of such transactions and evaluate whether that rationale (or the lack thereof) suggests that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.

In addition, the risk assessment standards also anticipate that the auditor will consider risks of material misstatement that are posed by significant unusual transactions. For example, one factor to be considered currently in the auditor's risk assessment is whether a risk involves a significant transaction outside the normal course of business for the company or otherwise appears to be unusual due to its timing, size, or nature.[25/]

Key Improvements from the Existing Standards: The reproposed amendments regarding significant unusual transactions constitute targeted changes to existing Board standards in a number of areas.

- *Descriptions of Significant Unusual Transactions:* The reproposed amendments regarding significant unusual transactions would amend paragraph 66 of AU sec. 316 to describe significant unusual transactions as significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature. The reproposed amendments regarding significant unusual transactions also would include conforming changes to introduce a uniform description of "significant unusual transaction" throughout the Board's standards.

- *Enhancing Requirements for Identifying Significant Unusual Transactions:* The reproposed amendments regarding significant unusual transactions would require the performance of specific procedures intended to improve the auditor's identification of significant unusual transactions, for example, by making inquiries of management and others.

[24/] *See* AU secs. 316.66-.67.

[25/] *See* paragraph 71.g. of Auditing Standard No. 12.

- *Enhancing Requirements for Evaluating Significant Unusual Transactions:* The reproposed amendments to AU secs. 316.66-.67A would include basic procedures, which may be expanded based upon the auditor's identification and assessment of the risks of material misstatement, for evaluating the business purpose (or the lack thereof) of significant unusual transactions.

  The basic procedures would include: (i) reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction; (ii) determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures; and (iii) evaluating the financial capability of the other parties with respect to significant uncollected balances, guarantees, and other obligations. Further, the reproposed amendments to AU secs. 316.66-.67 would enhance the auditor's evaluation of the business purpose of significant unusual transactions by, among other things, expanding the factors considered by the auditor in evaluating whether the business purpose (or the lack thereof) of significant unusual transactions indicates that such transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

- *Emphasizing Accounting and Disclosure:* The reproposed amendments to AU sec. 316.67 regarding significant unusual transactions would heighten the auditor's attention to accounting matters relative to significant unusual transactions by emphasizing that existing requirements include evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

Key Change from the Proposed Amendments Regarding Significant Unusual Transactions: The reproposed amendments regarding significant unusual transactions reflect certain changes made in response to comments received. The key change from the proposed amendments would enhance the linkage between the reproposed standard and the reproposed amendments in the area of significant unusual transactions. Specifically, the reproposed amendments regarding significant unusual transactions would add:

(i) a note to AU sec. 316.66 that would state that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions;

(ii) a note to the reproposed standard that would state that, for a related party transaction that is also a significant unusual transaction pursuant to AU secs. 316.66-.67A, the auditor should evaluate whether the business purpose (or the lack thereof) of the transaction indicates that the transaction was entered into to engage in fraudulent financial reporting or conceal asset misappropriation; and

(iii) a footnote to the reproposed standard that would state that information obtained from identifying and evaluating a company's significant unusual transactions (as well as from obtaining an understanding of a company's financial relationships and transactions with its executive officers) could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

The Board is seeking comment on whether the reproposed amendments regarding significant unusual transactions are appropriate, including proposed revisions that have been made, and has included specific questions for respondents at the end of Section II. of Appendix 4 to this release.

Financial Relationships and Transactions with Executive Officers

Overview of Other Reproposed Amendments: The other reproposed amendments provide for improved audit procedures in complementary areas, such as a company's financial relationships and transactions with its executive officers.[26/] The other reproposed amendments would require that the auditor perform procedures, as part of the auditor's risk assessment, to obtain an understanding of the company's financial relationships and transactions with its executive officers (including executive compensation arrangements). The other reproposed amendments would establish new procedures to heighten the auditor's attention to incentives or pressures for the

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

company to achieve a particular financial position or operating result, recognizing the key role that a company's executive officers may play in the company's accounting decisions or in a company's financial reporting. The other reproposed amendments would not require the auditor to assess the appropriateness or reasonableness of a company's compensation arrangements with its executive officers.

The Existing Standards and Key Improvements: The risk assessment standards require the auditor to consider obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses, as part of obtaining an understanding of the company.

The other reproposed amendments would strengthen existing requirements in the risk assessment standards by requiring the auditor, as part of the audit risk assessment process, to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers, a group that, because of their position in the company, can exert influence over the company's accounting and financial statement presentation.

Key Change from the Other Proposed Amendments: The other reproposed amendments relating to executive officers reflect certain changes made in response to comments received. The key change from the other proposed amendments would clarify that procedures regarding a company's financial relationships and transactions with its executive officers would be performed as part of the auditor's risk assessment process and would not require the auditor to make any determination regarding the appropriateness or reasonableness of a company's compensation arrangements with its executive officers or recommendations regarding such compensation arrangements.

The Board is seeking comment on whether the reproposed amendments regarding a company's financial relationships and transactions with its executive officers are appropriate, including proposed revisions that have been made, and has included specific questions for respondents at the end of Section III. of Appendix 4 to this release.

Other Reproposed Amendments to PCAOB Auditing Standards

In addition to the other reproposed amendments relating to financial relationships and transactions with executive officers, the other reproposed amendments would revise other auditing standards to conform them to the reproposed standard and amendments and, where appropriate, include new requirements that complement the reproposed standard and reproposed amendments regarding significant unusual transactions. For example, among other things, the other reproposed amendments

would require the auditor to obtain written representations from management (a) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor; and (b) if the company's financial statements include assertions that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction. In addition, the reproposed amendments also would include changes to management's written representations to provide that they have made available the names of all related parties and relationships and transactions with related parties. The other reproposed amendments are discussed in detail in Appendix 4 of this release.

The Board is seeking comment on whether the other reproposed amendments are appropriate, including proposed revisions that have been made, and has included specific questions for respondents at the end of Section III. of Appendix 4 to this release.

IV. Economic Considerations, Including Audits of Emerging Growth Companies

As described above, the reproposed standard and amendments are designed to address critical areas that warrant heightened scrutiny by auditors. As previously described, the Board's approach for promoting audit quality in these critical areas takes into account both the effectiveness of the auditing standards and the potential efficiency of implementation. Appendix 4 of this release provides additional discussion regarding the need for improvements to the existing standards, the Board's approach for promoting audit quality, and how the Board's approach reflects economic considerations. The discussion in Section IV. of Appendix 4 builds on the discussion of the reproposed standard and amendments in Sections I. through III. of Appendix 4 and seeks input on the potential economic implications of the reproposal.

Further, pursuant to Section 104 of the JOBS Act, any rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs (as defined in Section 3(a)(80) of the Exchange Act) unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[27/]

The reproposed standard and amendments are being issued by the Board for public comment, in part, to solicit views of commenters on the application of the

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[27/] *See* Section 103(a)(3)(a) of the Sarbanes-Oxley Act of 2002.

reproposed standard and amendments to audits of EGCs. The Board specifically requests comments, including empirical data, regarding (1) whether the application of the reproposed standard and amendments to audits of EGCs would promote efficiency, competition, and capital formation and (2) whether there are unforeseen consequences of the reproposed standard and amendments of which the Board should be aware. The Board also requests comments, including empirical data, regarding incremental costs that may be imposed by the reproposed standard and amendments, and in particular, their application to audits of EGCs.

Section IV. of Appendix 4 contains specific questions for commenters regarding economic considerations more generally, as well as questions regarding the application of the reproposed standard and amendments to audits of EGCs.

V. Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[28/] gave the Board explicit oversight authority over audits of brokers and dealers that are required under SEC rules. In light of the authority granted to the Board by the Dodd-Frank Act to establish standards governing audit reports to be included in broker-dealer filings with the Commission, the Commission issued transitional interpretive guidance in September 2010 to clarify that references in Commission rules, staff guidance, and in the federal securities laws to generally accepted auditing standards ("GAAS"), which are established by the ASB, or to specific standards under GAAS, as they relate to non-issuer brokers or dealers, should continue to be understood to mean auditing standards generally accepted in the U.S., in addition to any applicable rules of the Commission. The guidance also stated that the Commission intended to revisit this interpretation in connection with a rulemaking project to update the audit and attestation requirements under the federal securities laws for brokers and dealers. On June 15, 2011, the SEC proposed to amend its rules, including SEC Rule 17a-5 under the Exchange Act, to require, among other things, that audits of brokers' and dealers' financial statements and examinations of reports regarding compliance with SEC requirements be performed in accordance with the standards of the PCAOB.[29/]

[28/] Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

[29/] SEC, *Broker-Dealer Reports,* Exchange Act Release No. 64676 (June 15, 2011).

The Board requested comments on the application of the proposed standard and amendments to audits of brokers and dealers in its proposing release. As discussed in Appendix 4, a number of commenters stated that the proposed standard and amendments were appropriate for audits of brokers and dealers. The Board is continuing to solicit comments regarding issues that may be raised by the application of the Board's reproposal to audits of brokers and dealers in view of the revisions that are being proposed.

The Board requests comments from auditors of brokers and dealers and others regarding the application of the reproposed standard and amendments to audits of brokers and dealers. Specific questions are included at the end of Section V. of Appendix 4 to this release.

VI. Effective Date

The reproposed standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2013. The Board seeks comment regarding the feasibility of this date in Section VI. of Appendix 4 to this release.

VII. Appendices

The release contains the following appendices:

- Appendix 1 to this release contains the text of the reproposed standard, *Related Parties.*

- Appendix 2 to this release contains the reproposed amendments to certain PCAOB auditing standards regarding significant unusual transactions.

- Appendix 3 to this release contains the other reproposed amendments to PCAOB auditing standards.

- Appendix 4 provides additional discussion of the reproposed standard and amendments. Appendix 4 also includes discussion of the existing standards and discussion of significant comments and Board responses. This Appendix further contains information regarding the applicability of the reproposed standard and amendments to audits of brokers and dealers and audits of EGCs. Appendix 4 also contains questions that solicit comments regarding specific provisions in the reproposed standard and amendments, including the potential costs associated with the implementation of those provisions. Questions are included in each of the following sections of Appendix 4:

- Appendix 5 to this release discusses certain significant differences between the objectives and requirements of the reproposed standard and the amendments and the analogous standards of the IAASB and the ASB.

VIII. Opportunity for Public Comment

The Board solicits comments on any and all aspects of its reproposal, as well as seeking specific comments on the reproposed standard, the reproposed amendments regarding significant unusual transactions, and other reproposed amendments to other PCAOB auditing standards. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's Web site at: www.pcaobus.org. All comments should refer to the PCAOB Rulemaking Docket Matter No. 038 on the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on July 8, 2013.

The Board will consider carefully all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are rules of the Board under the Act.

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On the 7th day of May, in the year 2013, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary
May 7, 2013

APPENDIX 1

Proposed Auditing Standard, *Related Parties*

Introduction

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

Objective

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

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

3. The auditor should perform procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. The procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

a. Obtaining an understanding of the company's process (paragraph 4);

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

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

b. Performing inquiries (paragraphs 5-7); and

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

Note: Obtaining an understanding of the company's relationships and transactions with its related parties includes obtaining an understanding of the nature of the relationships between the company and its related parties and of the terms and business purposes (or the lack thereof) of the transactions involving related parties.

Note: Performing the risk assessment procedures described in paragraphs 4-9 of this standard in conjunction with the risk assessment procedures required by Auditing Standard No. 12 is intended to provide the auditor with a reasonable basis for identifying and assessing risks of material misstatement associated with related parties and relationships and transactions with related parties.

Obtaining an Understanding of the Company's Process

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

a. Identifying related parties and relationships and transactions with related parties;

b. Authorizing and approving transactions with related parties; and

c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

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

Performing Inquiries

5. The auditor should inquire of management regarding:[4/]

a. The names of the company's related parties during the period under audit, including changes from the prior period;

b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);

c. The nature of any relationships, including ownership structure, between the company and its related parties;

d. The transactions entered into, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;

e. The business purpose for entering into a transaction with a related party versus an unrelated party;

f. Any related party transactions that have not been authorized and approved in accordance with the company's established policies or procedures regarding the authorization and approval of transactions with related parties; and

g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

6. The auditor should inquire of others within the company regarding their knowledge of the matters in paragraph 5 of this standard. The auditor should identify others within the company to whom inquiries should be directed, and determine the extent of such inquires, by considering whether such individuals are likely to have knowledge regarding:

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

a. The company's related parties or relationships or transactions with related parties;

b. The company's controls over relationships or transactions with related parties; and

c. The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.[5/]

7. The auditor should inquire of the audit committee,[6/] or its chair, regarding:

a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and

b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

Communicating with the Audit Engagement Team and Other Auditors

8. The auditor should communicate to engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.[7/]

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

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

[7/] This communication complements the discussion among engagement team members regarding risks of material misstatement in accordance with paragraph 49 of Auditing Standard No. 12. *See also*, paragraph 5 of Auditing Standard No. 10, *Supervision of the Audit Engagement*, which establishes requirements regarding supervision of the engagement team members, including directing engagement team members to bring significant accounting and auditing issues arising during the audit to

9. If the auditor is using the work of another auditor, the auditor should communicate to the other auditor relevant information about related parties, including the names of the company's related parties and the nature of the company's relationships and transactions with those related parties.[8/] The auditor also should inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.

Identifying and Assessing Risks of Material Misstatement

10. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level.[9/] This includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties.

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

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the attention of the engagement partner or other engagement team members performing supervisory activities.

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

[9/] *See* paragraph 59 of Auditing Standard No. 12.

Responding to the Risks of Material Misstatement

11. The auditor must design and implement audit responses that address the identified and assessed risks of material misstatement.[10/] This includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.[11/]

> Note: The auditor also should look to the requirements in proposed paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). For such related party transactions, AU sec. 316.67 requires that the auditor evaluate whether the business purpose (or the lack thereof) of the transactions indicates that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

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

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

a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

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

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

b. Determine whether the transaction has been authorized and approved in accordance with the company's established policies and procedures regarding the authorization and approval of transactions with related parties;

c. Determine whether any exceptions to the company's established policies or procedures were granted;[12/]

d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;[13/] and

e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Note: The applicable financial reporting framework may allow the aggregation of similar related party transactions for disclosure purposes. If the company has aggregated related party transactions for disclosure purposes in accordance with the applicable financial reporting framework, the auditor may perform the procedures in paragraph 12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

Intercompany Transactions

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

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

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

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

14. The auditor should evaluate whether the company has properly identified its related parties and relationships and transactions with related parties.[14/] In making that evaluation, the auditor should take into account the information gathered during the audit.[15/] As part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

> Note: Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

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

[14/] Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

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

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

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

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

b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;[17/]

c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;

d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;

e. Perform the procedures required by paragraph 12 of this standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;

f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;

g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and

h. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related

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

party indicates that fraud or an illegal act may have occurred. If the auditor determines that it is likely that an illegal act has or may have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

Evaluating Financial Statement Accounting and Disclosures

17. The auditor must evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. This includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.[18/]

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

18. If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.[19/]

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

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[18/] *See* paragraph 31 of Auditing Standard No. 14.

[19/] *See* proposed paragraph .06.l. of AU sec. 333, which would require the auditor to obtain written representations from management if the financial statements include such an assertion. Representations from management alone are not sufficient appropriate audit evidence. *See also* paragraphs .35-.36 of AU sec. 508, *Reports on Audited Financial Statements*.

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

Communications with the Audit Committee

19. The auditor should communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.[20/] The auditor also should communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;

b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;

c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;

d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and

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

[20/] *See* Auditing Standard No. 16 regarding the timing of the communications to the audit committee.

APPENDIX A − Examples of Information and Sources of Information That Could Indicate That Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor Might Exist

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

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

- Buying or selling goods or services at prices that differ significantly from prevailing market prices;
- Sales transactions with unusual terms, including unusual rights of return or extended payment terms generally not offered;
- "Bill and hold" type transactions;
- Borrowing or lending on an interest-free basis or with no fixed repayment terms;
- Occupying premises or receiving other assets or rendering or receiving management services when no consideration is exchanged;
- Engaging in a nonmonetary transaction that lacks commercial substance;
- Sales without economic substance (e.g., funding the other party to the transaction to facilitate collection of the sales price, or entering into a transaction shortly prior to period end and unwinding that transaction shortly after period end);
- Loans to parties that, at the time of the loan transaction, do not have the ability to repay and possess insufficient or no collateral;
- Loans made without prior consideration of the ability of the party to repay;

- A subsequent repurchase of goods that indicates that at the time of sale an implicit obligation to repurchase may have existed that would have precluded revenue recognition or sales treatment;
- Advancing company funds that are used directly or indirectly to pay what would otherwise be an uncollectible loan or receivable;
- Sales at below market rates to an intermediary whose involvement serves no apparent business purpose and who, in turn, sells to the ultimate customer at a higher price, with the intermediary (and ultimately its principals) retaining the difference;
- Guarantees and guarantor relationships outside the normal course of business; or
- Transactions between two or more entities in which each party provides and receives the same or similar amounts of consideration (e.g., round-trip transactions).

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

- Periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies;
- Confirmation responses and responses to inquiries of the company's lawyers;
- Tax filings and related correspondence;
- Invoices and correspondence received from the company's professional advisors, for example, attorneys and consulting firms;
- Relevant internal auditors' reports;
- Conflicts-of-interest statements from management and others;
- Shareholder registers that identify the company's principal shareholders;
- Life insurance policies purchased by the company;
- Records of the company's investments, pension plans, and other trusts established for the benefit of employees, including the names of the officers and trustees of such investments, pension plans, and other trusts;
- Contracts or other agreements (including, for example, partnership agreements and side agreements or other arrangements) with management;

- Contracts and other agreements representing significant unusual transactions;
- Significant contracts renegotiated by the company during the period under audit;
- Records from a management, audit committee, or board of directors' whistleblower program;
- Expense reimbursement documentation for executive officers; or
- The company's organizational charts.

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APPENDIX 2 – Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

A. Identifying Significant Unusual Transactions (Section II.A. of Appendix 4)

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

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

In paragraph 14:

- The first bullet point is replaced with:

  Controls over significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature ("significant unusual transactions"), particularly those that result in late or unusual journal entries;[10A/] and

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

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

Auditing Standard No. 9, *Audit Planning*

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

In paragraph 12, subparagraph a. is replaced with:

The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, e.g., significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature ("significant unusual transactions") executed at the location or business unit.[14/]

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

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

a. In paragraph 13:

- The fifth bullet point is replaced with:

  The methods the company uses to account for significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature ("significant unusual transactions");[7A/] and

- Footnote 7A is added after the semicolon (;) at the end of the fifth bullet:

  [7A/] See AU secs. 316.66-.67A.

b. In paragraph 56.a.:

- In item (6), delete the word "and" at the end of the item.

- In item (7), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.

- Add Item (8):

  (8) Whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties.[31A/]

- Add footnote 31A at the end of item (8):

  [31A/] See AU secs. 316.66-.67A.

c. In paragraph 56.b.:

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- In item (3), delete the word "and" at the end of the item.
- In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
- Add item (5):

  (5) Whether the company has entered into any significant unusual transactions.

d. In paragraph 56.c.:

- In item (3), delete the word "and" at the end of the item.
- In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word "and" after the semicolon.
- Add item (5):

  (5) Whether the company has entered into any significant unusual transactions.

e. In paragraph 57, the third bullet point is replaced with:

Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements, a significant unusual transaction, or a significant related party transaction; and

f. Paragraph 71.g., is replaced with:

Whether the risk involves significant unusual transactions.

g. Paragraph 73A is added after paragraph 73:

73A. The auditor should obtain an understanding of the controls that management has established to identify, authorize and approve, and account for and disclose significant unusual transactions in the financial statements, if the auditor has not already done so when

obtaining an understanding of internal control, as described in paragraphs 18-40 and 72-73 of this standard.

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

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

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

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

b. Paragraph 15.c. is replaced with:

Evaluating whether the business purpose for significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature ("significant unusual transactions") indicates that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. (AU secs. 316.66-.67A).

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

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

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

- Related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business)

- Significant transactions with related parties whose financial statements are not audited or are audited by another firm

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b. The fourth item in paragraph .85A.2, section a., under "Opportunities" is replaced with:

- Significant or highly complex transactions or significant unusual transactions, especially those close to period end, that pose difficult "substance-over-form" questions

c. The following item is added as the last item to paragraph .85A.2, section a., under "Opportunities":

- Contractual arrangements lacking a business purpose

AU sec. 722, "Interim Financial Information"

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

a. In paragraph .55, Appendix B, paragraph B1., the tenth bullet is replaced with:

- The occurrence of infrequent or significant unusual transactions

B. Evaluating Significant Unusual Transactions (Section II.B. of Appendix 4)

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

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

a. Paragraph 11A is added after paragraph 11:

11A. *Responding to Risks Associated with Significant Unusual Transactions*. Paragraph 71.g. of Auditing Standard No. 12 indicates that one of the factors to be evaluated in determining significant risks is whether the risk involves significant unusual transactions. Also, AU secs. 316.66-.67A establish requirements for performing procedures to respond to fraud risks regarding significant unusual transactions. Because significant unusual transactions can affect the risks of material misstatement due to

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error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-.67A.

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

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

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

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

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

a. Paragraph .66 is replaced with:

.66 Evaluating whether the business purpose for significant unusual transactions indicates that the transactions may have been entered into to engage in fraud. Significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature ("significant unusual transactions") may be used to engage in fraudulent financial reporting or conceal misappropriation of assets.

Note: The auditor's identification of significant unusual transactions should take into account information obtained from: (a) the risk assessment procedures required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial

reporting) and (b) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

Note: The auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. See paragraphs 14-16 of proposed auditing standard, *Related Parties*. Appendix A of proposed auditing standard, *Related Parties,* includes examples of such information and examples of sources of such information.

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

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

a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;

c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;[fn 24A] and

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

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

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

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

d. Paragraph .67 is replaced with:

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

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);
- The transaction involves unconsolidated related parties, including variable interest entities;
- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor; fn 25A
- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company;

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- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);

- The transaction occurs with a party that falls outside the definition of a related party (as defined by the accounting principles applicable to that company), with either party able to negotiate terms that may not be available for other, more clearly independent, parties on an arm's-length basis;

- The transaction enables the company to achieve certain financial targets;

- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction (e.g., accounting-motivated structured transaction); and

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

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

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

fn 25A Related parties or relationships or transactions with related parties previously undisclosed to the auditor includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties. Proposed auditing standard, *Related Parties*, requires the auditor to perform certain

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procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

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

.67A The auditor must evaluate whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements. This includes evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework. [fn 25B]

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

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

[fn 25B] *See* paragraph 31 of Auditing Standard No. 14.

APPENDIX 3 – Other Proposed Amendments to PCAOB Auditing Standards

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (Section III.A. of Appendix 4)

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

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

> Also, proposed auditing standard, *Related Parties,* requires the auditor to perform procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements.

b. In paragraph 10, the note following the final bullet is deleted.

c. Paragraph 10A is added after paragraph 10:

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

d. In paragraph 11:

- The third bullet is replaced with:

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

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

- Add a fifth bullet:

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

- Add a sixth bullet:

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

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

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

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

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

a. The phrase "AU sec. 334, *Related Parties*" in footnote 25 is replaced with the phrase "proposed auditing standard, *Related Parties*."

b. The following bullet is inserted after the third bullet in Appendix B:

- Proposed auditing standard, *Related Parties*, paragraphs 7 and 19.

AU sec. 315, "Communications Between Predecessor and Successor Auditors" (Section III.B. of Appendix 4)

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

a. The following bullet is added to the end of paragraph .09:

- The predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions.[fn 5A]

b. Add the following footnote to the end of paragraph .09:

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

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

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

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit" (Section III.C. of Appendix 4)

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

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

Communication about Possible Fraud to Management, the Audit Committee, the Securities and Exchange Commission, and Others [fn 37]

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

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

c. For paragraph .82:

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

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

a. To a successor auditor when the successor makes inquiries in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors*.[fn 40]

b. In response to a subpoena.

c. To a funding agency or other specified agency in accordance with requirements for the audits of companies that receive governmental financial assistance.

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

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

AU sec. 330, "The Confirmation Process"

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

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

Proposed auditing standard, *Related Parties*, establishes requirements regarding the auditor's evaluation of relationships and transactions between the company and its related parties.

AU sec. 333, "Management Representations" (Section III.D. of Appendix 4)

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

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

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

b. In paragraph .06:

- Subparagraph c. is replaced with:

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

- Subparagraph f. is replaced with:

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

- Subparagraph l. is replaced with:

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

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

See paragraph 18 of proposed auditing standard, *Related Parties*.

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

Examples are fraud, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in proposed auditing standard, *Related Parties*.

e. In paragraph 6 of Appendix A:

- Item 2.a. is replaced with:

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

- Item 11.d. is added:

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

AU sec. 334, "Related Parties"

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

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

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

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

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

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

> The term *relationship* includes, but is not limited to, those situations meeting the definition of "related parties" contained in the financial reporting framework applicable to the company under audit.

AU sec. 560, "Subsequent Events" (Section III.E. of Appendix 4)

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

a. In paragraph .12b.:

- Item (v) is added:

  Whether there have been any changes in the company's related parties or whether there have been any significant new related party transactions.

- Item (vi) is added:

  Whether the company has entered into any significant unusual transactions.

AU sec. 722, "Interim Financial Information" (Section III.F. of Appendix 4)

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

a. In paragraph .24:

- Subparagraph g. is replaced with:

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

- Subparagraph j. is replaced with:

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

- Subparagraph m. is replaced with:

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

b. The second sentence of paragraph C5 of paragraph .56 is replaced with:

Examples are fraud, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in proposed auditing standard, *Related Parties*.

c. Within paragraph C6 of paragraph .56, within the second illustrative representation letter (2.) for a review of interim financial information (statements):

- Item 2.a. is replaced with:

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

- Item 12.d. is added:

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

APPENDIX 4 – Additional Discussion of the Reproposed Standard and Amendments and Questions for Public Comment

The Board is reproposing a new auditing standard, *Related Parties* (the "reproposed standard"); amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "reproposed amendments regarding significant unusual transactions"); and other amendments to PCAOB auditing standards (the "other reproposed amendments").[1/] This Appendix discusses the reproposed standard in Appendix 1, the reproposed amendments regarding significant unusual transactions in Appendix 2, and the other reproposed amendments in Appendix 3.

The Board previously issued a proposed auditing standard, *Related Parties* (the "proposed standard"), proposed amendments regarding significant unusual transactions (the "proposed amendments regarding significant unusual transactions") and the other proposed amendments (the "other proposed amendments").[2/] The comment period ended on May 31, 2012. The Board received 37 comment letters. The Board also discussed the proposed standard and amendments with its Standing Advisory Group ("SAG") on May 17, 2012 ("the SAG discussion").[3/]

[1/] The reproposed amendments regarding significant unusual transactions and the other reproposed amendments are collectively referred to as the "reproposed amendments." The reproposed standard and reproposed amendments are collectively referred to as the "reproposed standard and amendments" or the "reproposal."

[2/] *See Proposed Auditing Standard, Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards,* PCAOB Release No. 2012-001 (Feb. 28, 2012) (the "proposing release"), available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx. The proposed amendments regarding significant unusual transactions and the other proposed amendments are collectively referred to as the "proposed amendments." The proposed standard and proposed amendments are collectively referred to as the "proposed standard and amendments" or the "proposal."

[3/] The SAG transcript is available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx.

This Appendix provides additional background information regarding the reproposal and includes a discussion of the Board's consideration of significant comments received on its February 28, 2012 proposal.[4/] Each section of this Appendix includes questions for commenters regarding the reproposal. The Board also is seeking input and comment on economic considerations, including audits of emerging growth companies ("EGCs"), audits of brokers and dealers as well as on the appropriate effective date for the reproposed standard and amendments. This Appendix includes the following sections:

I. Reproposed Auditing Standard, *Related Parties*

Overall, commenters were generally supportive of the need to improve the existing auditing standard, AU sec. 334, *Related Parties*. However, some commenters suggested that the proposed standard could benefit from additional clarification and suggested changes. In response to comments received, the Board has made revisions to clarify and refine various aspects of the proposed standard. These comments and the

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4/ *See* PCAOB Release No. 2012-001.

proposed revisions are discussed in the following topical areas that address specific paragraphs of the reproposed standard:

Relevant information is provided for each topical area, including a description of the proposed standard and existing requirements, a description of the reproposed standard, and a discussion of significant comments received and Board responses. Following the "Other Considerations" discussion is a list of questions for commenters regarding the reproposed standard. Commenters are encouraged not only to respond to those questions but also to provide input on all aspects of the reproposed standard.

A. Introduction (Paragraph 1 of the Reproposed Standard in Appendix 1)

The Proposed Standard and Existing Requirements

Paragraph 1 of the proposed standard stated that this standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. In contrast, the existing standard, AU sec. 334, indicates that the standard provides guidance on procedures that should be considered by the auditor to identify related party relationships and transactions, and to satisfy himself concerning the required financial statement accounting and disclosures.[5/]

A footnote to paragraph 1 of the proposed standard stated that the auditor should look to the requirements of the U.S. Securities and Exchange Commission ("SEC") for the company under audit with respect to the accounting principles applicable to that company, including the definition of related parties and the financial statement disclosure requirements with respect to related parties (the "framework-neutral approach").[6/] This approach reflects the fact that applicable financial reporting frameworks may contain different definitions of the term "related party." Likewise, applicable financial reporting frameworks also may contain different disclosure requirements regarding relationships and transactions with related party transactions. AU sec. 334 refers auditors to the U.S. generally accepted accounting principles ("U.S. GAAP") definition of a "related party" and to the disclosure requirements in U.S. GAAP.[7/]

[5/] *See* AU sec. 334.01.

[6/] For SEC filings that include financial statements prepared in accordance with or reconciled to U.S. GAAP, *see*, *e.g.,* Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") Topic 850, Related Party Disclosures. For SEC filings that include financial statements prepared in accordance with International Financial Reporting Standards ("IFRS"), *see*, *e.g.*, International Accounting Standard No. 24, *Related Parties*.

[7/] *See* footnote 1 of AU sec. 334.01 for the definition of the term "related party" and AU secs. 334.02-.03 for discussion of U.S. GAAP disclosure requirements.

As more fully described below, after consideration of the comments received, the Board did not substantively revise the introduction to the proposed standard.

The Reproposed Standard

The introduction in the reproposed standard, like the introduction in the proposed standard, states that the standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. As reproposed, the introduction retains the footnote that refers the auditor to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties" and the financial statement disclosure requirements with respect to related parties.

Significant Comments and Board Responses

Several commenters supported the use of a framework-neutral approach. Some commenters provided suggestions on how to further clarify the standard. In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

Defining the Term "Related Party": Some commenters suggested replacing the reference to the SEC in footnote 1 with a direct reference to the applicable financial reporting framework. One of these commenters suggested that the footnote appears to imply that the SEC has its own definition of a related party. Another commenter suggested including a definition of a "related party" in an Appendix to the standard that would refer to the definition of a "related party" contained in the applicable financial reporting framework. The Board observed that the SEC determines the accounting principles applicable to issuers (for example, U.S. GAAP or IFRS) and other reporting requirements for SEC filings, as noted in footnote 1 of the proposed standard. The Board considered the comments received, noting that commenters generally agreed with the proposed framework-neutral approach. Accordingly, the Board is not proposing to revise the introduction for these comments.

Including Examples of Related Party Transactions: Another commenter recommended including examples of related party transactions. The Board considered this comment and noted that applicable financial reporting frameworks may contain different definitions and examples of related party transactions. Thus, including

examples in the reproposed standard might create inconsistencies and confusion. Consequently, this suggestion has not been incorporated into the reproposed standard.

Providing Additional Context of the Risks Associated with Related Party Transactions: The Board received some comments requesting additional context regarding the risks associated with related party transactions. One commenter recommended including an introductory discussion to focus the auditor's attention on the risks associated with related party transactions and to emphasize the importance of the use of professional skepticism. In contrast, another commenter suggested including language similar to that contained in International Standard on Auditing ("ISA") 550, *Related Parties*, which states that many related party transactions are in the normal course of business and, in such circumstances, may carry no higher risk of material misstatement of the financial statements than with similar transactions with unrelated parties. The Board considered these comments and did not include such discussion in the reproposed standard. However, the Board notes that the revisions made to clarify the relationship with the risk assessment standards could assist in providing context regarding potential risks of material misstatement due to error or fraud.[8/] The Board further noted that the proposing release included a discussion regarding the nature of the risks associated with related party transactions.

B. Objective (Paragraph 2 of the Reproposed Standard in Appendix 1)

An objective provides an overarching concept that can be especially helpful when an auditor is considering procedures and evaluating audit evidence during the course of an audit.[9/]

[8/] *See e.g., In the Matter of the Application of Wendy McNeeley, CPA,* SEC Accounting and Enforcement Release No. 3427, at 10-12 (Dec. 13, 2012), which states that related party transactions alert auditors that "heightened scrutiny" is warranted. *See also* the discussion entitled "Clarifying the Relationship with the Risk Assessment Standards" in Section I.C. of this Appendix.

[9/] The proposing release described the Board's considerations of the use of an objective in the proposed standard. *See* PCAOB Release No. 2012-001 at A4-4, available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx.

The Proposed Standard and Existing Requirements

The proposed standard stated that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements. In contrast, the existing standard, AU sec. 334, does not specifically describe an objective for the auditor's work regarding a company's relationships and transactions with its related parties.

As more fully described below, after consideration of the comments received, the Board did not substantively revise the objective.

The Reproposed Standard

Consistent with the proposed standard, the reproposed standard states that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

Like the proposed standard, a footnote refers the auditor to examples of other relevant standards and rules, including paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*, and paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

Significant Comments and Board Responses

Several commenters expressed support for the objective described in the proposed standard. Other commenters suggested expanding the objective, or expressed concern regarding the nature of the objective. In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

Expanding the Objective to Include Other Matters: One commenter suggested including the auditor's communication with the audit committee in the objective. Another commenter suggested including a statement in the objective that the auditor should take into account information obtained from the performance of risk assessment procedures. The Board considered these comments, noting that the intent of the objective of the proposed standard was to focus the auditor on the end result — obtaining sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and

disclosed in the financial statements. Therefore, the Board is not proposing to revise the objective for these comments.

Including the Consideration of "Fraud" as an Explicit Objective: Some commenters recommended that the objective should explicitly refer to the risk of fraud. In particular, one commenter noted that there were only two references to fraud in the proposed standard, and that the auditor's use of judgment would be more informed by reinforcing references to fraud in the objective. The Board believes that related party transactions deserve special attention by the auditor, in part, because of their historic association with fraudulent financial reporting.[10/] However, because the proposed standard was designed to align with and build upon the risk assessment standards, and because those risk assessment standards emphasize that the auditor's responsibilities for assessing and responding to fraud risks are an integral part of the audit process rather than a separate, parallel process, the Board is not proposing to revise the objective.

Clarifying the Nature of the Objective: The Board received comments regarding the nature of the objective of the proposed standard and the usefulness of the release text in elucidating the Board's objectives and expectations. For example, one commenter recommended clarifying how the requirements of the proposed standard relate to and support the objective. That commenter suggested explaining how the requirements of the proposed standard provide a sufficient basis to achieve the objective and how the objective ensures that sufficient appropriate evidence is obtained in all circumstances. Another commenter noted that the release text suggested that the auditor must exercise judgment to meet the objective over and above complying with the requirements of the proposed standard. This commenter further observed that such a statement is misplaced in the text of a proposing release and stated that the release would require open, thorough, and transparent due process before being articulated as a policy as the notions articulated appear to open the door to enabling PCAOB inspections to generate deficiencies and to otherwise extend auditor liability.

The Board considered these comments and notes that the objective stated in the proposed standard provides that the auditor's work takes place within the context of the

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[10/] The proposing release contained a discussion of related party transactions that have resulted in material misstatements and fraud. *See*, *e.g.*, PCAOB Release No. 2012-001 at 9-11, available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx.

Board's overall requirement that the auditor obtain sufficient appropriate evidence to support the auditor's opinion.[11/] The Board, therefore, is not proposing to revise the objective to add specific statements regarding how the requirements in the standard relate to, or assure the achievements, of the objective.

C. Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 – 9 of the Reproposed Standard in Appendix 1)

In an audit performed in accordance with PCAOB standards, the identification and assessment of, and response to, risks of material misstatement in the financial statements underlie the entire audit process, including the procedures that the auditor performs to support the opinion expressed in the auditor's report. Performing risk assessment procedures to obtain an understanding of a company's relationships and transactions with its related parties is important because such relationships and transactions could pose increased risks of material misstatement.

The Proposed Standard and Existing Requirements

The requirements in paragraphs 3 and 4 of the proposed standard built upon the foundational risk assessment requirements contained in Auditing Standard No. 12, *Identifying and Assessing the Risks of Material Misstatement*. Specifically, paragraph 3 of the proposed standard would have required that the auditor perform procedures to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purposes (or the lack thereof) of the types of transactions involving related parties. Paragraph 4 of the proposed standard would have required that the auditor take into account information obtained from the performance of risk assessment procedures required by Auditing Standard No. 12 in identifying related parties and obtaining an understanding of relationships and transactions with related parties.

The existing standard, AU sec. 334, states that in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor

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[11/] *See* paragraph 33 of Auditing Standard No. 14.

should obtain an understanding of management responsibilities and the relationship of each component of the entity to the total entity.[12/]

As more fully described below, after consideration of the comments received, the Board substantially revised paragraphs 3 and 4. In particular, in response to comments received that requested clarification of the relationship between the proposed standard and the risk assessment standards, the Board made revisions to better integrate the proposed requirements with the risk assessment standards.

The Reproposed Standard

As reproposed, paragraph 3 of the reproposed standard would require the auditor to perform procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12. Paragraph 3 of the reproposed standard specifies that the procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include: obtaining an understanding of the company's process; performing inquiries; and communicating with the audit engagement team and other auditors.

A note to paragraph 3 of the reproposed standard states that obtaining an understanding of the company's relationships and transactions with its related parties includes obtaining an understanding of the nature of the relationships between the company and its related parties and of the terms and business purposes (or the lack thereof) of the transactions involving related parties.

A second note would clarify that performing the risk assessment procedures described in paragraphs 4-9 of the reproposed standard in conjunction with the risk assessment procedures required by Auditing Standard No. 12 is intended to provide the auditor with a reasonable basis for identifying and assessing risks of material misstatement associated with related parties and relationships and transactions with related parties.

In clarifying the relationship to the risk assessment standards, the Board's reproposal would remove the second note to paragraph 10 of Auditing Standard No. 12.

[12/] *See* AU sec. 334.05.

That note states that the auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties in accordance with AU sec. 334. As described previously, the procedures in paragraphs 4-9 of the reproposed standard would be performed in conjunction with the risk assessment procedures in Auditing Standard No. 12.

The reproposed amendments would add a new sentence to footnote 3 of paragraph 4 of Auditing Standard No. 12 that states that proposed auditing standard, *Related Parties,* requires the auditor to perform procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements.

Significant Comments and Board Responses

In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

Clarifying the Relationship with the Risk Assessment Standards: Some commenters suggested that the Board take steps to more closely align the proposed standard with the risk assessment standards. One commenter noted that the omission of clear linkage to the concept of auditor risk assessment in paragraph 3 may result in an overly burdensome requirement for the auditor to identify and assess risks of material misstatement, and then perform appropriate audit procedures. Another commenter suggested revising paragraph 3 to include a preface that would refer to Auditing Standard No. 12. This commenter also suggested clarifying the relationship of paragraph 3 to the procedures set out in paragraphs 4-11 by incorporating discussion in the proposing release into the standard. Other commenters were concerned that certain requirements in the proposed standard appeared overly prescriptive and were inconsistent with the approach described in the risk assessment standards.

After considering these comments, the Board included changes in the reproposed standard that clarify that the auditor would perform the risk assessment procedures required by the reproposed standard in conjunction with the risk assessment procedures required by Auditing Standard No. 12. This would provide opportunities for an auditor to integrate audit effort, where appropriate. The specific risk assessment procedures that would be required by the reproposed standard, which are necessary for the auditor's identification and assessment of the risks of material misstatement associated with a company's related party transactions, would build upon the procedures being performed under Auditing Standard No. 12.

Also, as further described in Section I.F. of this Appendix, the Board revised its proposal to include a new section that would clarify the auditor's responsibilities for evaluating whether the company has properly identified its related parties and relationships and transactions with related parties.

Identifying Contradictory Information: At the SAG discussion, the point was raised that the auditor should search public information regarding a company's related parties and transactions and, in particular, to search for contradictory information to test representations provided by management. The point was also raised that such contradictory information would not come to the auditor's attention unless the auditor looked for it, and, without a requirement to do so, the auditor might place too much reliance on management for the identification of the company's related parties.

The Board considered these points and is not proposing to include requirements for the auditor to search public information indiscriminately as this could result in unnecessary costs. The Board anticipates however, that, in appropriate situations, the auditor might review public documents for information regarding a company's related parties and transactions, particularly when it is readily available. For example, a review of relevant available public information might be appropriate in situations in which information comes to the auditor's attention that suggests that related parties previously undisclosed to the auditor might exist. In addition, existing standards require that as part of obtaining an understanding of the company the auditor should consider reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements.[13/]

Evaluating the Materiality of Related Party Transactions: One commenter recommended deleting the footnote to paragraph 3 of the proposed standard, which referenced paragraph 7 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*. That commenter expressed concern that this reference implied that all related party transactions represent transactions for which lesser amounts than the materiality level for the financial statements taken as a whole would influence the judgment of a reasonable investor.

The Board considered this comment and noted that applicable financial reporting frameworks require the disclosure of material related party transactions. The footnote to paragraph 3 of the proposed standard noted that lesser amounts of misstatements

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[13/] *See* paragraph 11 of Auditing Standard No. 12.

could influence the judgment of a reasonable investor because of qualitative factors, such as conflicts of interest in related party transactions. While the Board continues to support the statement in this footnote, it has reconsidered the need for it in light of other revisions to the reproposed standard that clarify the relationship between the reproposed standard and the risk assessment standards. Accordingly, the reproposed standard does not include that footnote. The Board has also removed the other footnote to paragraph 3 of the proposed standard, which referred to paragraph 16 of Auditing Standard No. 9, *Audit Planning*.

Obtaining an Understanding of the Company's Process (Paragraph 4 of the Reproposed Standard in Appendix 1)

Obtaining an understanding of the company's process regarding identifying, authorizing, approving, accounting for, and disclosing transactions between the company and its related parties is an important procedure to assist the auditor in obtaining an understanding of the company's relationships and transactions with its related parties.

The Proposed Standard and Existing Requirements

Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatement, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.[14/] AU sec. 334.05, issued before the adoption of the risk assessment standards, is similar, but not as specific. Among other things, AU sec. 334.05 states that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities. AU sec. 334.05 further states that the auditor should consider controls over management activities.

Paragraph 5 of the proposed standard was intended to align with and build upon the requirements in Auditing Standard No. 12. Specifically, paragraph 5 of the proposed standard would have required that the auditor obtain an understanding of the controls that management has established to: (a) identify related parties and relationships and transactions with related parties; (b) authorize and approve transactions with related

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[14/] *See* paragraph 18 of Auditing Standard No. 12.

parties; and (c) account for and disclose relationships and transactions with related parties in the financial statements.

In response to comments, the Board made revisions to better integrate the proposed requirements with the risk assessment standards. In addition, the reproposed standard contains new references to relevant paragraphs in Auditing Standard No. 12.

The Reproposed Standard

Paragraph 4 of the reproposed standard would state that, in conjunction with obtaining an understanding of internal control over financial reporting, the auditor should obtain an understanding of the company's process for: (a) identifying related parties and relationships and transactions with related parties; (b) authorizing and approving transactions with related parties; and (c) accounting for and disclosing relationships and transactions with related parties in the financial statements.

A new footnote would refer the auditor to paragraphs 18 and 20 of Auditing Standard No. 12 to emphasize that the procedures required by paragraph 4 of the reproposed standard would be performed in conjunction with the auditor's risk assessment process.

Significant Comments and Board Responses

In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

Providing Additional Context Regarding Internal Control: Some commenters suggested that the Board provide additional context with respect to the auditor's understanding of internal control. For example, one commenter suggested explaining that, in certain situations controls over related party relationships and transactions may be deficient, may more readily be overridden by senior management, or may not exist, and, in those situations, the auditor may not be able to rely on internal controls in designing audit procedures to obtain sufficient audit evidence. Another commenter urged the Board to clarify that the quality of internal controls over the identification of related parties, transactions with related parties, and related disclosures is critical.

The Board considered these comments and is not proposing to include additional context regarding internal controls in the reproposed standard. However, the Board notes that the revisions to better integrate and clarify the relationship of the reproposed standard with existing requirements in the risk assessment standards regarding

obtaining an understanding of internal control over financial reporting should address these concerns.

Performing Inquiries (Paragraphs 5-7 of the Reproposed Standard in Appendix 1)

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

The Proposed Standard and Existing Requirements

Paragraphs 6-8 of the proposed standard would have required the auditor to make specific inquiries of company management, others within the company likely to have additional knowledge regarding the company's related parties or relationships or transactions with the company's related parties, and of the company's audit committee.

The existing standard, AU sec. 334, describes a variety of specific audit procedures for the auditor's consideration in determining the existence of related parties.[15/] These specific procedures include requesting from appropriate management personnel the names of all related parties and inquiring whether there were any transactions with these parties during the period.

The Board has made revisions to the proposed standard in response to a number of comments regarding the use of additional auditor judgment, including to clarify whether inquiry of certain individuals is necessary in all instances and with respect to the nature and extent of inquiries of others.

The Reproposed Standard

Paragraph 5 of the reproposed standard is substantially similar to paragraph 6 of the proposed standard. As reproposed, paragraph 5 would require the auditor to inquire of management regarding: the names of the company's related parties during the period under audit, including changes from the prior period; background information concerning the related parties (for example, physical location, industry, size, and extent

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15/ *See* AU sec. 334.07.

of operations); the nature of any relationships, including ownership structure, between the company and its related parties; the transactions entered into, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions; the business purpose for entering into a transaction with a related party versus an unrelated party; any related party transactions that have not been authorized and approved in accordance with the company's established policies or procedures regarding the authorization and approval of transactions with related parties; and any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

A new footnote to paragraph 5 of the reproposed standard would clarify that obtaining representations from management pursuant to AU sec. 333 complements the auditor's inquiries under paragraph 5 and is not a substitute for them.[16/]

Paragraph 6 of the reproposed standard would clarify the auditor's responsibilities when performing inquiries of others. As revised by the Board, paragraph 6 of the reproposed standard would require the auditor to inquire of others within the company regarding their knowledge of the matters in paragraph 5 of the reproposed standard. Pursuant to paragraph 6 of the reproposed standard, the auditor would be required to identify others within the company to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding: (a) the company's related parties or relationships or transactions with related parties; (b) the company's controls over relationships or transactions with related parties; and (c) the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

As described in further detail below, the examples of "others" within the company are not included in the reproposed standard. In addition, the Board added a footnote to paragraph 6 of the reproposed standard, which states that for purposes of this standard the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties. As

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[16/] *See* Section III.D. of this Appendix for discussion of amendments the Board is proposing to AU sec. 333, *Management Representations*.

reproposed, this footnote clarifies the meaning of the phrase previously described in the note to paragraph 3 of the proposed standard.

Paragraph 7 of the reproposed standard is substantially the same as paragraph 8 of the proposed standard and includes changes to a footnote to reflect the adoption of Auditing Standard No. 16, *Communications with Audit Committees*.

Specifically, paragraph 7 of the reproposed standard would require the auditor to inquire of the audit committee, or its chair, regarding: the audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns. As reproposed, a footnote to paragraph 7 of the reproposed standard would refer the auditor to Auditing Standard No. 16 for the definition of the term "audit committee."

The inquiries in paragraphs 5 through 7 of the reproposed standard could be performed at the same time as the inquiries about the risks of material misstatement, including fraud risks, that are required by paragraphs 54 through 58 of Auditing Standard No. 12.[17/] These inquiries also would provide an opportunity for the auditor to discuss the company's financial relationships and transactions with its executive officers with the audit committee, or its chair, as part of the auditor's procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers.[18/]

Significant Comments and Board Responses

Some commenters suggested making revisions to allow more room for the use of auditor judgment. Other commenters made suggestions pertaining to specific inquiries required by the proposed standard. In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

[17/] Paragraph 8 of Auditing Standard No. 16, *Communications with Audit Committees,* also requires the auditor to make certain inquiries of the audit committee; *see Communications with Audit Committees* PCAOB Release No. 2012-004 (Aug. 15, 2012).

[18/] *See* the reproposed amendments in Section III.A of this Appendix.

Allowing Judgment When Performing Inquiries of Management: Some commenters suggested revising the proposed standard to allow for the exercise of auditor judgment in determining which inquiries should be made of management and noted that certain inquiries may not be relevant depending on the facts and circumstances. Another commenter suggested combining certain of the inquiries listed in the proposed standard to better allow for the use of auditor judgment in determining the nature and extent of information regarding the identity of the company's related parties, including changes from the prior period. The Board considered these comments and believes the matters identified in the list of inquiries of management consist of basic information that the auditor should obtain as part of obtaining an understanding of the company's financial relationships and transactions with its related parties. Accordingly, the Board is not proposing to make revisions for these comments.

Allowing Judgment When Performing Inquiries of Others within the Company: Several commenters suggested revising the paragraph of the proposed standard that addresses inquiries of others within the company to include the phrase "as appropriate" or "as applicable" to allow auditors judgment in both identifying appropriate individuals within the company to whom inquiries should be made and to determine the extent of the inquiries to be made. Another commenter suggested that the auditor should inquire of any individuals from whom relevant information may be obtained and noted that some individuals who would respond to inquiries of management under paragraph 6 of the proposed standard also were included in the list of examples of "others" in paragraph 7 of the proposed standard.

The Board considered these comments and is proposing a number of revisions to clarify the auditor's responsibilities when performing inquiries of others. The revisions clarify that the auditor's inquiries of others within the company relate to their knowledge of the same matters that are the subject of the auditor's inquiries of management. These matters are identified in paragraph 5 of the reproposed standard. In addition, it was not the Board's intent to require the auditor to inquire of others within the company regarding matters that the auditor did not believe were reasonably within their knowledge. To remove the notion that the auditor should make inquiries in each audit of all the individuals that were listed in paragraph 7 of the proposed standard and to address the observation that some individuals included in the list of examples of "others" might also be members of management, the Board has removed the list of individuals. Revisions have also been made to clarify that the auditor should inquire of others within the company likely to have knowledge regarding the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Identifying Related Party Transactions Not Authorized or Approved: One commenter raised a concern regarding whether smaller issuers would have formalized policies and procedures pertaining to authorizing and approving transactions with related parties. While this comment was directed at the paragraph of the proposed standard related to the auditor's communications with the audit committee, the Board's consideration of this comment prompted a change to the paragraph of the reproposed standard related to inquiries of management. The commenter stated that, while the requirement to communicate significant related party transactions to the audit committee may be appropriate, such a communication requirement may imply a level of formality that does not exist for smaller issuers and, thus, may create uncertainty for auditors of those issuers as to their responsibility to assess the issuer's policies and procedures and the level of communication required.

The Board considered this comment, recognizing that material features of companies' procedures and policies for the review, approval or ratification of related party transactions will vary depending on both the size and complexity of the company and the types of transactions covered by such policies and procedures. The Board does not mean to imply that such policies and procedures should be in writing or adhere to any particular framework. The Board, however, believes that gaining an understanding of the policies and procedures, regardless of their formality or nature, is important to an auditor's consideration of the risks that relationships and transactions with related parties may pose for material misstatement of the company's financial statements.

The Board also revised the inquiry that had been in paragraph 6.f. of the proposed standard (which is now in paragraph 5.f. of the reproposed standard) to remove the word "significant" so that the auditor would inquire of management regarding any such related party transactions. Auditor communications with the audit committee of such matters, as would be required by paragraph 19.b.-c. of the reproposed standard, would maintain a focus on such significant transactions identified by the auditor. Accordingly, the reproposed standard would require the auditor, rather than management, to make the determination as to which transactions are significant.

Expanding the Inquiry of the Audit Committee: One commenter suggested requiring the auditor to inquire of the audit committee, or its chair, about the audit committee's understanding of the business purpose or business reasons of related party transactions to corroborate management's responses. The Board considered this comment and is not proposing to expand the list of required inquiries, given concerns expressed by other commenters who suggested that the Board allow the use of additional auditor judgment to avoid potentially unnecessary costs. In the Board's view, the required inquiries of the audit committee, or its chair, in concert with the auditor's

communications with the audit committee in the reproposed standard would provide an opportunity for corroboration of management's responses.

In considering this comment, the Board noted that in the proposed standard it had used the terms "business purpose" and "business reasons" in the list of auditor inquiries of management. To avoid confusion, the reproposal would change the phrase "business reasons" to "business purpose."

Communicating with the Audit Engagement Team and Other Auditors (Paragraphs 8-9 of the Reproposed Standard in Appendix 1)

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

In addition, under PCAOB standards, a principal auditor may use the work and reports of other auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the company's financial statements.[19/] Exchanging relevant information about related parties with the other auditor can assist the principal auditor in understanding the overall nature of the company's relationships and transactions with related parties and in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor.

The Proposed Standard and Existing Requirements

Paragraphs 9 and 10 of the proposed standard would have required the auditor to communicate to engagement team members and, if applicable, other auditors relevant information about related parties, including the names of the related parties and

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

the nature of the company's relationships and transactions with those related parties. Further, paragraph 10 of the proposed standard would have required the auditor to make certain inquiries of the other auditor regarding related parties.

The existing standard, AU sec. 334.08, contains audit procedures intended to provide guidance for identifying material transactions that may be indicative of the existence of previously unidentified related party relationships. One such procedure is to provide audit personnel performing segments of the audit, or auditing and reporting separately on the accounts of related components of the reporting entity, with the names of known related parties so that they may become aware of transactions with such parties during their audits. Further, AU sec. 334.07.g., suggests a number of audit procedures for determining the existence of related party relationships, including making inquiries of other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions. Finally, AU sec. 9334.13 states that the principal auditor and the other auditor should obtain from each other the names of known related parties and that, ordinarily, the exchange should be made at an early stage of the audit.

As more fully described below, after consideration of the comments received, the Board did not make substantive revisions to the communication requirements, other than to refer the auditor to relevant paragraphs of the risk assessment standards.

The Reproposed Standard

Paragraph 8 of the reproposed standard would require the auditor to communicate to engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.

The requirement in paragraph 8 of the reproposed standard would complement the existing requirement in paragraph 49 of Auditing Standard No. 12 that key engagement team members discuss the susceptibility to material misstatement due to error or fraud. Paragraph 52 of Auditing Standard No. 12 provides that the discussion, in part, includes the susceptibility of the financial statements to material misstatement through related party transactions.

A new footnote to paragraph 8 of the reproposed standard observes that the communication that would be required by the reproposed standard complements the discussion among engagement team members, required by Auditing Standard No. 12, regarding risks of material misstatement. In addition, the new footnote includes an

expanded discussion of Auditing Standard No. 10, *Supervision of the Audit Engagement*, which establishes requirements regarding supervision of the engagement team members, including directing engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities.

Paragraph 9 of the reproposed standard states that, if the auditor is using the work of another auditor, the auditor should communicate to the other auditor relevant information about related parties, including the names of the company's related parties and the nature of the company's relationships and transactions with those related parties. Paragraph 9 would also require the auditor to inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.[20/]

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

Significant Comments and Board Responses

In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

Clarifying the Responsibilities of "Other Auditors": One commenter stated that the Board should address the responsibility of other auditors to communicate with the principal auditor, particularly other auditors auditing equity method investees who are not subject to control by the reporting investor entity. Another commenter suggested that all audit engagement letters acknowledge a joint responsibility to inform investors of

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[20/] The Board has not proposed a similar inquiry of engagement team members because existing standards already require engagement team members to bring relevant matters to the attention of the audit engagement partner. *See, e.g.,* paragraph 5 of Auditing Standard No. 10.

material related party transactions, to reinforce to the company and the auditor the significance of informing investors of the effects of related party activity. That commenter also suggested that the proposed standard represents an opportunity to clarify that all registered firms must appropriately address suspicious activities involving a public company and should not knowingly facilitate transactions with non-public entities that have no business purpose other than to conceal activity of a registrant. The Board considered these comments and noted that they generally raise important issues that may be considered in other projects that are outside the scope of this project.

D. Identifying and Assessing Risks of Material Misstatement (Paragraph 10 of the Reproposed Standard in Appendix 1)

Identifying and appropriately assessing the risks of material misstatement provide a basis for designing and implementing responses to the risks of material misstatement.

The Proposed Standard and Existing Requirements

Paragraph 12 of the proposed standard aligned with the risk assessment requirements contained in Auditing Standard No. 12 for the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level.[21/] Paragraph 12 of the proposed standard stated that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties.

Under the risk assessment standards, the auditor is also required to determine whether any of the identified and assessed risks of material misstatement are fraud risks or other significant risks.[22/] Depending on the facts and circumstances, risks of material misstatement associated with related parties and relationships and transactions with related parties might also represent fraud risks or other significant risks. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, provides examples of fraud risk factors, including some relating to related parties.[23/]

21/ *See* paragraph 59 of Auditing Standard No. 12.

22/ *See* paragraphs 59.f. and 70-71 of Auditing Standard No. 12.

23/ *See* AU sec. 316.85.A.2, section a., under "Opportunities."

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

As more fully described below, after consideration of the comments received, the Board made revisions to further clarify the auditor's responsibilities for identifying and assessing the risks of material misstatement.

The Reproposed Standard

Like the proposed standard, paragraph 10 of the reproposed standard would remind the auditor of the requirement in Auditing Standard No. 12 to identify and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 10 of the reproposed standard would expand on the proposed standard by stating that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties or relationships or transactions with related parties. The addition of the clause "including whether the company has properly identified, accounted for, and disclosed its related parties or relationships or transactions with related parties" would highlight, among other things, that the auditor's assessment of risk includes a focus on risks related to the company's less than complete identification of its related parties or relationships or transactions with related parties. Such a focus helps support the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties.[24/]

A new note to paragraph 10 would state that in identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information

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[24/] *See* the footnote to paragraph 14 of the reproposed standard, which states that evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

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

Significant Comments and Board Responses

In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

Presuming Significant Risks or Fraud Risks: Some commenters noted that the proposed standard creates the presumption that all related party transactions are significant risks. Moreover, some commenters stated that the proposed standard should not deem certain related party transactions as significant risks as that determination should be based upon facts and circumstances. Other commenters suggested expanding the examples of fraud risk factors regarding related party transactions. The Board considered these comments and agrees that not all related party transactions should be presumed to be significant risks. Like the proposed standard, the reproposed standard would not mandate that all related party transactions be presumed to be or deemed to be significant risks, or designated as a fraud risk. Under the risk assessment approach, the auditor's assessment is scalable and based on the facts and circumstances of the audit, including the facts and circumstances of a company's relationships and transactions with related parties.

Incorporating the Proposing Release Discussion Regarding Dominant Influence into the Standard: One commenter recommended that those factors identified as "factors that may signal dominant influence" in Appendix 4 of the proposing release be incorporated into the standard. The Board notes that the other proposed amendments would revise AU sec. 316.85.A.2 to include the exertion of dominant influence by or over a related party as an example of a fraud risk factor and would expand that concept to encompass all related parties outside of management of the company. Accordingly, the Board is not proposing to include a discussion regarding dominant influence in the related party standard.

Providing Additional Guidance on Identifying and Assessing Risks of Material Misstatement: One commenter recommended that the Board provide specific guidance as to how to relate risk, materiality, and other circumstantial considerations to the selection of appropriate procedures to be employed, rather than a "one-size-fits-all" approach in the proposed standard. That commenter also noted that smaller, closely-held issuers engage in frequent related party transactions, that are often less subject to controls but, because of their significance, can be detected by auditors with fewer

procedures than would be required by the proposed standard. The Board considered this comment and, as described previously, has taken steps to further align the reproposed standard with the requirements in the risk assessment standards, which are scalable based on a company's size or complexity.

E. Responding to the Risks of Material Misstatement (Paragraphs 11-13 of the Reproposed Standard in Appendix 1)

As noted in the release, relationships and transactions with related parties can pose increased risks of material misstatement in company financial statements and have been a contributing factor in prominent corporate scandals.[25/] As discussed in more detail below, similar to the proposed standard, the reproposed standard would establish specific procedures for responding to risks of material misstatement associated with the company's related parties and relationships and transactions with related parties.

The Proposed Standard and Existing Requirements

Paragraph 13 of the proposed standard aligned with the foundational risk assessment requirements contained in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, which require the auditor to design and implement audit responses that address the identified and assessed risks of material misstatement.[26/] Paragraph 13 of the proposed standard stated that this includes designing and performing audit procedures in a manner that addresses the assessed risks of material misstatement associated with related parties and relationships and transactions with related parties.

A note to paragraph 13 of the proposed standard referred the auditor to AU secs. 316.66-.67A for related party transactions that are also significant unusual transactions. This note was intended to remind auditors that certain related party transactions also might be subject to the proposed amendments regarding significant unusual transactions.

[25/] *See also*, *In the Matter of the Application of Wendy McNeeley, CPA*, SEC Accounting and Auditing Enforcement Release ("AAER") No. 3427, at 10-12 (Dec. 13, 2012).

[26/] *See* paragraph 3 of Auditing Standard No. 13.

As described more fully below, after consideration of the comments received, the Board made revisions to better clarify the relationship between the reproposed standard and the risk assessment standards. The Board also expanded the note to paragraph 13 of the proposed standard to further describe the auditor's work regarding related parties that are significant unusual transactions.[27/]

The Reproposed Standard

Similar to paragraph 13 of the proposed standard, paragraph 11 of the reproposed standard would remind the auditor of the requirement in Auditing Standard No. 13 to design and implement audit responses that address the identified and assessed risks of material misstatement. Paragraph 11 of the reproposed standard states that this includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties. A new footnote refers the auditor to relevant paragraphs of the risk assessment standards, including paragraph 17 of Auditing Standard No. 15, *Audit Evidence*, which provides that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

The note to this paragraph has been expanded to further clarify the auditor's responsibilities for related party transactions that are also significant unusual transactions. As reproposed, the note states that the auditor also should look to the requirements in proposed paragraphs .66-.67A of AU sec. 316 for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). The revised note would clarify that, for such related party transactions, AU sec. 316.67 requires the auditor to evaluate whether the business purpose (or the lack thereof) of the transactions indicates that the transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

[27/] *See also* the discussion in Section II.A. of this Appendix that describes the linkage between the reproposed standard and the reproposed amendments regarding significant unusual transactions.

Significant Comments and Board Responses

In developing the reproposed standard, the Board considered all comments received, including the following significant comment:

Clarifying the Reference to Significant Related Party Transactions Outside the Normal Course of Business: One commenter questioned whether a related party transaction that, although within the normal course of business, otherwise appears to be unusual due to its timing, size, or nature could be a related party transaction that is also a significant unusual transaction. That commenter based their question on an example of a related party transaction that is also a significant unusual transaction that was contained in a note to paragraph 13 of the proposed standard. The Board considered this comment and notes that the example of a significant related party transaction outside the normal course of business represents just one example of a related party transaction that is also a significant unusual transaction. Accordingly, the Board is not proposing revisions for this comment.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk (Paragraph 12 of the Reproposed Standard in Appendix 1)

Securities regulators expect that auditors will provide "heightened scrutiny" of a company's related party transactions.[28/] Similar to the Board's proposal, the reproposed standard would require the auditor to perform certain basic procedures (supplemented by more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances) regarding related party transactions that are either required to be disclosed in the financial statements or determined to be a significant risk. In the Board's view, focusing the auditor's attention on these related party transactions is intended to enhance the effectiveness of the auditor's evaluation of whether the company's related party transactions are properly accounted for and disclosed.

28/ *See*, *In the Matter of the Application of Wendy McNeeley, CPA,* SEC AAER No. 3427, at 10-12 (Dec. 13, 2012), which states in part that the SEC and Courts have repeatedly held that related party transactions require heightened scrutiny by auditors, and notes the importance of the auditor understanding the business purpose of material related party transactions.

The Proposed Standard and Existing Requirements

Paragraph 15 of the proposed standard would have required the auditor to perform specific procedures for each related party transaction, or type of related party transaction, that is either required to be disclosed in the financial statements or determined to be a significant risk.

The existing standard, AU sec. 334, contains procedures that the auditor should consider performing when responding to risks arising from related party relationships and transactions. For example, AU sec. 334.11 requires that, for each material related party transaction that requires disclosure, the auditor should consider whether he or she has obtained sufficient appropriate evidential matter to understand the related party relationship and the effects of the related party transactions on the financial statements. AU secs. 334.09-.10 describe procedures for examining identified related party transactions. Those paragraphs direct the auditor to apply the procedures the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of identified related party transactions and their effect on the financial statements, noting that those procedures should extend beyond inquiry of management. Footnote 6 of AU sec. 334.09 states that "[u]ntil the auditor understands the business sense of material transactions, he cannot complete his audit."

As described more fully below, after consideration of the comments received, the Board made several revisions intended to more clearly articulate the nature and extent of the required procedures, including changes intended to clarify the auditor's responsibility when related party transactions are aggregated for disclosure purposes.

The Reproposed Standard

Paragraph 12 of the reproposed standard would require the auditor to perform specified procedures for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk. For such transactions, the reproposed standard would require the auditor to:

a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

b. Determine whether the transaction has been authorized and approved in accordance with the company's established policies and procedures

regarding the authorization and approval of transactions with related parties;

c. Determine whether any exceptions to the company's established policies or procedures were granted;

d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and

e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

As reproposed, paragraph 12.a. would clarify that the auditor should read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction.

As reproposed, paragraph 12.d. would be expanded to require the auditor's evaluation of the financial capability of the related party to include significant loan commitments and supply arrangements.

Paragraph 12.e., was revised in response to comments to remove the reference to the objective of the standard and to clarify the auditor's responsibilities. Like the proposed standard, paragraph 12.e. of the reproposed standard would provide an opportunity for the auditor to scale the audit by requiring the auditor to supplement the basic required procedures with more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. Specifically, as revised, paragraph 12.e. would require the auditor to perform other procedures as necessary to address the identified and assessed risks of material misstatement.

In response to comments, a note to paragraph 12 of the reproposed standard has been added to clarify the auditor's responsibility for aggregated related party disclosures. Specifically, the note would state that if the company has aggregated related party transactions for disclosure purposes in accordance with the applicable financial reporting framework, the auditor may perform the procedures in paragraph 12 of the reproposed standard for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement. The Board notes that a "selection of

transactions" could be the selection of one transaction from the aggregation in the appropriate circumstances.

A footnote to paragraph 12.c. of the reproposed standard states that information gathered while obtaining an understanding of the company also might assist the auditor in identifying agreements prohibiting or restricting related party transactions (for example, loans or advances to related parties).

A footnote to paragraph 12.d. of the reproposed standard states that examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.

Significant Comments and Board Responses

Although some commenters expressed general support for the procedures required by the proposed standard, others made specific suggestions regarding the nature and extent of the auditor's procedures.

Clarifying the Auditor's Responsibility for Aggregated Related Party Disclosures: Some commenters stated that the required procedures could be interpreted to suggest that all transactions comprising a "type" of related party transaction must be subject to the required procedures. One commenter suggested clarifying that testing transactions from each "type" of related party transaction is sufficient. Other commenters recommended clarifying the proposed standard by incorporating additional discussion from the proposing release into the standard. The Board considered these comments and, as previously discussed, added a note to paragraph 12 of the reproposed standard to clarify that testing each related party transaction that the company has aggregated for disclosure purposes is not required.

Allowing More Room for the Use of Auditor Judgment: Some commenters stated that the proposed audit procedures do not allow for sufficient application of auditor judgment when responding to the risks of material misstatement arising from a company's relationships and transactions with related parties required to be disclosed in the financial statements or determined to be a significant risk. The Board considered this comment and noted that the proposed standard established basic procedures that would be supplemented by more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. These facts and circumstances include the size and complexity of the transactions, the nature of a company's

relationships or transactions with its related parties, and the related risk of material misstatement in the financial statements. This approach permits auditor judgment, within a framework that assures that basic requirements are met and the interests of investors are protected.

Referencing the Objective of the Standard: Some commenters recommended clarifying the requirement in the proposed standard that the auditor "perform other procedures as appropriate, depending on the nature of the related party transaction and the related risks of material misstatement, to meet the objective of this standard."

The Board considered this comment, noting that the Board's auditing standards require the auditor to obtain sufficient appropriate audit evidence to support their audit opinion on the company's financial statements. Depending on the facts and circumstances of the audit, an auditor might determine that additional procedures beyond those required by paragraphs 12.a.-d. of the reproposed standard are necessary to obtain sufficient appropriate audit evidence regarding related party transactions that either are required to be disclosed in the financial statements or that are determined to be a significant risk. The Board made revisions to require the auditor to perform other procedures "as necessary to address the identified and assessed risks of material misstatement." The Board believes that this approach is more clearly linked to the auditor's responsibilities to obtain sufficient audit evidence to support his or her audit opinion.

Understanding the Business Purpose (or the Lack Thereof) of a Related Party Transaction: One commenter noted that more emphasis could be given to the importance of the auditor's understanding of the business purpose of related party transactions. At the SAG discussion, the point was raised that some auditors believe that as long as management has not asserted that the terms of the related party transaction are equivalent to those available on an arm's-length basis, the auditor has no obligation beyond determining whether management has disclosed the transaction.

Another commenter recommended deleting the phrase "(or the lack thereof)" from the proposed standard. That commenter agreed that auditors should be aware of the possibility that transactions with related parties may not have a business purpose but did not believe that the requirements in the proposed standard would provide the auditor with evidence about a lack of a business purpose.

In the Board's view, performing the procedures in paragraphs 3-9 of the reproposed standard in conjunction with the risk assessment procedures required by Auditing Standard No. 12 should inform the auditor's understanding of the company's

relationships and transactions with its related parties. That understanding would include the terms and business purposes (or the lack thereof) of the transactions involving related parties. Understanding the business purpose of related party transactions is an important consideration in assessing and responding to risks of material misstatement and requires the auditor to understand other factors underlying the transaction. For example, although a company may assert that it has utilized a related party transaction to achieve a particular goal, the company may, in fact, have used the transaction for some other purpose.[29/] Obtaining an understanding of the terms and business purpose of a related party transaction includes understanding why the company entered into the transaction with a related party versus an unrelated party.

The inclusion of the phrase "(or the lack thereof)" is intended to promote a questioning and skeptical approach by the auditor when obtaining an understanding of the business purpose of related party transactions. Sharpening the auditor's focus on evaluating the business purpose of related party transactions is particularly appropriate in view of the risk of material misstatement involving related party transactions.[30/] The importance of identifying transactions that appear to lack a business purpose is reinforced in other parts of the Board's proposal. For example, the reproposed standard, like the proposed standard, would require the auditor to communicate to the audit committee the identification of significant related party transactions that appear to the auditor to lack a business purpose. In addition, the other reproposed amendments to AU sec. 316.85 would add "contractual arrangements lacking a business purpose" as a new example of a fraud risk factor. Accordingly, the Board is not proposing to revise the

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[29/] For example, a broker or dealer might use related party transactions to make the size of their operations appear smaller to avoid regulatory requirements. *See* the discussion entitled "Related Party Transactions at Brokers and Dealers" in Section V. of this Appendix.

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

proposal for these comments. However, as described above, the Board is proposing revisions in paragraph 12.a. of the reproposed standard to clarify the auditor's procedures.

Evaluating the Financial Capability of the Related Party: Some commenters expressed concern regarding the proposed requirement to evaluate the financial capability of the related party. One commenter noted that while evaluating the financial capability of the related party is an important consideration, sufficient information may not be available to do so. That commenter recommended that the Board acknowledge such circumstances and the related auditor response. Another commenter stated that evaluating financial capability may be difficult to perform when the related party is privately held and not controlled by the audit client and further stated that the assessment that the audit client has the ability to exercise significant influence over a related party (or vice versa) for accounting purposes does not necessarily equate to management of the audit client having sufficient influence over the related party to demand the receipt of non-public information.

The Board considered these comments, noting that the proposed requirement would have applied only to items that are individually or collectively significant. In the Board's view, obtaining evidence to evaluate the financial capability of a related party can inform the auditor's evaluation of the business purpose (or the lack thereof), including whether the substance of that transaction differs materially from its form.[31/] The Board notes that auditors are currently performing procedures to evaluate the financial capability of counterparties in a variety of audit areas today, regardless of whether the counterparty is a related party. For example, auditors might examine the company's support regarding the financial capability of another party as part of evaluating the company's decision to recognize revenue on a particular transaction. Accordingly, the Board is not proposing to make revisions for this comment.

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

Performing Procedures at the Related Party: At the SAG discussion, the point was raised that the auditor should consider performing audit procedures at the premises of the related party. In considering this comment, the Board notes that its auditing standards require the auditor to obtain sufficient appropriate audit evidence to support his or her audit opinion. In certain circumstances, an auditor may decide that performing audit procedures at the related party is appropriate. The Board, however, is not proposing to require that procedures be performed at the related party's premises because the related party may not allow the auditor to perform such procedures. In some circumstances, such a requirement might place an unreasonable burden on the auditor and the company under audit.

Including Examples from the Proposing Release in the Standard: Several commenters recommended incorporating the additional discussion and examples of procedures that the auditor might perform pursuant to paragraph 15.d. of the proposed standard included in Appendix 4 of the proposing release into the standard. The Board considered these comments and determined, as it has done in other projects, to include performance requirements in the standard and to provide additional discussion and examples in an appendix to the release. This approach promotes a clear separation between the required procedures in the standard and the Board's discussion regarding the potential application of the standard. As such, the examples of procedures and other discussion in the proposing release have not been incorporated into the reproposed standard.

Intercompany Transactions (Paragraph 13 of the Reproposed Standard in Appendix 1)

Applicable financial reporting frameworks require the elimination of intercompany transactions in the preparation of consolidated financial statements. Based on a company's facts and circumstances, intercompany transactions could result in risks of material misstatement.

The Proposed Standard and Existing Requirements

Paragraph 14 of the proposed standard would have required the auditor to perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ. As such, paragraph 14 incorporated an existing procedure contained in AU sec. 334. Specifically, AU sec. 334.09.e. states that the auditor should consider arranging for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.

Other existing standards also reference the importance of the auditor's review of consolidating accounts, such as AU sec. 543, which states that, regardless of whether the principal auditor decides to make reference to the audit of the other auditor, the principal auditor should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.[32/]

As more fully described below, after consideration of the comments received, the Board is not proposing revisions to this paragraph. However, the Board is seeking additional comment on the auditor's responsibility for performing procedures on intercompany account balances, and has included a specific question at the end of this section.

The Reproposed Standard

As reproposed, paragraph 13 would require the auditor to perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

Significant Comments and Board Responses

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

Providing Expanded Guidance Regarding Intercompany Account Balances: Several commenters suggested that the Board clarify the auditor's responsibility regarding intercompany account balances. For example, some commenters suggested including examples of the risks associated with intercompany balances and guidance regarding the nature, timing, and extent of risk assessment procedures and related responses. Another commenter indicated that, when fiscal years differ, testing of intercompany transactions could be performed at a concurrent interim date and noted

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[32/] *See* AU sec. 543.10, which provides that those measures may include ascertaining through communication with the other auditor that a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.

that, in their view, the requirement in the proposed standard might be read to imply that testing is required as of period end.

The Board considered these comments, noting that the preparation of consolidated financial statements could involve complex matters regarding intercompany transactions. For example, a company could consolidate a subsidiary that has a different year-end. Further, some intercompany transactions that are eliminated in consolidation could include related party transactions that may not require disclosure under the applicable financial reporting framework, yet might give rise to significant risks of material misstatement.[33/] Such related party transactions would be subject to the procedures described in paragraph 12 of the reproposed standard. The Board is not proposing to revise the proposal for these comments, but has included a question at the end of Section I. of this Appendix seeking additional input from commenters in this area.

F. Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14-16 of the Reproposed Standard in Appendix 1)

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

The Proposed Standard and Existing Requirements

The proposed standard would have addressed the auditor's responsibility to identify a company's related party transactions in paragraph 3 (duty to perform procedures), paragraph 11 (evaluating whether information that comes to the auditor's attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist), paragraph 16 (determining whether related parties or relationships or transactions with related parties previously undisclosed to the auditor, in fact, exist), and paragraph 17 (performing audit procedures on related parties or relationships or transactions with related parties previously undisclosed).

33/ *See* paragraphs 59.f. and 70-71 of Auditing Standard No. 12.

AU sec. 334.07 describes a number of procedures for determining the existence of related parties, while AU sec. 334.08 provides examples of procedures for identifying material transactions with known related parties and for identifying material transactions that may be indicative of the existence of previously undetermined related party relationships. AU sec. 334.04 also states that during the course of his audit, the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and of common ownership or management control relationships that require disclosure even though there are no related party transactions. AU sec. 334.03 describes transactions that because of their nature may be indicative of the existence of related parties.

As more fully described below, after consideration of the comments received, the Board substantially revised paragraphs 3, 11, 16, and 17 of the proposed standard. As part of these revisions, the Board consolidated the auditor's responsibilities for evaluating whether the company has properly identified its related parties and relationships and transactions with related parties into a single section of the reproposed standard. In addition, as discussed in more detail below, the Board made revisions in response to commenters who suggested that the Board clarify the auditor's responsibility to identify the company's related parties and to allow more room for auditor judgment by removing the requirement that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk.

The Reproposed Standard

Paragraph 14 of the reproposed standard would focus the auditor more directly on a key aspect of the auditor's objective by requiring the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties.[34/] Paragraph 14 of the reproposed standard anticipates that, while the auditor would start its work regarding related parties with the names of related parties and relationships and transactions with related parties identified by the company, the auditor may not merely rely on management's representations as to the

[34/] Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

accuracy and completeness of the information provided to the auditor.[35/] A new footnote to paragraph 14 of the reproposed standard would state that evaluating whether a company has properly identified its related parties involves more than assessing the process used by the company to identify its related parties. It is the role of the auditor to go beyond management's representations and perform audit procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

Paragraph 14 of the reproposed standard would require the auditor to take into account the information gathered during the audit in evaluating whether the company has properly identified its related parties and relationships and transactions with related parties. Paragraph 14 would also require that as part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. A new footnote to paragraph 14 of the reproposed standard would state that information obtained from identifying and evaluating a company's significant unusual transactions and obtaining an understanding of a company's financial relationships and transactions with its executive officers could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Like the proposed standard, a note refers the auditor to Appendix A which describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Many of the examples contained in Appendix A of the reproposed standard are contained in AU secs. 334.07-.08.

The reproposed standard would not require an auditor to perform procedures with respect to each source of information referenced in Appendix A. However,

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[35/] The auditor's procedures to evaluate whether the company has properly identified its related parties should extend beyond the inquiries pursuant to paragraphs 5-7 of the reproposed standard. Paragraph 10 of Auditing Standard No. 15 requires that when using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to: test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and evaluate whether the information is sufficiently precise and detailed for purposes of the audit.

evaluating whether a company has properly identified its related parties and relationships and transactions with related parties requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company. Further, an auditor may be required to perform auditing procedures with respect to certain of those sources (for example, reading confirmation responses and responses to inquiries of the company's lawyers) by other auditing standards or through the performance of auditing procedures in other areas.[36/] Appendix A also states that the examples contained in that Appendix are not intended to represent a comprehensive listing.

The auditor's efforts to identify and evaluate a company's significant unusual transactions might also assist the auditor in identifying information that might indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Among other things, Appendix A states that contracts and other agreements representing significant unusual transactions are an example of a source of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

According to paragraph 15 of the reproposed standard, if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor would be required to perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Like the proposed standard, the reproposed standard also would require that these procedures extend beyond inquiry of management.

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

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

Paragraph 16 of the reproposed standard would require that if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

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

b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;

c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;

d. Assess the need to perform additional procedures to identify additional relationships or transactions with the related party previously undisclosed to the auditor;

e. Perform the procedures required by paragraph 12 of the reproposed standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;

f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;

g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and

h. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor determines that it is likely that an illegal act has or may have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

The requirements of paragraph 16 of the reproposed standard would, in large part, mirror those required by the proposed standard. Notably however, in response to

comments, revisions have been made to allow more room for auditor judgment. As reproposed, paragraph 16 would not require that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk.

Like the proposed standard, a footnote to paragraph 16 of the reproposed standard would refer the auditor to AU sec. 333.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.

Significant Comments and Board Responses

The Board received several comments regarding the auditor's responsibility for evaluating information and performing procedures regarding related parties or relationships or transactions with related parties previously undisclosed to the auditor. In developing the reproposed standard the Board considered all comments received, including the following significant comments:

Clarifying the Auditor's Responsibility for Evaluating the Company's Identification of Its Related Parties: Some commenters suggested that the Board clarify the auditor's responsibility to perform procedures to identify the company's related parties. In response, the reproposed standard has been revised to focus more directly on a key aspect of its objective, that is, whether related parties and relationships and transactions with related parties have been properly identified by the company under audit.

As reproposed, the standard would include a new requirement for the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties, as well as more focused audit steps intended to support the auditor's required evaluation. Such steps, which closely mirror the auditor's risk assessment process, include: (i) performing risk assessment procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements; (ii) identifying and assessing risks associated with a company's relationships and transactions with its related parties, including whether the company has properly identified its related parties and relationships and transactions with related parties; (iii) designing and performing audit procedures that address and respond to the risks of material misstatement associated with the company's related parties and transactions; and (iv) performing specific procedures that

address related party relationships or transactions identified by the auditor that were previously undisclosed by company management.

In the Board's view, the clarifications in the reproposed standard represent a more effective audit approach that recognizes that the company is responsible for the preparation of its financial statements, including, in the first instance, the identification of the company's related parties and relationships and transactions with related parties, and that the auditor begins the audit with information obtained from the company.[37/]

Allowing More Room for the Use of Auditor Judgment: Several commenters stated that the proposed standard should allow more room for the use of auditor judgment when the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Some of these commenters expressed concern over the proposed requirement that all previously undisclosed related party transactions identified by the auditor be treated as a significant risk. Some of these commenters noted that an undisclosed related party transaction could be inconsequential in nature, and, in such circumstances, treating the transaction as a significant risk, and performing all of the procedures set forth in the proposed standard would be unnecessary. Other commenters suggested it might be appropriate to perform some, but not all, of the related procedures in the proposed standard.

In the Board's view, certain basic procedures should be performed by the auditor when an undisclosed related party transaction comes to the auditor's attention. For example, because of the potential for fraud, paragraph 16.b. of the reproposed standard would require the auditor to evaluate why the related party or relationship or transactions with a related party was previously undisclosed to the auditor. However, in response to the concerns expressed by some commenters, the Board has removed the requirement that each related party transaction previously undisclosed to the auditor by management be treated as a significant risk. As reproposed, the auditor would only be required to perform the more extensive procedures required by paragraph 12 of the

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[37/] To further assist the auditor's efforts in identifying related parties, the reproposed other amendments include a complementary provision that would expand existing management representations contained in AU sec. 333, *Management Representations,* to state that the company has provided the names of all related parties and all relationships and transactions with its related parties to the auditor. However, the auditor may not solely rely on management's representations.

reproposed standard when the undisclosed related party transaction is either required to be disclosed in the financial statements or determined to be a significant risk.

Evaluating Information That Comes to the Auditor's Attention: Paragraph 11 of the proposed standard would have required the auditor to evaluate whether information that comes to the auditor's attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. One commenter indicated that this may infer a separate evaluation of all information obtained by the auditor. The commenter suggested that, alternatively, the auditor should be required to "remain alert" for information or other conditions that indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. The Board considered this comment, noting that it had considered the "remain-alert" approach contained in International Auditing and Assurance Standards Board ("IAASB") and AICPA Auditing Standards Board ("ASB") standards in developing the proposed standard. The Board believes, however, that "remain alert" may be too passive given the need for the heightened level of scrutiny associated with related party transactions. Accordingly, the Board is not proposing to replace the "evaluate-whether" language with a requirement to "remain alert."

Clarifying the Auditor's Responsibility Regarding Appendix A: Several commenters suggested that the Board clarify the auditor's responsibility regarding the examples of information and sources of information included in Appendix A of the proposed standard. For example, some commenters thought the auditor's responsibility with respect to Appendix A was not clear, others thought that Appendix A appeared too prescriptive, and one commenter expressed concern that PCAOB inspectors may interpret Appendix A to require the auditor to perform specific procedures. The Board considered these and similar comments and noted that many commenters generally requested that the Board provide additional guidance regarding the information, and sources of information that could indicate relationships or transactions with related parties. Appendix A to the proposed standard was included to assist the auditor's identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor. The information and sources relevant to a particular audit would depend on the facts and circumstances of the audit and, thus, not all of the information or sources of information in Appendix A would need to be considered in every audit. Other auditing standards, however, might require the auditor to examine certain items listed in Appendix A. The Board is proposing to retain Appendix A but seeks commenters' views on whether the addition of Appendix A is helpful to auditors or whether it should be removed.

Further, one commenter recommended requiring the auditor to read the minutes of the board of directors and its compensation committee, if any. While this comment was directed at the requirement to obtain an understanding of the company's financial relationships and transactions with its executive officers, the Board's consideration of this comment prompted a change to the paragraph of the reproposed standard related to evaluating whether the company has properly identified its related parties and relationships and transactions with related parties.

In the Board's view, reading minutes of meetings of the board of directors is an important procedure for identifying information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. The Board also noted that existing standards already require the auditor to read minutes of meetings of the board of directors and appropriate committees for other purposes[38/] and AU sec. 334 includes reading minutes as an example of a procedure for identifying transactions with related parties.[39/]

Consequently, the Board made revisions that would require that, as part of the auditor's evaluation whether the company has properly identified its related parties and relationships and transactions with related parties, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. Performing this procedure may also inform the auditor's understanding of the company's financial relationships and transactions with its executive officers.

Determining Whether Previously Undisclosed Related Parties Exist: One commenter noted that the proposed standard would have required the auditor to perform procedures that extend beyond inquiry of management in order to determine whether undisclosed relationships or transactions with related parties that might exist do, in fact exist, but that the Board provided no examples of such procedures. That commenter noted that if the Board has specific procedures in mind, then examples of such procedures should be provided. The Board considered these comments and noted that the risk assessment standards require the auditor to perform audit procedures to

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[38/] *See*, *e.g.*, AU sec. 560, *Subsequent Events*, AU sec. 722, *Interim Financial Information*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

[39/] *See* AU sec. 334.08b.

resolve inconsistencies in, or doubts about the reliability of, audit evidence.[40/] If the auditor identifies information that creates a doubt about the completeness of the company's identification of its related parties, the auditor should perform the audit procedures necessary to resolve the matter. For example, in resolving the matter, the auditor might review relevant available public information about the party in question, or inquire of other parties with knowledge about the party in question (e.g., banks, guarantors, agents, or attorneys). Because the nature of those procedures would depend upon the facts and circumstances of the audit, the Board is not proposing to make revisions for these comments.

Including the Discussion Contained in AU sec. 334.04: Some commenters expressed concern that the proposed standard could create an expectation that the auditor will always identify all of the company's related party transactions. One commenter recommended that the Board include language in the standard that is similar to that in AU sec. 334.04, which states that an audit cannot be expected to provide assurance that all related party transactions will be discovered.

In the Board's view, an audit performed in accordance with PCAOB auditing standards should provide reasonable assurance that the financial statements are free of material misstatements whether caused by fraud or error.[41/] This includes reasonable assurance regarding accounting for and disclosure of related party transactions. The auditor should perform such specific procedures to obtain sufficient appropriate evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the company's financial statements.

G. Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17-18 of the Reproposed Standard in Appendix 1)

The auditor’s evaluation of a company’s accounting and disclosure of relationships and transactions with related parties is important to the protection of investor interests because the substance of related party transactions might differ materially from their form. Furthermore, related party transactions not only may involve

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[40/] *See* paragraph 29 of Auditing Standard No. 15.

[41/] *See* paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

difficult measurement and recognition issues, but may also be used to engage in financial statement fraud and conceal misappropriation of assets.

The Proposed Standard and Existing Requirements

Paragraph 18 of the proposed standard would have required the auditor to evaluate whether the financial statements contain the information regarding related party transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

AU sec. 334.02 states that the auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure. AU sec. 334.02 also states that "the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form." Auditing Standard No. 14 describes the auditor's responsibility for evaluating the presentation of financial statements, including disclosures, more generally. Auditing Standard No. 14 requires the auditor to evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.[42/] Furthermore, AU sec. 411.06 requires the auditor to consider whether the substance of transactions or events differs materially from their form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. Like the proposed standard, the reproposed standard aligns with, and builds upon, the requirements in Auditing Standard No. 14 and AU sec. 411.

As more fully discussed below, after consideration of the comments received, the Board made revisions to clarify the auditor's responsibility for evaluating whether related party transactions have been properly accounted for and disclosed in the financial statements.

The Reproposed Standard

Paragraph 17 of the reproposed standard would require the auditor to evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. This would include evaluating whether the financial statements

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[42/] *See* paragraph 30 of Auditing Standard No. 14.

contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework. A new footnote to paragraph 17 would direct the auditor to paragraph 31 of Auditing Standard No. 14.

As reproposed, paragraph 17 is intended to align the auditor's evaluation with the objective of the standard and to focus the auditor on both the accounting and disclosure of the company's relationships and transactions with related parties.

Significant Comments and Board Responses

In developing the reproposed standard, the Board considered all comments received, including the following significant comment:

Evaluating Financial Statement Accounting and Disclosure: One commenter expressed concern that the substance-over-form issue discussed on page A4-20 of Appendix 4 of the proposing release could require auditors to challenge the appropriateness of the accounting standards and recommended changes to the proposed standard to focus the auditor's requirements only on the disclosure of related party transactions.

The Board considered this comment. The Board, however, does not agree that the proposed standard would have required the auditor to challenge accounting standards. Footnote 1 to paragraph 1 of the proposed standard stated that the auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company. The discussion in Appendix 4 of the proposing release is consistent with AU sec. 334.02, which notes that the auditor should be aware that the substance of a related party transaction could be significantly different from its form. This concept was not included in the proposed standard as it is already contained in AU sec. 411.06.

The Board further notes that financial statements may not be presented fairly if they do not include information about the matters that affect their use, understanding and interpretation.[43/] For example, to improve the appearance of its financial condition, a company and a related party could attempt to "dress up" the appearance of the company's balance sheet at period-end. Some period-end "window-dressing"

43/ *See* AU sec. 411.04.

transactions might involve side agreements undisclosed to the auditor, while others might represent transactions, that the auditor is aware of, in which management placed more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction. As reproposed, paragraph 12.e. would require the auditor to obtain the audit evidence necessary to address risks of material misstatement identified and assessed by the auditor, including risks of material misstatement associated with these matters.

To further clarify the auditor's responsibility for evaluating whether related party transactions (including related party transactions that pose difficult substance-over-form considerations or that appear to lack a business purpose) have been properly accounted for and disclosed in the financial statements, the Board is also proposing revisions in paragraph 17 of the reproposed standard. Those revisions would require the auditor to evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements.

This commenter also expressed concern that the proposed standard implied that the auditor's evaluation of the fair presentation of financial statements occurs in a piecemeal fashion and that auditors evaluate individual disclosures in isolation. The Board considered this comment, noting that, like the proposed standard, the reproposed standard would require that the auditor perform procedures for each related party transaction that requires disclosure in the financial statements. Similarly, the auditor's evaluation pursuant to paragraph 17 of the reproposed standard would encompass each related party transaction that requires disclosure.[44/] The Board is not proposing to revise the requirement in this paragraph for this suggestion.

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (Paragraph 18 of the Reproposed Standard in Appendix 1)

Financial reporting frameworks allow management to assert that a related party transaction was consummated on terms equivalent to those prevailing in arm's-length

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[44/] Like the proposed standard, footnote 2 of the reproposed standard refers the auditor to examples of other relevant standards and rules, including paragraph 31 of Auditing Standard No. 14 and paragraph .04 of AU sec. 411.

transactions only when management can substantiate that assertion.[45/] However, those financial reporting frameworks do not discuss what information is required to substantiate such an assertion or how management is to determine the terms and conditions that would prevail in an arm's-length exchange, including, for example, whether there would be a guarantee or an extension of credit.

The Proposed Standard and Existing Requirements

Paragraph 19 of the proposed standard would have required that if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. AU sec. 334 includes requirements regarding the auditor's evaluation of assertions that related party transactions occurred on terms equivalent to those occurring on an arm's length basis. For example, AU sec. 334.12 states that, except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been.

As more fully discussed below, after consideration of the comments received, the Board is reproposing paragraph 19 without revision.

The Reproposed Standard

Paragraph 18 of the reproposed standard would require that, if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. The reproposed standard also would state that if the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's

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[45/] *See* FASB ASC paragraph 850-10-50-5. Paragraph 23 of International Accounting Standard ("IAS") 24 also states that disclosures "that related party transactions were made on terms equivalent to those that prevail in arm's length transactions are made only if such terms can be substantiated."

assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.[46/]

Like the proposed standard, a note to paragraph 18 would state that transactions with related parties might not be conducted on terms equivalent to those prevailing in arm's-length transactions. Except for routine transactions, it may not be possible for management to determine whether a particular transaction would have taken place, or what the terms and manner of settlement would have been, if the parties had not been related. Accordingly, it may be difficult for the auditor to obtain sufficient appropriate audit evidence to substantiate management's assertion that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. The note retains the discussion contained in AU secs. 9334.22-.23 that a preface to an assertion such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

Significant Comments and Board Responses

In developing the reproposed standard, the Board considered all comments received, including the following significant comments:

Assessing the Implications of Management's Inability to Provide Support for Its Arm's-Length Assertion: One commenter recommended that footnote 35 in the proposing release should be included in the reproposed standard. That footnote provided that a decision by management to remove, at the auditor's request, an arm's-length assertion regarding a related party transaction from the financial statements due to management's inability to provide the auditor with sufficient appropriate audit evidence, might impact the auditor's assessment of internal control over financial reporting. The Board considered this recommendation and agrees that such circumstances might impact the auditor's assessment of internal control over financial reporting or understanding of the control environment. However, such a determination would be based on the facts and circumstances of the situation. In the Board's view, including the discussion in footnote 35 of the proposing release in the reproposed standard might inappropriately create an impression that further procedures regarding

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[46/] A decision by management to remove, at the auditor's request, such an assertion from the financial statements due to management's inability to provide the auditor with sufficient appropriate audit evidence might affect the auditor's assessment of internal control over financial reporting.

the control environment are always necessary. As a result, the Board is not proposing to make revisions for this comment.

Describing the Effect of the Auditor's Report on SEC Filings: Some commenters recommended that the standard should note that a qualified or adverse opinion will result in an inability to make appropriate SEC filings. The Board considered this comment, noting that the auditor's responsibility is to obtain sufficient appropriate audit evidence to support the auditor's opinion and issue the appropriate audit report. It is the responsibility of management to determine the impact of any modification to the auditor's standard report on the company's ability to make appropriate filings with the SEC. As such, the Board is not proposing to make revisions for this comment.

Allowing More Room for the Use of Auditor Judgment: Some commenters stated that the requirements in the proposed standard do not permit the auditor to exercise auditor judgment when responding to the significance of management's refusal to modify a disclosure that asserts that a related party transaction was conducted at arm's-length. Those commenters noted that the existing standard states that the evaluation is "based on the materiality" of the transaction and that this phrase has not been included in the reproposed standard. The Board considered these comments and noted that financial reporting frameworks permit management to assert that a related party transaction occurred on an arm's-length basis only when support for such an assertion exists. A statement by management in the financial statements that a related party transaction occurred on an arm's-length basis when support for that statement does not exist represents a departure from U.S. GAAP and IFRS. Such a misstatement would require the auditor to express either a qualified or adverse opinion on the financial statements. As such, the Board is not proposing to make revisions for this comment.

H. Communications with the Audit Committee (Paragraph 19 of the Reproposed Standard in Appendix 1)

Both the auditor and the audit committee benefit from a meaningful exchange of information regarding significant risks of material misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports, including matters arising from a company's relationships and transactions with related parties.[47/]

[47/] Higher quality financial reporting (as a result of better informed auditors, better informed audit committees, or both) improves the quality of information available

The Proposed Standard and Existing Requirements

Paragraph 20 of the proposed standard would have required the auditor to communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, as well as other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

In contrast, the existing standard, AU sec. 334, does not include requirements regarding the auditor's communication with the audit committee. Other, existing auditing standards, however, require that the auditor communicate significant matters to the audit committee, including those encountered during a review of interim financial information.[48/]

As more fully discussed below, the Board is reproposing the auditor's communication requirements substantially as proposed, with revisions to further align and work in concert with, the requirements in Auditing Standard No. 16, *Communications with Audit Committees*.[49/]

The Reproposed Standard

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

a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;

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to the markets and reduces the information asymmetry that exists about the company among investors as well as between investors and the company's management.

[48/] *See* Auditing Standard No. 16 and AU sec. 722.34.

[49/] *See* PCAOB Release No. 2012-004 (Aug. 15, 2012).

b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;

c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;

d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and

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

Paragraph 19 of the reproposed standard is intended to work in tandem with paragraph 7 of the reproposed standard, which would require the auditor to make inquiries of the audit committee, or its chair, at an earlier point in the audit. The communication required by paragraph 19 of the reproposed standard would provide an opportunity for the auditor to communicate information obtained during the audit relevant to those earlier inquiries.

Subsequent to the close of the comment period for the Board's proposal, the Board adopted Auditing Standard No. 16, *Communications with Audit Committees*.[50/] The Board made changes to align the requirements in the reproposed standard with Auditing Standard No. 16. For example, a new footnote has been added to paragraph 19 of the reproposed standard that would refer the auditor to Auditing Standard No. 16 regarding the timing of communications to the audit committee. This footnote in the reproposed standard replaces a note that was included in the proposed standard that indicated the auditor should communicate with the audit committee "in a timely manner" and "prior to the issuance of the auditor's report." That note is no longer necessary because Auditing Standard No. 16 includes specific requirements on the nature and timing of auditor communications with the audit committee. In addition, the phrase, "in a timely manner and prior to the issuance of the auditor's report" in paragraph 20 of the proposed standard has not been included in the reproposed standard to avoid confusion because Auditing Standard No. 16 includes specific guidance on the timing of communications.

50/ *See* PCAOB Release No. 2012-004 (Aug. 15, 2012).

The reproposed amendments include conforming amendments to Auditing Standard No. 16 that would:

- Replace the reference in footnote 25 to AU sec. 334 with a reference to the reproposed standard; and

- Add a reference in Appendix B, *Communications with Audit Committees Required by Other PCAOB Rules and Standards* of Auditing Standard No. 16 to the audit committee inquiries and communications required by paragraphs 7 and 19 of the reproposed standard.

Significant Comments and Board Responses

Commenters generally requested clarification regarding the alignment of the proposed standard with the requirements in the proposed auditing standard regarding auditor communications with audit committees. As described above, the Board has made revisions to the communication requirements to align with, and be incremental to, communications with the audit committee under Auditing Standard No. 16.

In developing the reproposed standard, the Board also considered all other comments received, including the following significant comments:

Reporting Matters on an Exception Basis: At the SAG discussion, the point was raised that the auditor's communications to audit committees should emphasize exceptions identified by the auditor. Another commenter recommended that the paragraph in the proposed standard requiring communication to the audit committee that the financial statements include a statement that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction be removed from the standard because, in the commenter's opinion, it would be more appropriate for the auditor to respond to questions in this area only if asked by the audit committee. Another commenter recommended waiving the communication to the audit committee when related party transactions are already well known, not unusual, or not material. This commenter questioned the benefit of communication in those instances. The Board considered these comments and is not proposing revisions to provide for communication of these matters on an exception basis. Doing so would not provide for the proactive communication that the Board believes should occur with the audit committee regarding a company's relationships and transactions with its related parties.

Making the Auditor's Communications Incremental to Management's: One commenter stated that the auditor’s communication with the audit committee should be

focused on matters not previously communicated by management and any other areas requiring significant auditor judgment. The Board considered this comment and noted that the proposed communication requirements would involve communication of the auditor's evaluation of certain matters and that management is not in a position to communicate the auditor's views. As such, the Board is not proposing to make revisions for this comment.

Timing of the Auditor's Communications: One commenter stated that the language in the proposed standard is "too soft" and is an argument for letting the information linger until "all the facts are in," up to the point when the audit report is released. That commenter recommended requiring early audit committee communication requirements regarding related party transactions. The Board considered this comment and noted that paragraph 7 of the reproposed standard would require the auditor to inquire of the audit committee as part of the auditor's risk assessment procedures. In addition, Auditing Standard No.16 anticipates timely and robust communications between the auditor and the audit committee throughout the audit. The Board, therefore, is not proposing to make revisions for this comment.

Clarifying Significant Matters: One commenter stated that it is unclear what the Board expects the auditor to communicate beyond the significant matters that are specifically identified in the proposed standard. That commenter recommended combining the requirements in the proposed standard into a single paragraph and including a requirement that the auditor communicate "other significant matters, if any, related to the auditor's evaluation of the company's identification of, accounting for, and disclosures of its relationships and transactions with related parties." Because the Board does not intend to limit audit committee communications to only those significant matters included in the reproposed standard, no revisions have been made in response to this comment. For example, in evaluating the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, the auditor might identify other significant matters that might be of interest to the audit committee, such as concerns over the company's process for identifying related parties and relationships and transactions with related parties.

I. Other Considerations

The Board did not propose any changes to the auditor's report in connection with the proposed standard and amendments, but sought input on whether the proposed standard should change the auditor's responsibilities for the auditor's report regarding related party transactions. The Board notes that any changes to the auditor's report in this area would be considered in conjunction with the Board's project on improvements

to the Auditor's Reporting Model. The Board encourages commenters to send comments on such issues in response to future Board proposals on the Auditor's Reporting Model.[51/]

Questions:

1. Are the requirements of the reproposed standard appropriate? Why or why not?

2. Do the changes in the reproposal clarify the relationship of the reproposed standard with the risk assessment standards? Why or why not?

3. Does the alignment of the reproposed standard with the risk assessment standards enable the auditor to introduce efficiencies in the audit approach? Why or why not?

4. Would the procedures required by the reproposed standard improve the auditor's understanding of a company's relationships and transactions with its related parties? Why or why not?

5. Is the requirement in the reproposed standard to evaluate whether the company has properly identified the company's related parties and relationships and transactions with its related parties appropriate? Why or why not?

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

7. Are the auditor's responsibilities for the examples of information and sources of information contained in Appendix A to the reproposed standard clear? Are there other examples that should be included in the reproposed standard?

8. Is the objective of the reproposed standard appropriate? Why or why not? Does the reproposing release clearly articulate that the objective of the reproposed standard works similarly to objectives contained in other PCAOB auditing standards?

51/ *See* http://pcaobus.org/Rules/Rulemaking/Pages/Docket034.aspx.

9. Does the requirement in the reproposed standard to perform specific procedures for each related party transaction required to be disclosed in the financial statements or determined to be a significant risk provide for a scaled approach? Why or why not?

10. Does the approach in the reproposed standard for the auditor to perform specific procedures for related party transactions that are required to be disclosed in the financial statements or that are determined to be a significant risk represent a cost-sensitive, yet effective, approach? Why or why not?

11. What additional guidance, if any, regarding the auditor's responsibility for performing procedures on intercompany account balances pursuant to paragraph 13 of the reproposed standard is necessary?

II. Reproposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

Overall, commenters were generally supportive of the need to improve the existing requirements regarding significant unusual transactions. However, some commenters suggested changes to the proposed requirements. In response, the Board has made certain revisions to clarify and refine the proposed amendments regarding significant unusual transactions. These comments and the proposed revisions are organized by the following topical areas:

Relevant information is provided for each topical area, including a description of the proposed amendments regarding significant unusual transactions and existing requirements, a description of the reproposed amendments regarding significant unusual transactions, and a discussion of significant comments received and Board responses. Specific questions for commenters follow the discussion of Evaluating Significant Unusual Transactions, however, commenters are encouraged to comment on all aspects of the reproposed amendments.

A. Identifying Significant Unusual Transactions (Section A. of the Reproposed Amendments in Appendix 2)

Financial reporting frauds have demonstrated that companies may use significant unusual transactions, such as transactions in which management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction, to materially misstate their financial statements. Significant unusual transactions can also result in material misstatement of financial statements due to error. Improving the auditor's identification of significant unusual transactions can promote audit quality.

Improving the auditor's identification of significant unusual transactions also can inform the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties, as a related party transaction previously undisclosed to the auditor might also be a significant unusual transaction.

The Proposed Amendments and Existing Requirements

The proposed amendments regarding identifying significant unusual transactions aligned the description of significant unusual transactions in the Board's auditing standards, enhanced the requirements for identifying a company's significant unusual transactions, and revised and added to the examples of fraud risk factors described in AU sec. 316.

The existing standard relating to the auditor's consideration of fraud in a financial statement audit, AU sec. 316, recognizes that during an audit the auditor may become aware of significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment.[52/] The risk assessment standards also anticipate that the auditor might come across significant transactions that are outside the normal course of business for the company or that are otherwise appear to be unusual due to their timing, size, or nature.[53/]

[52/] *See* AU sec. 316.66.

[53/] For example, paragraph 71.g. of Auditing Standard No. 12 states that one factor that should be evaluated for the auditor's determination of which risks are

As more fully described below, after consideration of the comments received, the Board is reproposing the amendments regarding identifying significant unusual transactions substantially as proposed, except for certain changes that are intended to enhance the linkage between the reproposed amendments regarding significant unusual transactions and the reproposed standard.

The Reproposed Amendments

Description of Significant Unusual Transactions

Like the proposed amendments, the reproposed amendments regarding significant unusual transactions would amend AU sec. 316.66 to describe significant unusual transactions as significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature. This description is consistent with the existing description in paragraph 71.g. of Auditing Standard No. 12. The reproposed amendments to AU sec. 316.66 also would state that significant unusual transactions may be used to engage in fraudulent financial reporting or conceal misappropriation of assets.

The reproposed amendments regarding significant unusual transactions also would make conforming changes to introduce a uniform description of "significant unusual transaction" throughout the Board's standards. Specifically, the reproposed amendments would align the terminology in paragraph 14 of Auditing Standard No. 5, *An Audit of Internal Control over Financial Reporting That Is Integrated with An Audit of Financial Statements,* paragraph 12 of Auditing Standard No. 9, paragraph 13 of Auditing Standard No. 12, paragraph 15.c. of Auditing Standard No. 13, paragraph .85.A.2 of AU sec. 316, and paragraph .55.B1. of AU sec. 722, *Interim Financial Information*. As compared to the proposed amendments, these conforming changes would reflect a number of minor revisions that are intended to further clarify the description of a significant unusual transaction throughout the Board's standards.

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significant risks is whether the risk involves significant transactions outside the normal course of business or that otherwise appear to be unusual due to their timing, size, or nature.

Enhancing Requirements for Identifying Significant Unusual Transactions

The reproposed amendments would include amendments to the Board's existing standards that would require the performance of procedures as part of the auditor's risk assessment process to identify significant unusual transactions. As discussed below, these procedures would include: (1) inquiring of management and others, (2) understanding controls relating to significant unusual transactions, and (3) taking into account other information obtained during the audit. The reproposed amendments in this area remain substantively the same, except for certain changes that serve to enhance the linkage between the reproposed amendments regarding significant unusual transactions and the reproposed standard.

Inquiring of Management and Others (Paragraphs 56-57 of Auditing Standard No. 12)

The reproposed amendments would build on existing requirements in Auditing Standard No. 12 that require the auditor to make inquiries of management and others within the company about the risks of material misstatement.[54/] Specifically, the reproposed amendments regarding significant unusual transactions would revise paragraph 56.a. of Auditing Standard No. 12 to require the auditor to inquire of company management regarding whether the company has entered into any significant unusual transactions, and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties. The proposed amendments regarding significant unusual transactions would also revise paragraphs 56.b. and 56.c. of Auditing Standard No. 12 to require the auditor to inquire of the audit committee and internal audit personnel (if applicable), respectively, regarding whether the company has entered into any significant unusual transactions.

Paragraph 57 of Auditing Standard No. 12 requires that the auditor inquire of others within the company about their views regarding fraud risks and includes the example of employees involved in initiating, recording, or processing complex or unusual transactions. The reproposed amendments would add significant unusual transactions as an example of a complex or unusual transaction to paragraph 57 of Auditing Standard No. 12.

54/ *See* paragraphs 56-57 of Auditing Standard No. 12.

Understanding Controls Relating to Significant Unusual Transactions (Paragraph 73A of Auditing Standard No. 12)

Auditing Standard No. 12 requires that the auditor obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.[55/]

The reproposed amendments regarding significant unusual transactions would build on the risk assessment standards by adding paragraph 73A to Auditing Standard No. 12. That paragraph would require the auditor to obtain an understanding of the controls management has established to identify, authorize and approve, and account for and disclose significant unusual transactions in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18-40 and 72-73 of Auditing Standard No. 12.

Taking into Account Other Information Obtained During the Audit (AU sec. 316.66)

The reproposed amendments regarding significant unusual transactions would add a note to AU sec. 316.66 stating that the auditor's identification of significant unusual transactions should take into account information obtained from: (a) the risk assessment procedures required by Auditing Standard No. 12 (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial reporting), and (b) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

As discussed above, revisions have been made in the reproposal to clarify the linkage between the reproposed standard and the reproposed amendments regarding significant unusual transactions. Specifically, unlike the proposal, the reproposed amendments would add a second note to AU sec. 316.66 that would state that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. In addition, a new note would also be included after paragraph 11 in the reproposed standard that would state

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55/ *See* paragraph 18 of Auditing Standard No. 12.

that, for a related party transaction that is also a significant unusual transaction pursuant to AU secs. 316.66-.67A, the auditor is required to evaluate whether the business purpose (or the lack thereof) of the transaction indicates that the transaction was entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. Further, a new footnote to the reproposed standard would state that information obtained from identifying and evaluating a company's significant unusual transactions (as well as from obtaining an understanding of a company's financial relationships and transactions with its executive officers) could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Fraud Risk Factors

Like the proposed amendments, the reproposed amendments regarding significant unusual transactions also would revise certain examples of fraud risk factors contained in AU sec. 316. For example, AU sec. 316.85A.2 notes that significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm can provide opportunities to engage in fraudulent financial reporting. The reproposed amendments regarding significant unusual transactions would bifurcate that discussion into two separate examples, namely: (1) related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business) and (2) significant transactions with related parties whose financial statements are not audited or are audited by another firm. The reproposed amendments also would add contractual arrangements lacking a business purpose as an example of a fraud risk factor.

Significant Comments and Board Responses

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

Defining Significant Unusual Transactions and Including Examples: Some commenters recommended defining the term "significant unusual transaction." Another commenter recommended including examples of significant unusual transactions. After considering these comments, the Board has not revised the proposed amendments. In the Board's view, the description of a significant unusual transaction included in the proposed amendments permits auditor flexibility in applying the description to different companies of different sizes and in different industries. Likewise, the Board has not included examples of significant unusual transactions in its reproposal. In the Board’s

view, whether a specific transaction constitutes a significant unusual transaction should be based upon the specific facts and circumstances.

Clarifying the Complementary Nature of Significant Unusual Transactions and Identifying Related Parties Previously Undisclosed to the Auditor: Some comments received by the Board appeared to indicate that commenters might not have fully appreciated the Board's intended emphasis on the complementary nature of the auditor's efforts regarding significant unusual transactions and identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor. The Board believes that emphasizing the complementary nature of the auditor's efforts in identifying significant unusual transactions can also inform the auditors evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties. To further emphasize the complementary nature of the auditor's efforts regarding a company's relationships and transactions with its related parties and significant unusual transactions, as discussed above, the Board is proposing revisions to further emphasize the linkage between these topics. These revisions include adding a new note to AU sec. 316.66, a new note to paragraph 11 of the reproposed standard, and a new footnote to paragraph 14 of the reproposed standard.

Determining Whether a Transaction is a Significant Unusual Transaction: One commenter noted that eliminating from AU sec. 316.66 the phrase "or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment," while also stating in the proposing release that significant unusual transactions need not be infrequent but could occur quarterly or more frequently, appears counterintuitive. That commenter was concerned that this could create ambiguity. Another commenter suggested providing examples of transactions that would not occur infrequently and nonetheless be considered significant unusual transactions. The Board considered these comments, noting that the description of a significant unusual transaction is designed so that the auditor determines whether a transaction is a significant unusual transaction based on the specific facts and circumstances. In the Board’s view, removing the phrase contained in AU sec. 316 does not change the need for the auditor to make this determination based on the facts and circumstances, which would include the auditor's understanding of the company and its environment. Specifically, a new note to AU sec. 316.66 would state that the auditor's identification of significant unusual transactions should take into account information obtained from the risk assessment procedures required by Auditing Standard No. 12. Auditing Standard No. 12 requires the auditor to obtain an understanding of the

company and its environment.[56/] The proposing release stated that a significant unusual transaction need not occur infrequently to clarify that the timing or frequency of transactions is only one element to be considered in determining whether a transaction is a significant unusual transaction. The Board, therefore, is not proposing to change the amendments regarding significant unusual transactions in response to these comments.

Using Management's Terminology: One commenter noted that management does not have an equivalent term for "significant unusual transaction" in its literature (that is, the applicable accounting framework, Committee of Sponsoring Organizations of the Treadway Commission ("COSO") or SEC management guidance). In that commenter's view, the transactions that the auditor determines are "significant unusual transactions" will likely be transactions that management views as the result of its non-routine or estimation processes. That commenter noted that management's processes and related controls may not be different for "significant unusual transactions" than for other similar transactions. The Board considered this comment, noting that inquiring of management and others within the company regarding the existence of significant unusual transactions as part of its risk assessment procedures is an important step – but not the only step - in the auditor's identification of significant unusual transactions. The auditor might determine that there are significant unusual transactions despite management's assertions (for example, through other procedures performed during the audit, such as reading minutes of the board of directors meetings and performing journal entry testing). Consequently, the Board is not proposing to revise the amendments regarding significant unusual transactions in response to this comment.

Incorporating Examples of Procedures That May Identify Significant Unusual Transactions from the Proposing Release: One commenter recommended including examples of procedures from the proposing release that may help identify significant unusual transactions in the proposed amendments. The Board considered this comment but is proposing to include the performance requirements in the proposed amendments, while providing the additional discussion of the amendments and related examples in an appendix to the release, as it has done in the past. This approach promotes a clear separation between the required procedures in the standard and the Board's discussion regarding the potential application of the reproposed amendments. As such, the examples of procedures and other discussion in the proposing release have not been incorporated into the reproposed amendments. However, as described above, the Board is proposing to add a second note to AU sec. 316.66 that would state

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[56/] *See* paragraph 7 of Auditing Standard No. 12.

that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. This note also refers the auditor to Appendix A of proposed auditing standard, *Related Parties,* which includes examples of information and examples of sources of such information.

B. Evaluating Significant Unusual Transactions (Section B. of the Reproposed Amendments in Appendix 2)

Because a company might use a significant unusual transaction to engage in fraudulent financial reporting or to obscure the company's financial position or operating results, existing standards require the auditor to perform procedures to evaluate significant unusual transactions identified by the auditor and discuss the auditor's evaluation of such transactions with the audit committee.[57/] The amendments in this area are designed to improve the auditor's evaluation of significant unusual transactions, including the auditor's evaluation of the business purpose (or the lack thereof), and whether the transactions have been appropriately accounted for and adequately disclosed in the company's financial statements. Improving the auditor's evaluation of significant unusual transactions should also result in a more meaningful exchange of information between the auditor and the audit committee.[58/]

The Proposed Amendments and Existing Requirements

The proposed amendments regarding significant unusual transactions were intended to strengthen the auditor's evaluation of significant unusual transactions. The proposed amendments, which would have built on existing requirements in AU secs. 316.66-.67, included specific procedures intended to focus the auditor's attention on critically evaluating whether the business purpose (or the lack thereof) for significant unusual transactions indicates that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.

[57/] *See* AU secs. 316.66-.67 and paragraph 13.d. of Auditing Standard No. 16.

[58/] Higher quality financial reporting (as a result of better informed auditors, better informed audit committees, or both) improves the quality of information available to the markets and reduces the information asymmetry that exists about the company among investors as well as between investors and the company's management.

The proposed amendments also would have included an evaluation of whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework.

Existing AU sec. 316.66 currently requires that once an auditor becomes aware of significant unusual transactions, the auditor should gain an understanding of the business rationale for such transactions and whether that rationale (or the lack thereof) suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. Existing AU sec. 316.67 identifies several matters that the auditor should consider in understanding the business rationale for those transactions.

As more fully described below, after consideration of the comments received, the Board made revisions to the proposed amendments regarding evaluating significant unusual transactions.

The Reproposed Amendments

Evaluating the Business Purpose of Significant Unusual Transactions

The reproposed amendments regarding evaluating significant unusual transactions would add a new paragraph to AU sec. 316, AU sec. 316.66A, to require that the auditor design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. The reproposed procedures would include:

a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;

c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and

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

As reproposed, item a. of the proposed amendments to AU sec. 316.66A would clarify that the auditor should read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction.

As reproposed, item c. of the proposed amendments to AU sec. 316.66A would be expanded to require the auditor's evaluation of the financial capability of the other party to include other significant matters, specifically, significant loan commitments and supply arrangements.

Item d. of the proposed amendments to AU sec. 316.66A would be revised to better clarify the auditor's responsibilities. Like the proposed amendments, item d. would provide an opportunity for the auditor to scale the audit by requiring the auditor to supplement the basic required procedures with more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. Specifically, as revised, item d. would require the auditor to perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Like the proposed amendments, a footnote to item c. of the reproposed amendments to AU sec. 316.66A also would state that examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

The reproposed amendments also would require the auditor to evaluate certain matters when evaluating whether the business purpose (or the lack thereof) of a significant unusual transaction suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. Like the proposed amendments, the reproposed amendments would largely incorporate the list of matters currently in AU sec. 316.67 and would add additional matters. Those additional matters would include:

- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end).

- The transaction occurs with a party that falls outside the definition of a related party (as defined by the accounting principles applicable to that company), with either party able to negotiate terms that may not be available for other, more clearly independent, parties on an arm's-length basis.

- The transaction enables the company to achieve certain financial targets.

These additional matters are intended to strengthen the auditor's evaluation of the business purpose (or the lack thereof) for significant unusual transactions, including whether they may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.

In addition, the reproposal would align the proposed footnote to AU sec. 316.67 with the description of "related parties or relationships or transactions with related parties previously undisclosed to the auditor." The revised footnote also would reference the requirement in the reproposed standard that the auditor perform certain procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

Evaluating the Accounting and Disclosure of Significant Unusual Transactions

The reproposed amendments would emphasize the auditor's responsibility to evaluate the accounting and disclosure of significant unusual transactions by adding a new paragraph to AU sec. 316, paragraph .67A. That new paragraph would require the auditor to evaluate whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements. AU sec. 316.67A would further state that this includes evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework. A new footnote would direct the auditor to paragraph 31 of Auditing Standard No. 14.

Like the proposed amendments, the reproposed amendments would add a new note to AU sec. 316.67A that would state that, in evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in accordance with the financial reporting framework, the auditor considers management's disclosure regarding significant unusual transactions in other parts of the company's SEC filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

Other Matters Regarding Significant Unusual Transactions

Like the proposed amendments, the reproposed amendments regarding significant unusual transactions also would include new paragraph 11A to Auditing Standard No. 13. That paragraph would remind auditors that significant unusual transactions can affect the risks of material misstatement due to error or fraud, and that the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to the reproposed amendments to AU secs. 316.66-.67A regarding significant unusual transactions.

The reproposed amendments regarding significant unusual transactions would complement the auditor communication requirements in Auditing Standard No. 16. Specifically, improving the auditor's identification and evaluation of significant unusual transactions could improve the quality of auditor communications with audit committees. The reproposed amendments also would revise paragraph 13.d. of Auditing Standard No. 16 to refer to the "business purpose (or the lack thereof)" instead of the "business rationale" of a significant unusual transaction.

Significant Comments and Board Responses

In developing the reproposed amendments regarding evaluating significant unusual transactions the Board considered all comments received, including the following significant comments:

Providing Additional Guidance for Identifying and Assessing Risks of Material Misstatement: One commenter recommended providing guidance as to how to relate risk, materiality, and other considerations to the selection of procedures for significant unusual transactions rather than a "one-size-fits-all" approach, which that commenter asserted was inherent in the proposed amendments regarding significant unusual transactions. The Board notes that the proposed amendments regarding significant unusual transactions were designed to establish basic procedures for the auditor to identify and evaluate significant unusual transactions, and allow the auditor to assess risks and respond to risks based on the facts and circumstances, including the size and complexity of the company and the assessed significance of the identified risks of material misstatement in the financial statements. The Board, therefore, did not change the amendments in response to this comment.

Evaluating the Financial Capability of the Other Party: Some commenters expressed concern that information pertinent to an unrelated third party may not be

available to the auditor, hindering the auditor's ability to evaluate the financial capability of the other party. After considering these comments, the Board is not proposing to make revisions for this comment. See the discussion "Evaluating the Financial Capability of the Related Party" under the heading "Transactions with Related Parties Required to Be Disclosed in the Financial Statements or That are a Significant Risk" in Section I.E. of this Appendix.

Incorporating Examples of "Other Procedures" from the Proposing Release: Some commenters suggested incorporating the examples of procedures that might be appropriate for the auditor to perform that were contained in the proposing release into the proposed amendments regarding significant unusual transactions. The Board considered these comments and determined, as it has done in other projects, to include the performance requirements in the Board's standards and to provide the additional discussion of the amendments and related examples in an appendix to the release. This approach promotes a clear separation between the required procedures in the standard and the Board's discussion regarding the potential application of the standard. As such, the examples of procedures and other discussion in the proposing release have not been incorporated into the reproposed amendments regarding significant unusual transactions.

Evaluating the Implications of the Lack of a Business Purpose: One commenter stated that older versions of the auditing standards suggested that if the auditor is unable to understand the business purpose of a transaction, the auditor may not be able to express an unqualified opinion. That commenter suggested that this provision be included, along with reporting guidance. Further, at the SAG discussion, the point was raised that the standard should include a statement similar to footnote 6 of AU sec. 334.09, which states that "[u]ntil the auditor understands the business sense of material transactions, he cannot complete his audit. If he lacks sufficient specialized knowledge to understand a particular transaction, he should consult with persons who do have the requisite knowledge."

The Board considered these comments and noted that significant unusual transactions, like all transactions, are subject to the requirements contained in AU sec. 411.06, which requires that the auditor consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. That evaluation would encompass an understanding of the "business sense" of material transactions. As a result, these comments are not reflected in the reproposal.

Evaluating Whether a Significant Unusual Transaction Enables the Company to Achieve Financial Targets: One commenter noted that the expanded list of factors (in AU sec. 316.67) was problematic. Specifically, that commenter noted that requiring the auditor to consider whether the accounting for a transaction enables the company to achieve certain financial targets could be a "catch-all" that covers a variety of unintended transactions. Another commenter suggested that this factor should be deleted, noting that the factor could result in an auditor unnecessarily evaluating transactions for fraud that clearly have not been entered into to engage in fraudulent financial reporting or the misappropriation of assets. That commenter stated that this factor is redundant as other factors, for example, whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transactions (e.g., accounting-motivated structured transaction) are sufficient.

The Board considered these comments, noting that considering whether a transaction enables the company to achieve certain financial targets is an important consideration when evaluating whether that transaction has been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. The Board is proposing to revise this factor to focus the auditor on whether the transaction enables the company to achieve financial targets.

Questions:

12. Are the reproposed amendments regarding the auditor's identification of significant unusual transactions appropriate? Why or why not?

13. Are the reproposed amendments regarding the auditor's evaluation of significant unusual transactions appropriate? Why or why not?

14. Would the procedures required by the reproposed amendments regarding significant unusual transactions improve the auditor's identification and evaluation of a company's significant unusual transactions? Why or why not?

15. Are the reproposed amendments regarding significant unusual transactions appropriately aligned with the risk assessment standards? Why or why not?

16. Do the reproposed amendments regarding significant unusual transactions appropriately allow for the use of auditor judgment? Why or

why not? Does the requirement that the auditor perform specific procedures for each significant unusual transaction identified by the auditor provide for a scaled approach? Why or why not?

17. Is the complementary relationship between the amendments regarding significant unusual transactions and the reproposed standard clear? Why or why not?

III. Other Reproposed Amendments to PCAOB Auditing Standards

The Board also proposed amendments regarding a company's financial relationships and transactions with executive officers, other new requirements that complement the proposed standard and amendments, and amendments that would have conformed other auditing standards to the proposed standard and amendments. Overall, while the proposed changes regarding a company's financial relationships and transactions with executive officers drew support from a range of commenters, some commenters raised concerns that performing such procedures could have unintended consequences, including impacting the design of compensation arrangements. In response to the comments received the Board made revisions to clarify and refine various aspects of the other proposed amendments. The discussion of the comments and proposed revisions pertains to the following PCAOB auditing standards:

Relevant information is provided regarding the reproposed amendments to each standard, including a description of the proposed amendments and existing requirements, a description of the reproposed amendments, and a discussion of significant comments received and Board responses. Following the discussion of the reproposed amendments to AU sec. 722 are specific questions for commenters, although the Board encourages comments on all aspects of the reproposed amendments. In particular, the Board seeks comment regarding the reproposed amendments to Auditing Standard No. 12 that would require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment.

A. Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Appendix 3)

A company's financial relationships and transactions with its executive officers might create incentives and pressures that could create risks of material misstatement of the financial statements. Performing procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers can benefit the auditor's identification of fraud risks and other significant risks. Further, performing procedures to obtain such an understanding can result in the identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor, which in turn can contribute to the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties.

The Proposed Amendments and Existing Requirements

The Board's proposal included amendments to Auditing Standard No. 12 that would have required the auditor to perform specific procedures to obtain an understanding of relationships and transactions with the company's executive officers as part of the auditor's risk assessment. The proposed amendments also would have included procedures that the auditor *should consider* performing, namely: (i) obtaining an understanding of the company's policies and procedures regarding executive officer expense reimbursements and (ii) inquiring of the chair of the company's compensation committee (or its equivalent) and any company compensation consultants regarding the structuring of the company's compensation for its executive officers. The proposed amendments were intended to assist the auditor in identifying and assessing risks associated with a company's financial relationships and transactions with its executive officers.

The other proposed amendments were designed to build on the existing risk assessment standards. Specifically, paragraph 11 of Auditing Standard No. 12 already requires that, as part of obtaining an understanding of the company, the auditor should consider obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses. The proposal anticipated that the additional procedures to be performed would contribute to the auditor's consideration of fraud in a financial statement audit pursuant to AU sec. 316, which recognizes certain incentives and pressures on management to commit fraud as examples of fraud risk factors.

As more fully described below, after consideration of the comments received, the Board is proposing revisions to the other proposed amendments to Auditing Standard No. 12 to clarify that the auditor's procedures in this area would be performed as part of the auditor's risk assessment process and would not require the auditor to make any determination regarding the reasonableness of the company's compensation arrangement with its executive officers or recommendations regarding such compensation arrangements.

The Reproposed Amendments

As reproposed, the Board's amendments relating to financial relationships and transactions with a company's executive officers would add paragraph 10A to Auditing Standard No. 12. The proposed change would require the auditor, as part of the auditor's risk assessment process, to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers (for example, executive compensation, including perquisites, and any other arrangements). As stated in the proposing release, the Board intends that the procedures should be sufficient to identify whether these financial relationships and transactions could create conditions (for example, incentives and pressures) that could result in risks of material misstatement, including fraud risks.[59/]

The reproposed amendments, like the proposed amendments, would require the auditor to perform procedures that include, but are not limited to:

[59/] *See* page A4-41 of the proposing release.

- Reading the employment and compensation contracts between the company and its executive officers; and

- Reading proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.[60/]

The focus of the reproposed procedures is the company's "executive officers." As noted above, the Board's reproposed amendments would build on the existing focus in paragraph 11 of Auditing Standard No. 12 on the company's compensation arrangements with "senior management." Like the proposed amendments, the reproposed amendments would include a definition of the term "executive officer" that links to the SEC's definition of an executive officer in Rule 3b-7 under the Exchange Act, for issuers, and a list contained in Schedule A of Form BD, for broker-dealers.[61/]

The reproposed amendments would not change the existing requirement to consider obtaining an understanding of compensation arrangements with senior management. The population for the procedures required by paragraph 10A of the other reproposed amendments is the list of "executive officers," as defined in the SEC rules or

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[60/] The auditor also might read the company's proxy statements and other relevant SEC company filings in meeting the requirements of paragraph 11 of Auditing Standard No. 12, which states that the auditor should consider reading public information regarding the company as part of the process for obtaining an understanding of the company.

[61/] Specifically, the reproposed amendments to Auditing Standard No. 12 would include the following definition of an "executive officer": For issuers, the president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policy-making functions for the company. (*See* Rule 3b-7 under the Exchange Act.) For brokers and dealers, the term "executive officer" includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions. (*See* Schedule A of Form BD.)

included on Schedule A of Form BD,[62/] while the existing requirement in paragraph 11 of Auditing Standard No. 12 continues to apply to what may be a larger population of a company's management.

Like the Board's proposed amendments, the reproposed amendments also would include a number of other changes designed to strengthen the auditor's consideration of the risk of material misstatement associated with financial relationships and transactions with its executive officers. As reproposed, the revisions to paragraph 11 of Auditing Standard No. 12 would require the auditor to consider performing procedures to:

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

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

In the Board's view, understanding a company's financial relationships and transactions with its executive officers can assist the auditor in understanding whether those relationships and transactions affect the risks of material misstatement.[63/] For example, the auditor could consider whether the company's internal control over

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[62/] *See* Exchange Act Rule 3b-7, 17 C.F.R. §240.3b-7, and Schedule A of Form BD. *See generally* Item 401(b) of Regulation S-K, 17 C.F.R. §229.4-01(b).

[63/] For example, according to a May 2010 academic study that examined in detail SEC accounting and auditing enforcement releases from 1998 to 2007, the chief executive officer or chief financial officer was named in 89 percent of the enforcement actions involving fraudulent financial reporting. That study also noted that the SEC's most commonly cited motivations for fraud included the need to meet internal or external earnings expectations, an attempt to conceal the company's deteriorating financial condition, the need to increase the stock price, the need to bolster financial performance for pending equity or debt financing, or the desire to increase management compensation based on financial results. *See,* M. Beasley, J. Carcello, D. Hermanson, and T. Neal, "*Fraudulent Financial Reporting 1998-2007 An Analysis of U.S. Public Companies*," at 3, available at http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.

financial reporting is designed and operating to address risks that management might seek accounting results solely to boost certain executive officers' compensation. This understanding could also assist the auditor in determining areas where management bias might occur (for example, certain accounting estimates, including fair value measurements).

Similarly, obtaining an understanding of how the company has structured its compensation for its executive officers can assist the auditor in identifying fraud risks. Existing standards identify a company's financial relationships and transactions with its executive officers as examples of fraud risk factors.[64/] The information obtained from this risk assessment procedure, therefore, could complement the requirement in paragraph 52 of Auditing Standard No. 12 that key engagement team members discuss the potential for material misstatement due to fraud, including consideration of the known external and internal factors affecting the company that might create incentives or pressures for management and others to commit fraud.

As described above, the reproposed amendments are not intended to call into question the compensation policies and procedures of the company, but rather, to assist the auditor in identifying and assessing risks of material misstatement in the financial statements that may be a consequence of a company's financial relationships and transactions with its executive officers.[65/]

Significant Comments and Board Responses

Many commenters generally supported the proposed amendments to Auditing Standard No. 12 relating to executive compensation. One commenter stated that requiring the auditor to perform additional procedures to obtain an understanding of this aspect of company governance should result in higher quality audits that better assist investors in making informed investment decisions and improve public confidence in the financial markets. Other commenters however, did not support the proposed amendments and expressed concerns, including concerns that the proposed amendments might influence the design and appropriateness of company compensation arrangements with its executive officers and that the proposed amendments might impair auditor independence. Other commenters provided

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64/ *See* AU sec. 316.85.

65/ *See* page A4-44 of the proposing release.

recommendations to further strengthen the proposed amendments. In developing its reproposal, the Board considered all comments received, including the following significant comments:

Clarifying That the Proposed Procedures are Performed As Part of the Auditor's Risk Assessment: Some commenters expressed a concern that the proposal might result in auditors influencing the design and appropriateness of compensation arrangements with executive officers. One commenter suggested that the proposed amendments could potentially transform the traditional auditor's role from providing assurance on the reliability of financial statements to evaluating the design or appropriateness of executive compensation, including the business purpose and impact of executive compensation arrangements on the company.

Another commenter stated that the amendments would require the auditor to substantively judge executive compensation and that this could fundamentally change the relationship between the board and the auditor. That commenter also noted that the proposed amendments would appear to place the auditor in the role of advising the board on substantive business decisions. That commenter stated that this seems inconsistent with the non-audit service prohibitions in Section 201 of the Sarbanes-Oxley Act and, in fact, not suited to the auditor's areas of expertise. That commenter stated that this expanded role would entail analyzing executive compensation risk, without the need to connect the risk with the rewards and that the auditor's advice may be skewed in favor of limiting compensation in a manner that may not be in the best interest of the shareholders. That commenter further stated that the proposed amendments could result in certain companies having uncompetitive compensation arrangements, thereby, putting those companies at risk of losing talented executives.

Other commenters supported the proposed amendments but noted that there was confusion surrounding the proposal and suggested that the Board clarify the purpose of the proposed amendments. In addition, during the SAG discussion it was suggested that the Board clarify that there is no expectation that auditors will be engaged in the compensation committee process or in an audit of that process.

The Board considered all comments received and made revisions to emphasize that the purpose of the procedures is to further the auditor's risk assessment rather than to require the auditor to determine the appropriateness of a company's compensation agreements with its executive officers. The Board notes that the reproposed amendments would not require the auditor to assess the appropriateness of the compensation of executive officers. As reproposed, the first sentence of paragraph 10A of Auditing Standard No. 12 would read as follows:

> To assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers.

The revisions are intended to clarify that the procedures performed are intended to occur in the context of the auditor's process for assessing the risks of material misstatement of the company's financial statements.

Performing the Proposed Procedures Could Impair Auditor Independence: Some commenters expressed concern that the proposed amendments might affect an auditor's independence. Those commenters noted that, while the PCAOB recognized in the proposing release that it is not suggesting that auditors become involved in or influence executive compensation decisions, they are concerned that auditor independence could in fact be compromised in this manner. As support, those commenters noted their belief that it would be unreasonable to assume that auditors would not express opinions or have discussions with board members or management that could influence, wittingly or not, decisions regarding performance-based compensation plans.

The Board considered these comments and noted that auditors already have an existing responsibility to assess the risk of material misstatement of the financial statements. The Board further noted that obtaining an understanding of compensation arrangements with a company's senior management is already part of procedures that are considered in the context of the auditor's risk assessment activities. As proposed, the amendments relating to a company's financial relationships and transactions with its executive officers extend the auditor's existing work in this area, with a focused set of required procedures to address a critical area that could pose substantial risk to the integrity of companies' financial statements and reporting processes. Thus, the Board did not make changes in response to these comments. In the Board's view, performing procedures to understand a company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment represents an extension of the auditor's existing responsibilities. The performance of such audit procedures should not impair auditor independence.

Performing the Proposed Procedures Might Require Specialists: Several commenters suggested that auditors might need to engage specialists to understand

company employment contracts, noting that the time to obtain and understand these contracts might be significant.

The Board considered these comments and noted that Auditing Standard No. 12 already requires the auditor to consider performing procedures with respect to employment arrangements with a company's senior management. The Board did not receive comments from auditing firms that suggested that they would have difficulty performing the procedures that would have been required by the proposed amendments. Accordingly, the Board is not proposing revisions to the proposed amendments, but is soliciting comment regarding potential costs of its reproposal.

Generating Documentation That Complicates Litigation: One commenter stated that the proposed amendments would generate documentation and other records that could complicate any litigation or claims relating to executive compensation discussions. That commenter further stated that these records would not be subject to attorney-client privilege or similar protections and could result in increased liability on the part of companies and their shareholders.

In the Board's view, the auditor's responsibilities to conduct the audit and prepare related documentation generally should not be limited by the threat of potential litigation against the company. Obtaining an understanding of the company, including by performing procedures relating to a company's financial arrangements with its executive officers, is an important part of the auditor's risk assessment activities. This understanding may lead to the discovery of incentives and pressures that could foster fraudulent financial reporting or conceal the misappropriation of assets. After consideration, the Board is not proposing to make revisions in response to this comment.

Determining the Company's Executive Officers: Some commenters recommended that the amendments clarify the auditor's role in determining who is considered an "executive officer." In particular, commenters questioned whether the auditor is expected to determine whether the list of executive officers, as set out in Rule 3b-7 under the Exchange Act or Schedule A of Form BD for brokers and dealers, is complete. Other commenters suggested that the Board incorporate portions of the discussion in the proposing release into the text of the amendments to clarify that it is management's responsibility to designate the company's executive officers.

The Board considered these comments, noting that the proposed amendments would not have required the auditor to evaluate management's identification of its "executive officers," for other regulatory and SEC filing purposes. In the Board's view,

the SEC rules cited in the amendments provide an objective definition of the term "executive officers."[66/] The Board did not make revisions in response to these comments.

Defining the Term "Senior Management": Some commenters stated that the amendments should clarify the interaction between the terms "executive officer" and "senior management." Several commenters recommended that the Board define senior management. One commenter recommended that the amendments recognize that, for certain entities, it may be possible for executive officers and senior management to be the same individuals (for example, at non-issuer brokers and dealers). That commenter further suggested discussing how the definition of executive officer would be applied to other types of non-issuer entities, for example, subsidiaries of issuers.

The Board notes that the term "senior management" is not a defined term in Auditing Standard No. 12 or SEC rules. The Board also recognizes that, for certain companies or brokers or dealers, senior management might be the same population as its executive officers. Further, the individuals the company considers to be its "senior management" may differ among issuers and among broker-dealers. The existing standard anticipates that a company's or broker's or dealer's facts and circumstances may affect the composition of its "senior management." The Board does not wish to foreclose the possibility that an auditor would (1) gain an understanding of the compensation arrangements with a larger group of "senior management" under Auditing Standard No. 12 in order to obtain an understanding of the company and then (2) perform the procedures under the other reproposed amendments regarding the financial arrangements with a smaller group of "executive officers." As such, the Board is not proposing revisions for these comments.

Using the "Named Executive Officers" ("NEOs") Contained in the Company's Proxy Statement: One commenter stated that the proposed amendments cast a wide net that places unnecessary requirements on auditors and unnecessary costs and burdens on issuers, management, and board members of companies. That commenter suggested narrowing the scope of the auditor's inquiries to NEOs, which consist of five executive officers that are specified in the SEC's rules, and that requiring auditors to perform procedures relating to the more broadly defined universe of "executive officers"

66/ *See* Item 401(b) of Regulation S-K, 17 C.F.R. §229.4-01(b).

is unnecessary.[67/] That commenter noted that, in their case, using the executive officers listed in their Form 10-K (pursuant to Rule 3b-7) would triple the amount of work as compared to using the NEOs contained in the company's proxy statement.

The Board considered this comment and observed that the term "senior management" is used in the risk assessment standards and that a review of the compensation arrangements for those "executive officers," as defined in the reproposed amendments, would represent a targeted expansion of work the auditor already considers performing under the existing standards.

The Board considered the commenter's suggestion that the auditor's work be limited to performing procedures for NEOs. However, using the universe of "NEOs," which includes the CEO, CFO, and the three other most highly compensated individuals at an issuer, might not include individuals with direct oversight of the financial reporting process, for example, the chief accounting officer. Additionally, the Board notes that, according to a recent study, the median number of "executive officers" for the S&P 500 is 8 (the mean is 8.71), and the median number of executive officers for the Russell 2000 is 5 (the mean is 6.12).[68/] Accordingly, the Board is not proposing to incorporate this suggestion into the reproposed amendments. The Board, however, welcomes additional empirical data and other input on this matter.

Performing Procedures after Identifying a Significant Risk: Some commenters were concerned that the proposed amendments could be interpreted by auditors to require that performance-based compensation arrangements with executive officers would need to be substantively audited, rather than assessed for risk of material misstatement. Those commenters noted that the auditor should first determine that a significant risk to the financial statements exists prior to performing extended substantive procedures related to executive compensation arrangements.

The Board considered these comments and noted that the reproposed amendments would better position the auditor to identify and assess risks of material

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[67/] *See* Item 402(a)(3) of SEC Regulation S-K; 17 C.F.R. §229.4-02(a)(3) and SEC Securities Release Act No. 8732A, *Executive Compensation and Related Person Disclosure* (Aug. 29, 2006).

[68/] *See* Study: Benchmarking the Number of "Executive Officers" The Corporate Counsel.net and LogixData (March 2, 2011).

misstatement, including significant risks, that may be a consequence of the company's financial relationships and transactions with its executive officers. The reproposed amendments would not alter the auditor's responsibility under existing standards for performing substantive auditing procedures.[69/] The Board is not proposing to make revisions in response to these comments.

Reading Proxy Statements and Other Company Documents: One commenter objected to the proposed requirement that the auditor read the proxy statement as part of the auditor's risk assessment procedures. That commenter questioned the availability of, and relevancy of the information in, the company's proxy statement. The Board considered this comment and, in the Board's view, reading proxy statements that are available to the auditor can provide the auditor with relevant information regarding a company's financial relationships and transactions with its executive officers that may be helpful to informing the auditor's understanding of the company. In addition, the risk assessment standards require that the auditor should consider reading public information about the company, for example, SEC filings.[70/] Accordingly, the Board is not proposing any revisions in response to these comments.

Addressing Transactions Outside of Executive Compensation: One commenter noted that there are greater areas of exposure related to relationships with executive officers, such as supplier or customer relationships, that outweigh the risk of executive compensation. The Board considered this comment and notes that the reproposed amendments, like the proposed amendments, address all of a company's financial relationships and transactions with its executive officers, which would include supplier and customer relationships.

Inquiring of the Compensation Committee and Consultants: The proposed amendments would require that the auditor should consider inquiring of the compensation committee and its chair and any compensation consultants. One commenter noted that the Board should not require such inquiries, because any required inquiry by the auditors of the compensation committee chairperson would be unnecessarily intrusive and burdensome on the chairperson's time. That commenter further noted that any discussion with consultants seems to be a duplication of efforts. In contrast, other commenters recommended that the standard include a requirement

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69/ *See* paragraphs 36-47 of Auditing Standard No. 13.

70/ *See* paragraph 11 of Auditing Standard No. 12.

for the auditor to discuss the structure of the company's compensation plans for executive officers with the chair of the compensation committee, or its equivalent, and any compensation consultants engaged by either the compensation committee or the company. Further, other commenters stated that the proposed standard may be too imprecise and recommended that the Board clarify the information auditors should seek from compensation committees and compensation consultants regarding executive compensation arrangements.

The Board considered these comments, noting that the proposed standard was designed to permit the auditor to decide whether to inquire of the compensation committee or any compensation consultants and, if so, the nature and extent of inquiries to make based on the company's facts and circumstances. This flexibility would allow the auditor to avoid potentially unnecessary efforts, while focusing on matters that are important to the audit. Accordingly, the reproposal maintains the same approach taken in the proposal.

Obtaining an Understanding of Policies and Procedures Regarding Executive Officer Expense Reimbursements: Commenters expressed differing opinions regarding the proposed requirement that the auditor consider obtaining an understanding of established policies and procedures regarding executive officer expense reimbursements in paragraph 11 of Auditing Standard No. 12. One commenter recommended that the amendments establish a requirement for the auditor to review the expense reports of executive officers, whether or not it demonstrated a possible risk. Another commenter noted that, while there have been many recent headlines regarding executive officer expense reimbursements, those instances were generally immaterial to the financial statements. That commenter stated that, for this reason, because examining expense reimbursements for executive officers is likely to be time consuming, any expense reimbursement reviews should focus on detecting material misstatement.

The Board considered these comments and determined that the proposed amendments, which would have required that the auditor consider obtaining an understanding of the company's established policies and procedures for executive officer expense reimbursements, would have permitted the auditor to determine whether to perform this risk assessment procedure. Further, obtaining an understanding of the company's policies and procedures would not require the auditor to examine all of a company's executive officer reimbursements. Accordingly, the Board is not proposing to make revisions in this area, but is soliciting comments regarding potential costs relating to its reproposal.

Coordinating with Other Regulators: One commenter stated, that while the proposed amendments were based upon existing audit standards, it had concerns regarding the possible encroachment of the PCAOB into areas of corporate governance that are within the purview of state corporate law, or under federal legislation, such as the Sarbanes-Oxley Act, or within the jurisdiction of the SEC. That commenter noted that under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the SEC is involved in or expected to propose a series of regulations on executive compensation, including incentive-based compensation in the financial services industry, pay-for-performance disclosures, pay ratio disclosures, and independent compensation committees. That commenter further noted that the proposed incentive-based compensation regulation is a joint rulemaking of several financial regulators and recommended that the PCAOB act within the bounds of its jurisdiction and also coordinate with these regulators to understand how the proposal interacts with expected regulatory changes.

The Board considered this comment and notes that the Board's existing standards already require that the auditor consider performing procedures to obtain an understanding of compensation arrangements with a company's senior management. The reproposed amendments would be an incremental expansion of the auditor's existing requirements and, thus, in the Board's view, represents an appropriate matter for Board standard setting. In addition, before any standard adopted by the Board becomes effective, it is subject to approval by the SEC.

Retaining Existing Requirements: One commenter recommended that the Board reconsider the need for the requirement in paragraph 11 of the proposed amendment to Auditing Standard No. 12 to consider obtaining an understanding of compensation arrangements for senior management other than executive officers. That commenter noted that, should the Board decide to retain the proposed requirement in the final amendment, it would be helpful to understand the reasons why the additional requirement is considered necessary. That commenter also recommended that the Board provide guidance as to the procedures the auditor should perform with respect to senior management other than executive officers, similar to paragraph 10A of the proposed amendments. Further, during the SAG discussion, the point was made that financial arrangements with employees other than executive officers could also result in risks of material misstatement.

The Board considered these comments, noting that the intent of these amendments is to better inform the auditor's risk assessment about possible risks of material misstatement arising from an "executive officer" population that is generally smaller than the senior management population. The intent is not to restrict the

performance of existing risk assessment procedures that might provide the auditor with additional information regarding possible risks of material misstatement, including fraud risks or other significant risks. As such, the Board is not proposing to revise the existing requirements in Auditing Standard No. 12 for this comment.

Existing Requirements Are Sufficient: One commenter stated that the requirement in existing paragraph 11 of Auditing Standard No. 12 is more appropriate than the proposed amendment because other auditing standards state that the auditor's identification of fraud risks should include the risk of management override of controls.[71/] Some commenters expressed the view that high-profile audit failures, such as Enron and Worldcom, did not occur because of a failure to understand the incentive compensation arrangements of these companies and recommended that the focus of the amendments should instead be on the control environment of the company.

The Board considered these comments, noting that obtaining an understanding of the company's financial relationships and transactions with its executive officers can assist the auditor in identifying incentives and pressures that might cause management to override controls. This understanding could also inform the auditor how and where management override might be likely to occur. Thus, no revisions have been made for these comments.

B. AU sec. 315, *Communications Between Predecessor and Successor Auditors* (Appendix 3)

Inquiring of a predecessor auditor regarding the company's relationships and transactions with its related parties and its significant unusual transactions can assist the successor auditor in determining whether to accept the engagement. Such inquiries also can benefit the successor auditor in obtaining an understanding of the company's relationships and transactions with its related parties and in identifying significant unusual transactions.

The Proposed Amendments and Existing Requirements

Existing AU sec. 315, *Communications Between Predecessor and Successor Auditors*, provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place but does not

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[71/] *See* paragraph 69 of Auditing Standard No. 12.

specifically address a company's relationships or transactions with its related parties or its significant unusual transactions. AU sec. 334 notes that determining the existence of relationships with related parties requires the application of audit procedures that may include inquiring of predecessor auditors concerning their knowledge of existing relationships and the extent of management involvement in material transactions.[72/]

The proposed amendments to AU sec. 315 would have required the auditor to make inquiry of the predecessor auditor's understanding of the company's relationships and transactions with related parties and significant unusual transactions. The proposed amendments also would have included within the successor auditor's review of the predecessor auditor's working papers any documentation regarding relationships and transactions with related parties and significant unusual transactions.

As more fully described in the following section, after consideration of the comments received, the Board did not substantively revise the other proposed amendments to AU sec. 315.

The Reproposed Amendments

The reproposed amendments would revise AU sec. 315.09 to require that the successor auditor make specific and reasonable inquiries of the predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions. The reproposed amendments also would revise AU sec. 315.11 to include in the successor auditor's review of the predecessor auditor's working papers any documentation regarding related parties and significant unusual transactions.

Significant Comments and Board Responses

The Board received general comments concerning communications between predecessor and successor auditors, but not comments specific to a company's relationships and transactions with related parties or its significant unusual transactions. The Board acknowledges those comments, but believes that the issues raised fall outside the scope of this standard-setting project.

[72/] *See* AU sec. 334.07.g. and AU secs. 9334.12-.13.

C. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (Appendix 3)

Emphasizing the auditor's identification and evaluation of significant unusual transactions could lead to more instances of auditors becoming aware of indications that fraud or another illegal act has or may have occurred.

The Proposed Amendments and Existing Requirements

The proposed amendments would have amended AU sec. 316 by expanding the discussion in the standard regarding certain audit requirements contained in Section 10A of the Exchange Act. The proposed amendments would have emphasized the auditor's responsibility to investigate and disclose possible fraud to management, the audit committee and, upon the satisfaction of certain conditions, the SEC, consistent with the auditor's responsibility under Section 10A of the Exchange Act.

As more fully described in the following section, the Board did not substantively revise the other proposed amendments to AU sec. 316.

The Reproposed Amendments

The other reproposed amendments to AU sec. 316 would add paragraph AU sec. 316.81A, which would state that the auditor has a responsibility, under certain conditions, to disclose possible fraud to the SEC to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change and the fraud or related risk factors constitute a reportable event or are the source of a disagreement, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required pursuant to Section 10A(b) of the Exchange Act of 1934 relating to an illegal act that the auditor concludes, among other things, has a material effect on the financial statements.

The other reproposed amendments would amend AU sec. 316.82 to state that the auditor also may have a duty to disclose the existence of possible fraud to parties outside the entity in the following circumstances: (a) to a successor auditor when the successor makes inquiries in accordance with AU sec. 315, (b) in response to a subpoena, and (c) to a funding agency or other specified agency in accordance with requirements for the audits of companies that receive governmental financial assistance.

Significant Comments and Board Responses

The Board did not receive comments in this area.

D. AU sec. 333, *Management Representations* (Appendix 3)

Obtaining written management representations regarding the information that management has provided to the auditor can inform the auditor's efforts regarding a company's relationships and transactions with its related parties and a company's significant unusual transactions.

The Proposed Amendments and Existing Requirements

Existing AU sec. 333 requires auditors to obtain written representations from management for the periods covered by the auditor's report. That standard addresses representations covering financial statements; completeness of information; recognition, measurement, and disclosure; and subsequent events. AU sec. 333 currently requires the auditor to obtain a representation regarding the recognition, measurement, and disclosure of related party transactions.

The proposed amendments to AU sec. 333 would have required the auditor to obtain written representations regarding the company's related parties and the absence of side agreements or other arrangements.

As more fully described below, after consideration of the comments received, the Board did not substantively revise the other proposed amendments to AU sec. 333, except to remove a proposed amendment that was considered duplicative.

The Reproposed Amendments

The reproposed amendments to AU sec. 333 would revise AU sec. 333.06 to require that the auditor obtain written representations that management has disclosed to the auditor: (i) the names of all related parties and all relationships and transactions with related parties; (ii) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor; and (iii) that management has made available support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

The reproposed amendments also would revise the illustrative management representation letter in Appendix A of AU sec. 333, consistent with the amendments described above.

Significant Comments and Board Responses

In developing the reproposed amendments to AU sec. 333, the Board considered all comments received, including the following significant comments:

Necessity for the Proposed Amendments: One commenter stated that the proposed amendments to AU sec. 333: (1) were unnecessary, (2) imply that related party transactions are more important than other information that the auditor must obtain from management, and (3) could result in voluminous management representation letters. The Board considered this comment, noting that obtaining the names of all of the company's related parties and relationships and transactions with related parties is important to the auditor's evaluation of whether a company has properly identified its related parties and relationships and transactions with related parties. Obtaining this information also is important to evaluating whether the company's relationships and transactions with its related parties have been appropriately accounted for and disclosed. Consequently, the Board has maintained the same approach in the reproposal as it did in the proposal.

Duplicative Requirements Regarding Arm's-Length Assertions: Some commenters noted that the proposed amendments to paragraph .06.l. and the addition of paragraph .11A to AU sec. 333 regarding assertions that a related party transaction was conducted on terms equivalent to those prevailing in an arm's-length transaction appeared to be duplicative. These commenters recommended either combining these proposed requirements into a single amendment or eliminating one of the proposed amendments. The Board considered these comments and agreed that the proposed amendments to AU sec. 333.06.l. are sufficient to explain the auditor's responsibilities to obtain a written representation from management regarding an arm's-length assertion included in the financial statements. Accordingly, the representation that would have been required by paragraph .11A has not been included in the reproposal.

E. AU sec. 560, Subsequent Events (Appendix 3)

Events or transactions that occur subsequent to the balance sheet date, but prior to the issuance of the financial statements, may have a material effect on the financial statements. Making specific inquiries during the "subsequent period" regarding a company's relationships and transactions with its related parties and its significant unusual transactions can benefit the auditor's identification of matters that might require disclosure in the financial statements.

The Proposed Amendments and Existing Requirements

The proposal did not include amendments to AU sec. 560, *Subsequent Events*. That standard requires the auditor to perform auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles.[73/] Existing AU sec. 560 does not require the auditor to inquire regarding the company's relationships and transactions with its related parties and its significant unusual transactions.

As more fully described below, after consideration of the comment received in this area, the Board is proposing amendments to require inquiries regarding related parties and significant unusual transactions during the "subsequent period."

The Reproposed Amendments

The reproposed amendments would amend AU sec. 560.12 to require that during the "subsequent period" the auditor inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to whether: (1) there have been any changes in the company's related parties or significant new related party transactions and (2) the company has entered into any significant unusual transactions.

Significant Comments and Board Responses

One commenter recommended including a requirement that the auditor inquire of management during the period after the balance-sheet date to assess whether any related party transactions have occurred that may require adjustment or disclosure essential to the fair presentation of the financial statements. The commenter recommended amending AU sec. 560.12.b. to specifically address related party transactions. The Board agrees with this recommendation and, as discussed above, is proposing an amendment because performing this inquiry might benefit investors by improving the auditor's identification of matters that might require disclosure in the financial statements.

[73/] *See* AU sec. 560.12.

F. AU sec. 722, *Interim Financial Information* (Appendix 3)

Obtaining written management representations during a review of interim financial information regarding the information that management has provided to the auditor can inform the auditor's efforts regarding a company's relationships and transactions with its related parties and a company's significant unusual transactions.

The Proposed Amendments and Existing Requirements

Existing AU sec. 722 requires the auditor to inquire of management that has responsibility for financial and accounting matters concerning unusual or complex matters that might have an effect on the interim financial information. The other proposed amendments would have revised AU sec. 722 to be consistent with the proposed amendments to AU sec. 333 and would have required the auditor to obtain written representations each interim period regarding the company's related parties and the absence of side agreements or other arrangements.

As more fully described below, after consideration of the comments received, the Board is reproposing the amendments to AU sec. 722 substantively as proposed.

The Reproposed Amendments

The reproposed amendments to AU sec. 722 would require that the auditor obtain written representations each interim period that management has disclosed to the auditor: (i) the names of all related parties and all relationships and transactions with related parties; (ii) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor; and (iii) that management has made available support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

The Board also is reproposing amendments to the illustrative management representation letter contained in Appendix C of AU sec. 722, consistent with the amendments described above.

Significant Comments and Board Responses

In developing the reproposed amendments to AU sec. 722, the Board considered all comments received, including the following significant comment:

Obtaining the Names of The Company's Related Parties During an Interim Review: One commenter stated that the proposed amendment to AU sec. 722.24.g.

indirectly may imply that the auditor should obtain the names of all related parties and all relationships and transactions with related parties on a quarterly basis. However, that commenter stated that AU sec. 722 contains no corresponding required auditor inquiry of management to obtain such information. That commenter suggested amending AU sec. 722.18.c. to require inquiries of management regarding changes in related parties or significant new related party transactions, noting that the representation in AU sec. 722.24.g. then may focus on management's communication of such changes to the auditor.

The Board considered this comment and noted that the second bullet of AU sec. 722.18.c. states that the auditor ordinarily inquires of members of management who have responsibility for financial and accounting matters concerning unusual or complex situations that may have an effect on interim financial information. Appendix B to AU sec. 722 states that changes in related parties or significant new related party transactions is an example of a situation about which the auditor ordinarily would inquire of management pursuant to AU sec. 722.18.c. Consequently, the Board is not proposing to make revisions for this comment.

G. AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543*

Existing standards note that determining the existence of relationships with related parties requires the application of audit procedures, which may include inquiring of principal or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions.[74/]

The Proposed Amendments and Existing Requirements

The proposed amendments to AU sec. 9543 would have revised AU sec. 9543.05 to remove the reference to AU sec. 334 and state that, before issuing his or her report, the other auditor should inquire of the principal auditor as to matters significant to the audit. Those matters would have included relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties. Accordingly, the proposed amendment aligned AU sec. 9543 with the requirements for a principal auditor included in paragraph 10 of the proposed standard.

[74/] *See* AU sec. 334.07.g. and AU secs. 9334.12-.13.

The Reproposed Amendments

The Board is not proposing revisions to AU sec. 9543. After consideration of the comments received, the Board has decided that any substantial revision to AU sec. 9543 should be considered as part of the Board's standard-setting project on AU sec. 543.

Significant Comments and Board Responses

In developing the revisions to the proposed amendment, the Board considered all comments received, including the following significant comments:

Clarifying the Other Auditor's Inquiries: One commenter noted that the Board did not propose amendments to AU secs. 9543.06-.07 and that those paragraphs infer that the inquiry of the principal auditor is based on the other auditor's judgment. Another commenter stated that the Board should clarify that other communications anticipated by AU sec. 9543 with respect to "matters significant to the audit" are those transactions, adjustments, or other matters that have come to the auditor's attention that may require adjustment to or disclosure in the financial statements. As discussed above, any substantive revision to AU sec. 9543 will be done as part of the Board's standard-setting project on AU sec. 543.

Questions:

18. Are the other reproposed amendments appropriate to address risks of material misstatement of the financial statements? Why or why not?

19. Is it sufficiently clear that the auditor (a) should obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment and (b) should not assess the appropriateness of executive officer compensation? Why or why not?

20. Are "executive officers" the appropriate population for the audit procedures designed to provide the auditor with an understanding of the company's financial relationships and transactions as part of its risk assessment process? Why or why not?

IV. Economic Considerations, Including Audits of Emerging Growth Companies

The Board is considering the reproposed standard and amendments pursuant to its mandate to protect the interest of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The Board designed the reproposed standard and amendments to reduce the risk of material misstatements of financial statements not being detected by the auditor in three critical areas that have been contributing factors in prominent financial reporting frauds over the last few decades, which have resulted in investor losses and lost jobs. The auditor, serving in the role as a gatekeeper in the financial reporting system, should be alert to the possibility that transactions in these areas require heightened scrutiny during the audit process.[75/] As such, the reproposed standard and amendments are intended to enhance audit quality.

As more fully described in the release and in Sections I. through III. of this Appendix, the Board believes that the reproposed standard and amendments regarding relationships and transactions with related parties, significant unusual transactions, and relationships and transactions with executive officers can improve the auditor's identification of, assessment of and response to the risks of material misstatement of financial statements, which may lead to higher quality accounting and disclosures for investors. Further, the Board's approach anticipates a more meaningful exchange of information between the auditor and a company's audit committee. These improvements have the potential to reduce information asymmetry in these critical areas.[76/]

Throughout the development of its proposals, the Board has been sensitive to economic considerations, with the goal of adopting new requirements that make its

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[75/] *See, e.g., In the Matter of the Application of Wendy McNeeley, CPA,* SEC AAER No. 3427 at 10-12 (Dec. 13, 2012).

[76/] Information asymmetry refers to situations involving separate parties in which one party has more, or better, information than the other party. For example, the separation of ownership and control in companies results in information asymmetry between managers and stakeholders. *See* Jensen, M.C. and Meckling, W.H. 1976. Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics* 3 (4): 305-360.

auditing standards in these critical areas more effective, while avoiding unnecessary costs. The Board's approach to promoting audit quality features a scaled approach, requiring the auditor to perform basic procedures and then to determine, based on the risks posed by the company's facts and circumstances, whether additional procedures would be necessary.

Underlying the scaled approach is the concept that the procedures performed, and therefore the associated costs, are commensurate with the risks of material misstatement of the financial statements. Under such a scaled approach, the Board would not expect there to be a significant change in costs for the audit of a company that does not have: (1) extensive relationships or transactions with related parties; (2) significant unusual transactions or (3) financial relationships and transactions with the company's executive officers that give rise to risks of material misstatement.

In contrast, a company that has extensive relationships and transactions with related parties or significant unusual transactions, or that has financial relationships and transactions with executive officers that give rise to risks of material misstatement, could anticipate an increase in audit costs. Further, if the auditor identifies related parties or relationships or transactions with related parties that were previously undisclosed to the auditor, there would be incremental costs associated with the auditor's response to the increased risks of material misstatement.

The release and Sections I.-III. of this Appendix discuss how the reproposed standard and amendments will result in improved audit quality. This section provides a further discussion of economic considerations, including the need for improvements to existing standards, the Board's approach for promoting audit quality, and how the Board's approach reflects economic considerations. This section also discusses considerations for audits of emerging growth companies ("EGCs"). Following each discussion are lists of specific questions for commenters. Commenters are encouraged not only to respond to those questions but also to provide input on all aspects of the reproposed standard and amendments.

A. The Need for Improvements to Existing Standards

As described more fully in the proposing release, several factors collectively indicate a need for improvement to the existing standards.[77/] Specifically, the Board

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[77/] The Board also recognizes that the interim auditing standard for auditing related party relationships and transactions adopted by the Board in 2003 had not been

developed the proposed standard and amendments in light of the magnitude and number of financial reporting frauds involving companies' relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers.[78/] The Board's proposal also was informed by observations from the PCAOB's oversight activities, discussions with the SAG, and international developments.

The Board's inspection program has identified deficiencies relating to the auditing of related party transactions, many of which relate to audits of financial statements of smaller public companies that were conducted by smaller audit firms.[79/] In addition, the

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revised since its issuance. The Board's interim standard, AU sec. 334, replaced AU sec. 335, *Related Party Transactions,* which was issued in July 1975. In 1983, AU sec. 334 was amended to remove guidance relating to accounting considerations and disclosure standards for related parties provided in Financial Accounting Standard Board ("FASB") Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, and by making other related technical changes. However, the nature and extent of the auditor's responsibilities and procedures pertaining to related parties in AU sec. 335 was carried over into AU sec. 334. Thus, audit procedures relating to related parties have remained largely unchanged since the issuance of AU sec. 335 in July 1975.

[78/] The proposing release contains a discussion of prominent cases involving fraudulent financial reporting. In addition, a recent SEC case has supported the need for heightened scrutiny of related party transactions. In a case involving company transactions with its executive officers, the SEC, quoting the D.C. Circuit, stated: "although in an ordinary arms-length transaction, one may assume that parties will act in their own economic interest, this assumption breaks down when the parties are related. A company that would perform a thorough credit-risk assessment before extending a loan might not do so if the loan were to one of its officers or directors." *See*, *In the Matter of the Application of Wendy McNeeley, CPA,* AAER No. 3427 (Dec. 13, 2012).

[79/] *See Report On 2007-2010 Inspections Of Domestic Firms That Audit 100 Or Fewer Public Companies,* PCAOB Release No. 2013-001 (Feb. 25, 2013) at 29, available at: http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf, which states, in part:

> Inspections staff have observed deficiencies related to firms' failures to test for undisclosed related parties or transactions with undisclosed

Board took note of the fact that a significant number of the Board's settled disciplinary actions to date have involved auditors' failures to perform sufficient procedures regarding related party transactions, many of which also involved audits of smaller public companies.

As part of its standard-setting process, the Board initially considered whether sufficient improvements could be made through its inspection and enforcement programs, without amending its standards and requirements but concluded that new requirements were appropriate as these critical areas could pose significant risks of material misstatement.[80/] The Board also concluded that it was appropriate to propose a new standard regarding related parties, rather than amend the existing standard, because of, among other things, the nature and extent of changes necessary to align the existing standard with the risk assessment standards. In contrast, the Board concluded that appropriate improvements in audit quality with respect to a company's significant unusual transactions and financial relationships and transactions with its executive officers could be achieved by amendments to existing standards in those areas.

The Board further noted that in July 2008, the IAASB revised its auditing standard on related parties with the issuance of International Standard on Auditing No.

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

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

80/ For example, before deciding to issue its initial proposal, the Board issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010), which discusses a range of auditor practice issues identified by PCAOB staff pertaining to significant unusual transactions.

550, *Related Parties*.[81/] The ASB also has revised its auditing standard on related parties with the issuance of AU-C Section 550, *Related Parties*, contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification*, in October 2011.

As described previously, commenters were generally supportive of the Board's efforts to enhance the auditor's identification and evaluation of related party and significant unusual transactions and agreed that improvements to the auditing standards were appropriate. While the proposed changes regarding a company's financial relationships and transactions with its executive officers drew support from a range of commenters, some commenters raised concerns that performing such procedures could have unintended consequences, including impacting the design of compensation arrangements.

As discussed in Section III.A, the Board is proposing revisions to the proposed amendments to Auditing Standard No. 12 to clarify that the auditor's procedures in this area would be performed as part of the auditor's risk assessment process and would not require the auditor to make any determination regarding the reasonableness of the company's compensation arrangements with its executive officers or recommendations regarding such compensation arrangements.

B. The Board's Approach for Promoting Audit Quality

The following discussion contains a general overview of how the improvements in the reproposed standard and amendments are designed to improve the auditor's assessment of and response to the risks of material misstatement, and promote the exercise of professional skepticism and audit quality. These improvements are more fully discussed in the release and Sections I.-III. of this Appendix.

Related Parties

The reproposed standard is designed to address specific risks associated with a company's relationships and transactions with its related parties, including whether the

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[81/] The IAASB emphasized that a new standard was warranted given the public focus on the accounting and auditing of related party relationships and transactions after recent major corporate scandals. *See* IAASB Exposure Draft, *Related Parties* (Dec. 2005).

company has (1) properly identified its related parties and relationships and transactions with its related parties and (2) properly accounted for and disclosed its relationships and transactions with its related parties in the financial statements. The reproposed standard also includes new requirements regarding the auditor's communications with the audit committee.

The reproposed standard includes specific procedures that would require the auditor, in order to identify and assess the risks of material misstatement, to obtain an understanding of the company's relationships and transactions with its related parties and then evaluate whether the company has properly identified its related parties and relationships and transactions with its related parties.

The reproposed standard has been developed to permit the auditor flexibility in determining the nature, timing, and extent of audit procedures to perform when evaluating whether the company has properly identified its related parties and relationships and transactions with related parties. In addition, this approach contemplates that the auditor's efforts regarding significant unusual transactions can assist in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor.

The reproposed standard also includes basic procedures that would require the auditor to evaluate whether the company has properly accounted for and disclosed its relationships and transactions with its related parties in the financial statements. Those procedures are designed to assist the auditor in identifying potential "red flags" that might indicate a risk of material misstatement.

Notably, research indicates that where fraud does exist, the presence of related parties is one of the top reasons cited for audit failures.[82/] Research also indicates that 67% of alleged audit deficiencies with respect to related party transactions involved inadequate examination of the transaction.[83/] Additional research indicates if auditors

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[82/] *See* Gordon, E.A., Henry, E., Louwers, T.J., and Reed, B.J. 2007. Auditing Related Party Transactions: A Literature Overview and Research Synthesis. *Accounting Horizons* 21 (1): 81-102.

[83/] *See* Louwers, T.J., Henry, E., Reed, B.J., and Gordon, E.A. 2008. Deficiencies in Auditing Related-Party Transactions: Insights from AAERs. *Current Issues in Auditing* 2 (2): A10-A16.

increase their sensitivity to fraud risk, they will likely exert more effort.[84/] Consistent with this research, the reproposed standard is designed to assist auditors in evaluating whether the company's relationships and transactions have been properly accounted for and disclosed in the financial statements.

The reproposed standard also would require the auditor to communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties and other significant matters arising from the audit regarding the company's relationships and transactions with related parties. Improving the auditor's evaluation of a company's accounting and disclosure of its related parties should result in a more meaningful exchange of information between the auditor and the audit committee.

Significant Unusual Transactions

The reproposed amendments would require the auditor to perform specific procedures to identify a company's significant unusual transactions. In contrast, the existing standards only anticipate that the auditor may become aware of such transactions while performing other audit procedures. Once a significant unusual transaction is identified, the reproposed amendments should improve the effectiveness of the auditor's evaluation of that transaction, including whether the business purpose (or the lack thereof) indicates that the transaction was entered into to engage in financial statement fraud or conceal misappropriation of assets.

In addition to assisting in the auditor's evaluation of possible misstatements in a company's financial statements, improving the auditor's evaluation of significant unusual transactions should result in a more meaningful exchange of information between the auditor and the audit committee.

The identification and evaluation of a company's significant unusual transactions also may inform the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with its related parties.

[84/] *See, e.g.,* Zimbelman, M.F. 1997. The Effects of SAS No. 82 on Auditors' Attention to Fraud Risk Factors and Audit Planning Decisions. *Journal of Accounting Research* 35 (Supplement): 75-97.

Financial Relationships and Transactions with a Company's Executive Officers

The other reproposed amendments would require the auditor to perform procedures to obtain an understanding of the company's relationships and transactions with its executive officers. This understanding could assist the auditor in determining whether there are incentives or pressures for the company's executive officers that might give rise to a fraud risk or other significant risk. The auditor's efforts in obtaining an understanding of the company's financial relationships and transactions with its executive officers also has the potential to identify related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Other Reproposed Amendments to PCAOB Auditing Standards

The requirements in the other reproposed amendments are designed to complement the efforts in the reproposed standard and amendments to improve the auditor's: (1) efforts to address the risks associated with a company's relationships and transactions with its related parties and (2) identification and evaluation of significant unusual transactions. For example, the other reproposed amendments are designed to improve the auditor's identification of significant unusual transactions through improvements to the auditor's: (1) communications with a predecessor auditor, (2) procedures during the "subsequent period," and (3) procedures during interim reviews.

The Board's reproposal provides complementary audit procedures that consider the links and relationships between a company's relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with its executive officers. Clarifying the linkages between these areas can increase the probability of the auditor's uncovering the potential for fraud or error in a company's financial statements – as the auditor is more likely to "connect the dots."

C. How the Board's Approach Reflects Economic Considerations

As discussed above, the Board believes that the reproposed standard and amendments should enhance audit quality in ways that could also enhance the quality of a company's financial reporting. Enhancing the quality of a company's financial reporting could serve to reduce information asymmetry, foster increased public confidence in the financial markets, and potentially enhance capital formation and the efficiency of capital allocation decisions.

The reproposed standard and amendments are intended to raise the minimum threshold across audit firms for audit procedures. Improving consistency across audit

firms could level the playing field in terms of the probability of uncovering events that could impact investors, such as misstatements due to fraud or errors arising from non-arm's length transactions or significant unusual transactions. Similarly, raising the minimum threshold for audit procedures could lead to an increase in the perceived value of the auditor's assurances regarding a company's disclosures and accounting, which could have a positive impact on the efficient allocation of capital.

The auditor's increased focus on these critical areas could lead companies to improve their disclosures of such transactions. Incrementally increasing the transparency of relevant disclosures could reduce information asymmetry.[85/] To the extent that the reproposed standard and amendments are viewed by the market as a step towards increasing the transparency of these areas and/or lowering the probability of fraudulent financial reporting, this could reduce the cost of capital for issuers.[86/]

Enhancements to audit committee communications anticipated by the reproposed standard and amendments also may reduce information asymmetry and potentially enhance corporate governance mechanisms to improve company financial reporting and the quality of information available to the markets. Research has indicated that improving the quality of financial reporting can reduce investors' uncertainty about the information being provided in companies' financial reports, and thus increase efficiency in capital allocation and foster capital formation.[87/]

[85/] *See* Lambert, R.A., Leuz, C., and Verrecchia, R.E. 2012. Information asymmetry, information precision, and the cost of capital. *Review of Finance* 16 (1): 1-29.

[86/] If the reproposed standard and amendments are successful at "shedding light" on these disclosures, it could reduce the level of information asymmetry. Information asymmetry has been linked to increased costs of capital (*See e.g.,* Easley, D., and O'hara, M. 2004. Information and the Cost of Capital. *The Journal of Finance* 59 (4): 1553-1583.

[87/] An increased level and/or quality of financial disclosures has been found to decrease the cost of equity (*See* Botosan, C., and M. Plumlee. 2002. A Re-examination of Disclosure Level and the Expected Cost of Equity Capital. *Journal of Accounting Research* 40 (1): 21-40.), decrease the cost of debt (*See* Sengupta, P. 1998. Corporate Disclosure Quality and the Cost of Debt. *The Accounting Review* 73 (4): 459-474.) and decrease bid-ask spreads (*See* Welker, M. 1995. Disclosure Policy,

While the reproposed standard and amendments are designed to improve audit quality in critical areas that could pose significant risks of material misstatement, the Board recognizes that transactions with related parties are also used for legitimate purposes, including the efficient procurement of necessary resources.[88/] To the extent that potential costs stemming from the reproposed standard and amendments increase audit costs related to transactions with related parties, this could conceivably serve as a deterrent against their use. This unintended consequence could adversely affect the competitiveness of companies that rely on transactions with related parties during their normal course of operations.

The Board recognizes that its proposals to enhance and update its existing auditing procedures involve new requirements that will impose costs. Being sensitive to the potential burden imposed by such costs, the Board developed an approach for improving audit quality in these three critical areas that encourages the efficient and effective implementation of its standards.

To the extent that the Board received comments on issues relating to costs in the context of its proposal, such comments were not uniform. For example, while one commenter criticized the Board for the lack of a specific economic analysis that could help commenters ascertain what additional burdens would be placed upon businesses and auditors as a result of the proposed standard and amendments, another commenter stated that they did not expect that the more specific requirements of the Board's proposed amendments regarding a company's financial relationships and transactions with its executive officers would result in a meaningful increase in audit costs.

As described above, the Board has attempted to be responsive in its reproposal to comments regarding audit effort (and resulting costs) by seeking to further align its reproposal with its existing risk assessment framework, by describing the differences between existing requirements and its proposals, and by considering revisions that would provide the auditor with more flexibility in appropriate situations.

Information Asymmetry and Liquidity in Equity Markets. *Contemporary Accounting Research* 11 (2): 801 – 827.).

[88/] *See* Gordon, E.A., Henry, E., and Palia, D. 2004. Related party transactions and corporate governance. *Advances in Financial Economics* 9: 1-27.

The Board received a number of comments regarding the potential costs that could arise from the proposed amendments regarding a company's financial relationships and transactions with its executive officers. As discussed in Section III.A. of this Appendix, in response to comments, the Board has revised its proposal to clarify its expectations that these new audit procedures are performed as part of the auditor's risk assessment process.

The following paragraphs describe the Board's considerations to date, including how the application of the Board's approach was revised, based on the comments received:

Alignment with the Risk Assessment Standards: The foundational requirements in the risk assessment standards cover the entire audit process, and focus the auditor's attention on considering the risks of material misstatement, whether due to error or fraud. Aligning the proposal with these requirements could promote audit quality by maintaining the auditor's focus, in connection with the audit procedures required by the reproposed standard, on risks of material misstatement. In the Board's view, this approach also should provide for the integration of audit effort, where appropriate, to achieve a more effective and cohesive audit. In response to comments received, the Board made revisions to clarify the relationship of the reproposed standard to the risk assessment standards.

Linkages with Other Standards: The auditor's efforts regarding a company's relationships and transactions with its related parties, its significant unusual transactions, and its financial relationships and transactions with its executive officers are complementary to one another and offer opportunities for the proposed standard and amendments to be implemented in an efficient manner. For example, the auditor's work on identifying and evaluating significant unusual transactions might assist the auditor in identifying related party transactions that management had not previously disclosed to the auditor.

Use of Existing Concepts and Procedures: Retaining existing auditing concepts and procedures in the proposed standard and amendments, to the extent appropriate, permits audit firms to build on their existing methodologies. This could minimize the incremental costs of implementing the reproposed standard and amendments. For example, Appendix A of the reproposed standard includes examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Many of the examples contained in Appendix A are in the existing standard, AU sec. 334.

Opportunity for Scalability: The proposals employ a scaled approach, requiring basic procedures that are supplemented, as needed, by more in-depth procedures commensurate with the risks posed by the company's facts and circumstances. Such facts and circumstances may include the size or complexity of the transaction, the nature of the company's relationships or transactions with its related parties, and the related risk of material misstatements in the financial statements. For example, the improvements in the reproposed standard are designed for the auditor to perform specific procedures regarding related party transactions that require disclosure in the financial statements, rather than requiring the auditor to presume related party transactions are fraud risks in all cases, an approach that could result in unnecessary audit effort and costs.

Further, the Board revised its proposal in response to comments requesting the additional use of auditor judgment to avoid unnecessary costs. For example, the Board removed the proposed requirement that the auditor always treat each related party transaction previously undisclosed by management to the auditor as a significant risk, which would have triggered additional audit work in all cases.

Focus on Executive Officers: As proposed, the auditor's consideration of a company's financial relationships and transactions with its executive officers does not require the auditor to perform procedures relating to all members of a company's senior management, but, rather, generally focuses the auditor's attention on a smaller group who are more likely to be in a position to influence the company's accounting and financial statements or conceal misappropriation of assets.

As reproposed, the amendments regarding the auditor's consideration of a company's financial relationships and transactions with its executive officers has been clarified to explicitly provide that the procedures regarding a company's financial relationships and transactions with its executive officers are performed as part of the auditor's risk assessment process. The reproposed amendments would not require the auditor to make any determination regarding the appropriateness or reasonableness of the company's compensation arrangements with its executive officers or recommendations regarding such compensation arrangements.

Notwithstanding the efforts the Board has made to tailor the reproposed standard and amendments to achieve audit efficiencies and provide for a more cohesive and effective audit effort, the Board recognizes that its proposals to enhance and update its existing auditing procedures involve new requirements that will impose costs.

To further inform its considerations, the Board is seeking comment regarding economic considerations that should be taken into account when considering its reproposal, including seeking comment and empirical data regarding costs. As noted above, the Board anticipates that there will be some costs imposed by the reproposed standard and amendments, and that anticipated costs could include costs to audit firms, audit costs, and costs to companies. For example, audit firms will need to incur costs to update their audit methodologies to reflect the new requirements and conduct initial training of their personnel on the new requirements.

Audit fees also may increase due to the new auditor performance requirements in the Board's reproposal. Likewise, companies may need to incur additional expenses as, for example, audit committees may incur additional time and expense resulting from the new audit committee communication requirements for related party transactions, and management and others within the company might spend more time responding to inquiries by the auditor. Although the Board's reproposal builds on, and works in concert with, the approach taken in Auditing Standard No. 16, companies may need additional time or resources to conduct the new audit committee communications regarding related parties.

In addition to information and data involving costs, generally, the Board also is interested in receiving comments focusing on issues related to smaller companies and smaller audit firms. The benefits to audit quality that should result from the strengthening of auditor performance requirements for related party transactions, significant unusual transactions, and relationships and transactions with a company's executive officers, should accrue to companies of various types and natures, but they may have a differential impact on smaller companies and smaller audit firms.

For example, the Board notes that smaller companies may engage in more related party transactions, as was generally asserted by one commenter. In addition, as noted above, the Board's oversight activities in inspections and enforcement have revealed auditor failures to perform sufficient procedures regarding related party transactions, with most of these deficiencies involving smaller audit firms. Thus, smaller audit firms and their clients may incur costs to improve their existing audit approach regarding a company's relationships and transactions with its related parties. On the other hand, those firms and their clients may benefit from greater improvements in audit quality through the requirements contained in the reproposed standard and amendments. Smaller audit firms also may pass on additional costs to smaller companies in the form of increased audit fees.

The Board specifically requests commenters' views regarding the various economic considerations discussed above and is particularly interested in obtaining empirical data regarding both benefits and costs and other effects that may be related to the reproposed standard and amendments. The Board also requests comments on the questions outlined below.

Questions:

21. Would improving the auditor's understanding of a company's relationships and transactions with its related parties assist the auditor in obtaining sufficient appropriate evidence necessary to support the audit opinion? Would improving the auditor's understanding promote the exercise of professional skepticism? Would improving the auditor's understanding increase the likelihood of the auditor identifying material misstatements? Are there additional benefits that the Board should consider?

22. Could the required communications with audit committees in the reproposed standard result in improvements to audit committees' abilities to fulfill their duties?

23. Could the improved communications between the audit committee and the auditor lead to an improvement in the company's financial statement disclosures about its relationships and transactions with its related parties?

24. Would improving the auditor's identification and evaluation of significant unusual transactions increase the likelihood of the auditor identifying potential misstatements, including misstatements due to fraud? Would improving the auditor's identification and evaluation of significant unusual transactions promote the exercise of professional skepticism by the auditor? Are there additional benefits that the Board should consider?

25. Could the reproposed amendments regarding significant unusual transactions lead to an improvement in the company's disclosures about its significant unusual transactions?

26. What benefits are associated with auditors obtaining an understanding of a company's financial relationships and transactions with its executive officers as part of its risk assessment? Are there additional benefits that the Board should consider?

27. What benefits are associated with the other reproposed amendments?

28. What costs will audit firms incur when implementing the reproposed standard and amendments? Please discuss both initial costs and recurring costs.

29. What costs will companies incur as a result of the implementation of the reproposed standard and amendments?

30. Could the reproposed standard and amendments lead to other changes in behavior by the auditor, the company, or the audit committee that the Board should consider?

31. Are there considerations relating to smaller companies that the Board should be aware of in considering its reproposal? Do smaller companies share the same risks of material misstatement of the financial statements regarding related party transactions and significant unusual transactions as the broader issuer population? Are related party transactions more common in smaller companies than the broader issuer population? Would the reproposed standard and amendments result in smaller companies experiencing unnecessarily greater or disproportionate costs compared to those experienced by larger companies? If so, how could such costs be controlled while improving audit quality?

32. Are there any unique considerations regarding costs for audits of brokers and dealers?

33. Are there unique considerations regarding costs for specific types of companies based on characteristics other than size of the transaction (e.g., industry)?

34. Are there additional considerations relating to competition, efficiency, and capital formation that the Board should take into account with respect to the reproposed standard and amendments? Specifically, are there benefits in lowered cost of capital from confidence in audits of issuers with related party disclosures?

D. Considerations For Audits of Emerging Growth Companies

Pursuant to Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act"), any rules adopted by the Board subsequent to April 5, 2012, do not apply to the

audits of EGCs (as defined in Section 3(a)(80) of the Exchange Act) unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[89/]

The Board's proposal was issued for comment prior to the enactment of the JOBS Act. The Board is reproposing the standard and amendments, in part, to obtain commenters views regarding the applicability of its reproposal to audits of EGCs. As a result of the JOBS Act, the Board expects to provide information to assist the SEC in its determination regarding whether to apply the reproposed standard and amendments to audits of EGCs.

The Board is thus requesting that commenters provide any views or empirical data that will assist the PCAOB in providing information to the SEC regarding whether the reproposed standard and amendments should be applicable to audits of EGCs. The Board specifically requests comments, including empirical data, regarding the impact of the reproposed standard and amendments on investor protection, and whether the application of the reproposed standard and amendments would promote efficiency, competition, and capital formation. The Board also specifically requests comments that include empirical data regarding costs that are specific to the application of the reproposed standard and amendments to audits of EGCs. Specific questions are also set forth below.

The PCAOB has begun to monitor implementation of the JOBS Act in order to understand the characteristics of EGCs[90/] and inform the Board's considerations

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[89/] Pub. L. No. 112-106 (April 5, 2012). *See* Section 103(a)(3)(C) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. §7213(a)(3)), as added by Section 104 of the JOBS Act.

[90/] Pursuant to the JOBS Act, an "emerging growth company" is defined in Section 3(a)(80) of the Exchange Act. In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than $1 billion during its most recently completed fiscal year (and its first sale of common equity securities pursuant to an effective Securities Act registration statement did not occur on or before December 8, 2011). *See* JOBS Act Section 101(a), (b), and (d). Once an issuer is an EGC, the entity retains its EGC status until the earliest of: (i) the first year after it has total annual gross revenue of $1 billion or more (as indexed for inflation every five years by the SEC); (ii) the end of the fiscal year after the fifth anniversary of its first sale of common equity

regarding whether it should request that the SEC apply the standard and amendments to audits of EGCs. To assist commenters, the Board is providing the following information regarding EGCs that it has compiled from public sources.[91/]

Characteristics of Self-Identified EGCs

As of November 15, 2012, based on the PCAOB's research, 579 SEC registrants have identified themselves as EGCs in SEC filings.

These entities operate in diverse industries. The five most common Standard Industrial Classification (SIC) codes applicable to these entities are: blank check companies; pharmaceutical preparations; prepackaged software services; real estate investment trusts; and computer processing/data preparations services.

A majority of the entities that have identified themselves as EGCs have begun reporting information under the securities laws, whether under the Securities Act or Exchange Act, since 2012. Of these entities, approximately:

- 36% identified themselves in registration statements and were not previously reporting under the Exchange Act.

- 47% of entities that have identified themselves as EGCs began reporting under the Exchange Act in 2012.

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securities under an effective Securities Act registration statement; (iii) the date on which the company issues more than $1 billion in non-convertible debt during the prior three year period; or (iv) the date on which it is deemed to be a "large accelerated filer" under the Exchange Act (generally, an entity that has been public for at least one year and has an equity float of at least $700 million).

[91/] To obtain data regarding EGCs, the PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and November 15, 2012, for disclosures by entities related to their EGC status. Only those entities that have voluntarily disclosed their EGC status have been identified. The PCAOB has not validated these entities' self-identification as EGCs. The information presented also does not include data for entities that have filed confidential registration statements and have not subsequently made a public filing. The PCAOB intends to update this information semi-annually.

- 17% of these entities have been reporting under the Exchange Act since 2011 or earlier.

Approximately 20% of these entities have securities listed on a U.S. national securities exchange as of November 15, 2012.

Audited financial statements were available for nearly all of the entities that have identified themselves as EGCs. For those entities for which audited financial statements were available, based on information included in the most recent audited financial statements filed as of November 15, 2012:

- The reported assets for those entities ranged from zero to approximately $13 billion. The average and median reported assets of the entities were approximately $122.1 million and approximately $0.2 million, respectively.[92/]

- The reported revenue for these entities, ranged from zero to approximately $973.7 million. The average and median reported revenue of these entities was approximately $53.7 million and zero, respectively.

- The average and median reported assets among these entities that reported revenue greater than zero was approximately $257.3 million and $42.9 million. The average and median reported revenue among these entities that reported revenue greater than zero was approximately $109.1 million and $16.5 million.

[92/] For purposes of comparison, the PCAOB compared the data compiled with respect to the 579 entities with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The Russell 3000 was chosen for comparative purposes because it is intended to measure the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market (as marketed on the Russell website). The average and median reported assets of issuers in the Russell 3000 was approximately $11.4 billion and approximately $1.4 billion, respectively. The average and median reported revenue from the most recent audited financial statements filed as of November 15, 2012 of issuers in the Russell 3000 was approximately $4.6 billion and $705.5 million, respectively.

- Approximately 52% of the entities that filed audited financial statements identified themselves as "development stage entities" in their financial statements.[93/]

- Approximately 31% were audited by firms that are annually inspected by the PCAOB (i.e., firms that have issued audit reports for more than 100 public company audit clients in a given year). Approximately 69% were audited by triennially inspected firms (i.e., firms that have issued audit reports for 100 or fewer public company audit clients in a given year).

Special Considerations Relating to Smaller Companies that are EGCs. Based on the data outlined above, EGCs generally appear to be smaller public companies. As noted above, based on the PCAOB's oversight findings, enhanced auditor consideration of related party transactions may be of particular benefit to smaller audit firms. As previously discussed, the Board's inspection program has identified deficiencies relating to the auditing of related party transactions, particularly with respect to smaller audit firms. Further, a significant number of the Board's settled disciplinary actions to date, many of which involved audits of smaller public companies, have involved auditors' failures to perform sufficient procedures regarding identified related party transactions and transactions with related parties previously undisclosed to the auditor.

Under the scaled approach of the reproposed standard and amendments, required audit procedures would vary based on each EGC's facts and circumstances. For EGCs without extensive related party relationships or transactions, the reproposed standard and amendments should not result in a significant change in audit costs. But, EGCs with extensive related party relationships or transactions would see a cost increase. The Board is sensitive to the disproportionate effects additional audit costs may have on smaller companies.

The Board also has taken note of the potential for a differential effect of its reproposal on small companies, including EGCs. Based on the Board's ongoing, but

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[93/] According to FASB guidance, development stage entities are entities devoting substantially all of their efforts to establishing a new business and for which either of the following conditions exists: (a) planned principal operations have not commenced or (b) planned principal operations have commenced, but there has been no significant revenue from operations. See FASB Accounting Standards Codification, Subtopic 915-10, Development Stage Entities – Overall.

preliminary, analysis of EGC data, EGCs generally appear to be companies that are relatively new to the SEC reporting process. There is likely less information available to investors regarding such companies (e.g., they may have fewer audited results, fewer analysts follow them, and less press coverage).

The staff has reviewed the financial statements of certain companies that have identified themselves as EGCs and noted a significant percentage of EGCs disclose related party transactions.[94/]

To the extent that the reproposed standard and amendments result in increased disclosure of relationships or transactions with related parties or significant unusual transactions, this information may be incrementally more valuable to both EGCs and investors in EGCs because the decrease in information asymmetry for such companies would be incrementally larger relative to other operating companies.

Further, improved disclosure of an EGC's relationships and transactions with its related parties, when entering public capital markets, could increase investor confidence in the reliability of the financial statements and, therefore, the supply of capital. Conversely, the additional audit related costs may deter certain EGCs from entering public markets, if those costs weigh heavily on their potential profitability.

To the extent that the market perceives adoption of the standard and amendments as a step towards lowering the probability of fraudulent financial reporting, exempting EGCs from the reproposed standard and amendments may put them at a competitive disadvantage as they would not derive this and the other benefits outlined above.

The Board specifically requests commenters' views regarding the various economic considerations discussed above, and is particularly interested in obtaining empirical data regarding benefits and costs and other effects that may result from the

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[94/] As previously noted, the PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012 and November 15, 2012 for disclosures by entities related to their EGC status. An analysis of 450 audited financial statements from the self-identified sample of EGCs indicates that 54 percent of the EGCs disclosed at least one related party transaction.

reproposed standard and amendments. The Board also requests comments on the questions outlined below.

Questions:

35. Should the reproposed standard and amendments be applicable for audits of EGCs? Why or why not? Please provide empirical data, examples and explanations for why the requirements should or should not be applicable for audits of EGCs.

36. Are related party transactions or significant unusual transactions more common at EGCs than the broader issuer population? Do financial relationships and transactions with executive officers at EGCs give rise to increased risks of material misstatements than the broader issuer population? Please provide any data you have to support your views.

37. Are there other characteristics of EGCs (e.g., the size of the company and the length of time it has been a reporting company) that the Board should consider?

38. Would EGCs benefit more or less from the reproposed standard and amendments than other companies? Would inherently riskier EGCs receive benefits relative to other EGCs because the market cannot observe certain undisclosed related party risks that the new standards would otherwise make available through better compliance by management with its disclosure obligations?

39. What costs would firms incur when implementing the reproposed standard and amendments for audits of EGCs? How will those costs differ from the costs for the larger issuer population? Which of the costs are initial or recurring or both?

40. Are there particular costs, benefits, or burdens applicable to EGCs that the Board should consider when determining whether to recommend to the Commission the application of the reproposed standard and amendments to audits of EGCs? For example, do EGCs share the same risk of material misstatement of the financial statements as the broader issuer population due to relationships and transactions with related parties?

41. Regardless of the applicability of the reproposed standard and amendments to audits of EGCs, would an audit firm perform the same

procedures for an audit of an EGC and an audit of a non-EGC to ensure a consistency in the training, methodology, and tools in their audit practice or to respond to risks of material misstatement with similar approaches?

42. Would the implementation and training costs that a firm would incur be dependent upon whether the standard is applicable to EGCs? Would such costs generally be fixed once required to be implemented, regardless of whether the standard is applicable to audits of EGCs?

43. For auditors of both EGCs and other SEC registrants, would it be more costly to not apply the reproposed standard and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?

44. Are there any other considerations relating to competition, efficiency, and capital formation that the Board should take into account when determining whether to recommend to the Commission the application of the reproposed standard and amendments to audits of EGCs?

V. Audits of Brokers and Dealers

As described in Section V. of the release, the Dodd-Frank Wall Street Reform and Consumer Protection Act gave the Board explicit oversight authority over audits of brokers and dealers that are required under SEC rules. In the event that the SEC directs that audits of brokers and dealers be conducted in accordance with PCAOB standards, the reproposed standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to such audits.

The Board requested comments from auditors of brokers and dealers and others on the proposed standard and amendments. Several commenters generally stated that the proposed standard and amendments are appropriate for audits of brokers and dealers.

Related Party Transactions at Brokers and Dealers: At the SAG discussion the point was raised that a robust auditing standard on related parties was important for both regulators of brokers and dealers and users of their financial statements. Several scenarios were discussed by which related party transactions might be improperly used by brokers and dealers, including to: overpay for goods or services and disguise capital withdrawals; avoid the imposition of higher capital requirements and various capital

charges; structure a broker's or dealer's business model to appear smaller; and transfer customer assets to parties that are not approved custodians.

Providing Exceptions for Audit Committee Communications: One commenter noted that many non-issuer securities broker-dealers may have no financial oversight or functional governance bodies other than the owner-managers, making audit committee communication of no practical benefit. That commenter recommended providing exceptions in these cases. The Board considered this comment and noted that the definition of "audit committee," including for audits of brokers and dealers, was established by Auditing Standard No. 16 and is not being amended by the new proposed auditing standard or the other reproposed amendments.[95/] As discussed in the adopting release for Auditing Standard No. 16, this definition should allow the auditor to identify the appropriate persons within brokers and dealers to receive such communications. The proposed standard therefore has not been revised for this comment.

Questions:

45. Are the reproposed standard and reproposed amendments appropriate for audits of brokers and dealers? Why or why not?

46. Are there additional procedures specific to audits of brokers and dealers that should be included in the reproposed standard and reproposed amendments?

47. Should auditors of brokers and dealers be required to evaluate whether a broker's or dealer's relationships and transactions with its related parties impact that broker's or dealer's compliance with its regulatory requirements? Why or why not?

48. Should the auditor's communications to audit committees included in the reproposed standard be applicable to audits of brokers and dealers? If not, provide examples and explanations for why the communication requirement should not be applicable for audits of brokers and dealers.

95/ *See* earlier discussion of paragraph 19 of the reproposed standard in Section I.H. of this Appendix.

VI. Effective Date

The Board anticipates that the reproposed standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2013. In developing the effective date, the Board considered the comments received regarding the anticipated effective date of the Board's proposal. The Board seeks comment regarding whether the anticipated effective date would allow sufficient time for PCAOB registered firms to incorporate the new requirements into their methodology, guidance and audit programs, and to provide training for staff.

Questions:

49. Is the Board's anticipated effective date appropriate? Why or why not?

50. Does the new proposed effective date allow sufficient time for firms to incorporate the new requirements into their methodology, guidance and audit programs, and training for staff? Why or why not?

APPENDIX 5 – Comparison of the Objectives and Requirements of the Reproposed Standard and Amendments with the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

The Board is reproposing a new auditing standard, *Related Parties* (the "reproposed standard"); amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "reproposed amendments regarding significant unusual transactions"); and other amendments to PCAOB auditing standards (the "other reproposed amendments").[1/] This Appendix discusses the reproposed standard in Appendix 1, the reproposed amendments regarding significant unusual transactions, in Appendix 2, and the other reproposed amendments in Appendix 3.

This appendix compares certain significant differences between the objectives and certain key requirements of the reproposed standard and amendments with the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA").

The analogous standards of the IAASB discussed in this comparison include:

- International Standard on Auditing 550, *Related Parties* ("ISA 550");
- International Standard on Auditing 210, *Agreeing the Terms of Audit Engagements* ("ISA 210");
- International Standard on Auditing 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* ("ISA 240");
- International Standard on Auditing 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* ("ISA 315");
- International Standard on Auditing 510, *Initial Audit Engagements-Opening Balances* ("ISA 510");
- International Standard on Auditing 560, *Subsequent Events* ("ISA 560");

[1/] The reproposed amendments regarding significant unusual transactions and the other reproposed amendments are collectively referred to as the "reproposed amendments." The reproposed standard and reproposed amendments are collectively referred to as the "reproposed standard and amendments" or the "reproposal."

- International Standard on Auditing 580, *Written Representations* ("ISA 580");
- International Standard on Auditing 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* ("ISA 600"); and
- International Standard on Review Engagements 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*, ("ISRE 2410").

The analogous standards of the ASB discussed in this comparison include:

- AU-C Section 550, *Related Parties* ("AU-C Section 550");
- AU-C Section 210, *Terms of Audit Engagements* ("AU-C Section 210");
- AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit* ("AU-C Section 240");
- AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* ("AU-C Section 315");
- AU-C Section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements* ("AU-C Section 510");
- AU-C Section 560, *Subsequent Events* ("AU-C Section 560");
- AU-C Section 580, *Written Representations* ("AU-C Section 580");
- AU-C Section 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors*) ("AU-C Section 600"); and
- AU-C Section 930, *Interim Financial Information* ("AU-C Section 930").[2/]

This comparison is organized in the following sections: (I.) the reproposed auditing standard, (II.) the reproposed amendments regarding significant unusual transactions, and (III.) the other reproposed amendments to PCAOB auditing

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[2/] These AU-C Sections are contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification* ("SAS No. 122"). In October 2011, the ASB adopted SAS No. 122, which contains 39 clarified SASs with "AU-C" section numbers for each clarified SAS. The "AU-C" is a temporary identifier to avoid confusion with references to existing "AU" sections in AICPA Professional Standards. *See* https://www.aicpa.org/interestareas/frc/auditattest/pages/improvingclarityasbstandards.aspx.

standards.[3/] This comparison does not cover the application and explanatory material in the analogous standards of the IAASB or ASB.[4/]

This appendix is provided for informational purposes only. It is not a summary of or substitute for the reproposed standard in Appendix 1 or the reproposed amendments in Appendices 2 and 3 of this release. This comparison may not represent the views of the IAASB or the ASB regarding the interpretations of their standards.

I. Reproposed Auditing Standard, *Related Parties* (Appendix 1)

A. Introduction (Paragraph 1 of the Reproposed Standard in Appendix 1)

PCAOB

The reproposed standard would refer auditors to the requirements of the U.S Securities and Exchange Commission ("SEC") for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties", and the financial statement disclosure requirements with respect to related parties. The reproposed standard would not include definitions that might represent accounting guidance, including a definition for an arm's-length transaction.

IAASB

[3/] This comparison does not cover the foundational requirements contained in the risk assessment standards. Appendix 11 of PCAOB Release No. 2010-004, *Auditing Standards Related to Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards,* contains a comparison of the objectives and requirements of those standards with the analogous standards of the IAASB and the ASB.

[4/] Paragraph A59 of International Standard on Auditing 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, states that the Application and Other Explanatory Material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards,* states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section."

Paragraph 10(b) of ISA 550 defines a related party as a party that is either:

i. A related party as defined in the applicable financial reporting framework; or

ii. Where the applicable financial reporting framework establishes minimal or no related party requirements:

a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;

b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or

c. Another entity that is under common control with the reporting entity through having:

(i) Common controlling ownership;

(ii) Owners who are close family members; or

(iii) Common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

ISA 550 also defines an arm's-length transaction as a transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

ASB

AU-C Section 550 defines a related party as a related party as defined in generally accepted accounting principles. AU-C Section 550 also contains a definition of arm's-length transaction that is similar to the definition in ISA 550.

B. Objective (Paragraph 2 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 2 of the reproposed standard would state that the auditor's objective is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

IAASB

Paragraph 9 of ISA 550 states that the objectives of the auditor are:

(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements to obtain an understanding of related party relationships and transactions sufficient to be able:

i. To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and

ii. To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:

a. Achieve fair presentation (for fair presentation frameworks); or

b. Are not misleading (for compliance frameworks); and

(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

ASB

AU-C Section 550 contains a similar objective to the objective in ISA 550 for fair presentation frameworks.

C. Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3 – 9 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 3 of the reproposed standard would require that the auditor perform procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Paragraph 3 of the reproposed standard also would state that the procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

a. Obtaining an understanding of the company's process (paragraph 4);

b. Performing inquiries (paragraphs 5-7); and

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

A note to paragraph 3 of the reproposed standard would state that obtaining an understanding of the company's relationships and transactions with its related parties includes obtaining an understanding of the nature of the relationships between the company and its related parties and of the terms and business purposes (or the lack thereof) of the transactions involving related parties.

Another note to paragraph 3 of the reproposed standard would state that performing the risk assessment procedures described in paragraphs 4-9 of the reproposed standard in conjunction with the risk assessment procedures required by Auditing Standard No. 12 is intended to provide the auditor with a reasonable basis for identifying and assessing risks of material misstatement associated with related parties and relationships and transactions with related parties.

IAASB

Paragraph 11 of ISA 550 states that as part of the risk assessment procedures and related activities required by ISA 315 and ISA 240, the auditor shall perform the audit procedures and related activities set out in paragraphs 12-17 of ISA 550 to obtain

information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Obtaining an Understanding of the Company's Process (Paragraph 4 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 4 of the reproposed standard would require that in conjunction with obtaining an understanding of internal control over financial reporting, the auditor obtain an understanding of the company's process for:

a. Identifying related parties and relationships and transactions with related parties;

b. Authorizing and approving transactions with related parties; and

c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

IAASB

Paragraph 13 of ISA 550 requires that the auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to:

a. Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;

b. Authorize and approve significant transactions and arrangements with related parties; and

c. Authorize and approve significant transactions and arrangements outside the normal course of business.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Performing Inquiries (Paragraphs 5 – 7 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 5 of the reproposed standard would require the auditor to inquire of management regarding:

a. The names of the company's related parties during the period under audit, including changes from the prior period;

b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);

c. The nature of any relationships, including ownership structure, between the company and its related parties;

d. The transactions entered into, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;

e. The business purpose for entering into a transaction with a related party versus an unrelated party;

f. Any related party transactions that have not been authorized and approved in accordance with the company's established policies or procedures regarding the authorization and approval of transactions with related parties; and

g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

Paragraph 6 of the reproposed standard would require the auditor to inquire of others within the company regarding their knowledge of the matters in paragraph 5 of the reproposed standard. Paragraph 6 also would require the auditor to identify others within the company to whom inquiries should be directed, and determine the extent of

such inquires, by considering whether such individuals are likely to have knowledge regarding:

a. The company's related parties or relationships or transactions with related parties;

b. The company's controls over relationships or transactions with related parties; and

c. The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Paragraph 7 of the reproposed standard would require the auditor to inquire of the audit committee, or its chair, regarding:

a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and

b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties, and, if so, the substance of those concerns.

IAASB

Paragraph 13 of ISA 550 requires the auditor to inquire of management regarding:

a. The identity of the entity's related parties, including changes from the prior period;

b. The nature of the relationships between the entity and these related parties; and

c. Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

D. Identifying and Assessing Risks of Material Misstatement (Paragraph 10 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 10 of the reproposed standard would align with the existing requirements for the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 10 also would state that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties or relationships or transactions with related parties. Paragraph 59 of Auditing Standard No. 12 requires that the auditor identify which risks are significant risks. Further, paragraph 71 of Auditing Standard No. 12 provides factors that the auditor should evaluate in determining which risks are significant risks. Those factors include: (1) whether the risk involves significant transactions with related parties, (2) whether the risk involves significant transactions that are outside the normal course of business and (3) whether the risk is a fraud risk. The reproposed amendments regarding significant unusual transactions to AU sec. 316.85A.2 would state that a related party transaction that is also a significant unusual transaction (e.g., a significant related party transaction outside the normal course of business) is an example of a fraud risk factor.

A note to paragraph 10 of the reproposed standard would state that in identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4-9 of the proposed standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

IAASB and ASB

ISA 550 and AU-C Section 550 require that the auditor identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. ISA 550 and AU-C Section 550 require the auditor to treat identified significant related party transactions outside the normal course of business as giving rise to significant risks.

E. Responding to the Risks of Material Misstatement (Paragraphs 11-13 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 11 of the reproposed standard would align with existing requirements that the auditor design and implement audit responses that address the identified and assessed risks of material misstatement. Paragraph 11 of the reproposed standard also would state that this includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.

A note to paragraph 11 of the reproposed standard would state that the auditor should look to the requirements of AU secs. 316.66-.67A for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). That note would further state that for such related party transactions, AU sec. 316.67 would require that the auditor evaluate whether the business purpose (or the lack thereof) of the transactions indicates that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

IAASB

Paragraph 20 of ISA 550 requires that the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21-24 of ISA 550.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Transactions with Related Parties Required to be Disclosed in the Financial Statements or Determined to be a Significant Risk (Paragraph 12 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 12 of the reproposed standard would require that for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:

a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

b. Determine whether the transaction has been authorized and approved in accordance with the company's established policies and procedures regarding the authorization and approval of transactions with related parties;

c. Determine whether any exceptions to the company's established policies or procedures were granted;

d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and

e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

A note to paragraph 12 of the reproposed standard would state that the applicable financial reporting framework may allow the aggregation of similar related party transactions for disclosure purposes. If the company has aggregated related party transactions for disclosure purposes in accordance with the applicable financial reporting framework, the auditor may perform the procedures in paragraph 12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

IAASB

Paragraph 23 of ISA 550 requires that for identified significant related party transactions outside the entity's normal course of business, the auditor shall:

a. Inspect the underlying contracts or agreements, if any, and evaluate whether:

i. The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;

ii. The terms of the transactions are consistent with management's explanations; and

iii. The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and

b. Obtain audit evidence that the transactions have been appropriately authorized and approved.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

F. Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14-16 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 14 of the reproposed standard would require that the auditor evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Paragraph 14 also would require that in making that evaluation, the auditor take into account information gathered during the audit. Paragraph 14 would also require that as part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. A note to paragraph 14 of the reproposed standard would further state that Appendix A describes examples of information and sources of information that could indicate that related parties previously undisclosed to the auditor might exist.

A footnote to paragraph 14 of the reproposed standard would state that evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. That footnote would further state that this evaluation requires the auditor to perform procedures to test the accuracy and completeness of the

related parties and relationships and transactions with related parties identified by the company.

As described in Section I.F. of Appendix 4, other PCAOB auditing standards might impose requirements relating to the sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist (e.g., reading confirmation responses and responses to inquiries of the company's lawyers).[5/]

Paragraph 15 of the reproposed standard would require that if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Paragraph 15 also would state that those procedures should extend beyond inquiry of management.

Paragraph 16 of the reproposed standard would describe the procedures that the auditor would be required to perform if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Paragraph 16 of the reproposed standard would require that the auditor:

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

b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;

c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;

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

d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;

e. Perform the procedures required by paragraph 12 of this standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;

f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;

g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and

h. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor determines that it is likely that an illegal act has or may have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

IAASB

Paragraph 15 of ISA 550 requires the auditor to remain alert, during the audit, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. Paragraph 15 of ISA 550 further requires that, in particular, the auditor inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

(a) Bank and legal confirmations obtained as part of the auditor's procedures;

(b) Minutes of meetings of shareholders and of those charged with governance; and

(c) Such other records and documents as the auditor considers necessary in the circumstances of the entity.

Paragraph 21 of ISA 550 requires that if the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships and transactions.

Paragraph 22 of ISA 550 requires that if the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

a. Promptly communicate the relevant information to the other members of the engagement team;

b. Where the applicable financial reporting framework establishes related party requirements;

   (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation;

   (ii) Inquire why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;

c. Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions;

d. Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor and perform additional audit procedures as necessary.

e. Evaluate the implications for the audit if the nondisclosure by management appears intentional (and, therefore, indicative of a risk of material misstatement due to fraud).

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

G. Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17—18 of the Reproposed Standard in Appendix 1)

PCAOB

Paragraph 17 of the reproposed standard would align with the existing requirement that the auditor evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. Paragraph 17 would state that this includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.

IAASB

Paragraph 25 of ISA 550 requires that in forming an opinion on the financial statements, the auditor shall evaluate:

a. Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and

b. Whether the effects of the related party relationships and transactions:

(i) Prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or

(ii) Cause the financial statements to be misleading (for compliance frameworks).

ASB

AU-C Section 550 contains similar requirements to the requirements in ISA 550 for fair presentation frameworks.

Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (Paragraph 18 of the Reproposed Standard in Appendix 1)

PCAOB

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

A note to paragraph 18 of the reproposed standard would further state that a preface to a statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

IAASB

Paragraph 24 of ISA 550 states that if management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

H. Communications with the Audit Committee (Paragraph 19 of the Reproposed Standard in Appendix 1)

PCAOB

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

a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;

b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;

c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;

d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and

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

IAASB

Paragraph 27 of ISA 550 requires that the auditor communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

II. Reproposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions (Appendix 2)

A. Identifying Significant Unusual Transactions (Section A of the Reproposed Amendments in Appendix 2)

PCAOB

The reproposed amendments to paragraph 56.a. of Auditing Standard No. 12 would require the auditor to inquire of management regarding whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involve related parties. The reproposed amendments regarding significant unusual transactions to paragraph 56.b. of Auditing Standard No. 12 would require that the auditor inquire of the audit committee or equivalent, or its chair, regarding whether

the company has entered into any significant unusual transactions. The reproposed amendments regarding significant unusual transactions to paragraph 56.c. of Auditing Standard No. 12 require similar inquiries of internal audit personnel.

A note to AU sec. 316.66 would state that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. That note would refer the auditor to paragraphs 14-16 of reproposed auditing standard, *Related Parties*. That note would further state that Appendix A of the proposed standard, *Related Parties,* includes examples of such information and examples of sources of such information.

IAASB and ASB

ISA 315, ISA 550, AU-C Section 315, and AU-C Section 550 do not contain similar requirements for the auditor to those in the PCAOB's reproposed amendments.

B. Evaluating Significant Unusual Transactions (Section B of the Reproposed Amendments in Appendix 2)

PCAOB

The reproposed amendments regarding significant unusual transactions would add paragraph .66A to AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.* That paragraph would require the auditor to design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. AU sec. 316.66A would require that those procedures include the following:

a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

b. Determining whether the transaction has been appropriately authorized and approved in accordance with the company's established policies and procedures;

c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and

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

The reproposed amendments to AU sec. 316.67 would require that the auditor evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. The reproposed amendments would require that, in making that evaluation, the auditor evaluate whether:

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

- The transaction involves unconsolidated related parties, including variable interest entities;

- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor;

- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company;

- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);

- The transaction occurs with a party that falls outside the definition of a related party (as defined by the accounting principles applicable to that company), with either party able to negotiate terms that may not be available for other, more clearly independent, parties on an arm's-length basis;

- The transaction enables the company to achieve certain financial targets;

- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction (e.g., accounting-motivated structured transaction); and

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

Further, the reproposed amendments would add paragraph 11A to Auditing Standard No. 13. That paragraph would require that because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66-.67A.

The reproposed amendments to AU sec. 316.67A would require that the auditor evaluate whether significant unusual transactions identified by the auditor have been properly accounted for and disclosed in the financial statements.

IAASB

Paragraph 16 of ISA 550 requires that if the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required by paragraph 15 or through other audit procedures, the auditor shall inquire of management about:

(a) The nature of these transactions; and

(b) Whether related parties could be involved.

Paragraph 32(c) of ISA 240 requires the auditor to evaluate whether the business rationale (or the lack thereof) of a significant transaction outside the normal course of business suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. As discussed in Section I.E. of this Appendix, paragraph 23 of ISA 550 requires the auditor to perform certain procedures for identified significant related party transactions outside the entity's normal course of business.

ASB

AU-C Section 550 and AU-C Section 240 contain similar requirements to those in ISA 550 and ISA 240.

III. Other Reproposed Amendments to PCAOB Auditing Standards (Appendix 3)

A. Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (Appendix 3)

PCAOB

The other reproposed amendments to paragraph 10A of Auditing Standard No. 12 would require that to assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers. The other reproposed amendments to Auditing Standard No. 12 also include a definition of executive officer that aligns with definitions used in SEC filings.

In addition, the other reproposed amendments would amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider:

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

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

IAASB and ASB

ISA 315 and AU-C Section 315 do not contain similar requirements for the auditor to those in the PCAOB's reproposed amendments.

B. AU sec. 315, *Communications Between Predecessor and Successor Auditors* (Appendix 3)

PCAOB

The other reproposed amendments to other PCAOB Auditing Standards would amend AU sec. 315, *Communications Between Predecessor and Successor Auditors,* to require the auditor to inquire of the predecessor auditor regarding the predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions. The other reproposed amendments also would require the successor auditor to review documentation regarding related parties and significant unusual transactions.

IAASB and ASB

Neither ISA 210 and ISA 510, nor AU-C Section 210 and AU-C Section 510 contain similar requirements to those in the PCAOB's reproposed amendments.

C. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (Appendix 3)

PCAOB

The other reproposed amendments to AU sec. 316.81A would describe the auditor's responsibility, under certain conditions, to disclose possible fraud to the SEC to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change on Form 8-K and the fraud or related risk factors constitute a *reportable event* or are the source of a *disagreement*, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required pursuant to Section 10A(b) of the Exchange Act relating to an illegal act that the auditor concludes has a material effect on the financial statements.

IAASB and ASB

ISA 240 and AU-C Section 240 do not inform the auditor of certain obligations under Section 10A of the Securities Exchange Act of 1934, which is applicable to auditors of U.S. public companies registered with the PCAOB.

D. AU sec. 333, *Management Representations* (Appendix 3)

PCAOB

The other reproposed amendments to AU sec. 333, *Management Representations,* would require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The other reproposed amendments to AU sec. 333 also would require the auditor to obtain written representation from management if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction.

IAASB and ASB

Neither ISA 580 and ISRE 2410, nor AU-C Section 580*,* and AU-C Section 930 contain similar requirements to those in the PCAOB's reproposed amendments.

E. AU sec. 560, *Subsequent Events* (Appendix 3)

PCAOB

The other reproposed amendments would amend paragraph .12 of AU sec. 560, *Subsequent Events*, to require that during the "subsequent period" the auditor inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:

- Whether there have been any changes in the company's related parties or significant new related party transactions, and

- Whether the company has entered into any significant unusual transactions.

IAASB and ASB

ISA 560 and AU-C Section 560 do not contain similar requirements to those in the PCAOB's reproposed amendments.

F. AU sec. 722, *Interim Financial Information* (Appendix 3)

PCAOB

The other reproposed amendments to AU sec. 722, *Interim Financial Information*, would require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The other reproposed amendments to AU sec. 722 also would require the auditor to obtain written representations from management when management has made an assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in arm's-length transactions.

IAASB

ISA 550 and ISRE 2410 do not contain similar requirements to those in the PCAOB's reproposed amendments.

ASB

AU-C Section 550 and AU-C Section 930 do not contain similar requirements to those in the PCAOB's reproposed amendments.