



1800 Gateway Drive, Ste 200  
San Mateo CA 94404-4072  
(800) 922-5272  
www.calcpa.org

Via email: [comments@pcaobus.org](mailto:comments@pcaobus.org)

May 10, 2012

Office of the Secretary  
PCAOB  
1666 K Street, N.W.  
Washington, D.C. 20006-2803

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

February 28, 2012

PCAOB Rulemaking Docket Matter No. 038

The Accounting Principles and Auditing Standards Committee (“the Committee” or “We”) of the California Society of Certified Public Accountants (“CalCPA”) is grateful for the opportunity to comment on the proposed auditing standard referenced above. The Committee is the senior technical committee of CalCPA. CalCPA has approximately 40,000 members. The Committee is comprised of 43 members, of whom 56 percent are from local or regional firms, 21 percent are from large multi-office firms, 12 percent are sole practitioners in public practice, 9 percent are in academia and 2 percent are in an international firm.

The Committee generally supports the issuance of the proposed amendments to PCAOB auditing standards regarding related parties and additional guidance on significant unusual transactions, and has provided our responses to the questions set forth in Appendix 4.

1. Is the framework neutral approach described in the introduction of the proposed standard appropriate? If not, why not?

The Committee believes the framework neutral approach is appropriate as it establishes requirements for the auditor’s evaluation of related parties.

2. Is the objective of the proposed standard appropriate? If not, why not?

The Committee agrees with the intent of the stated objective, but believes the objective as worded is too broad. The Committee notes the objective is stated in absolute terms without reference to concepts of materiality and reasonable assurance; which are fundamental to the overall audit process. The audit process, cannot, and should not, be viewed as the dominant means by which to achieve a higher level of corporate governance.

3. Does the proposed standard clearly articulate the auditor's responsibility for identifying related parties and obtaining an understanding of the company's relationships and transactions with related parties?

Yes, if the responsibility is limited to performing the procedures listed in paragraphs 5-8 and matters that come to the auditor's attention in performing other procedures. Otherwise, the Committee expresses the same concerns as noted in our response to question 2 above regarding materiality and reasonable assurance in satisfying the completeness assertion being applied to the identification of related parties.

4. Are the procedures for identifying related parties and obtaining an understanding of relationships and transactions with related parties appropriate?

Yes, and we suggest adding an additional item to the list in paragraph A3 of Appendix A to review the invoices of outside counsel. Knowing the subject matters to which counsel is giving attention can be a very fertile audit procedure.

5. Are the proposed requirements regarding the auditor's responsibility for information that comes to the auditor's attention that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist appropriate? If not, why not? Are there additional examples that should be included in Appendix A?

The Committee agrees with the proposed requirements and recommends the addition of reviewing the invoices of outside counsel to the list in Appendix A.

6. Is paragraph 12 of the proposed standard appropriately aligned with the existing requirements regarding the identification and assessment of risks of material misstatement?

The Committee believes the guidance in paragraph 12 is appropriately aligned with the existing requirements.

7. Are there other examples of fraud risk factors, in addition to dominant influence, that should be included in the proposed amendments to assist the auditor when determining whether a related party transaction is a fraud risk or other significant risk?

The Committee believes the current proposal makes it clear that related party transactions have inherently higher fraud risk because of the absence of third-party (arm's length) constraints.

8. Are there particular related party transactions that should be deemed a fraud risk or other significant risk?

As noted in the Committee's response to Question 7. above, all related party transactions have this potential.

9. Is paragraph 13 of the proposed standard appropriately aligned with the existing requirements regarding responding to the risks of material misstatement?

The Committee believes an auditor will always be challenged by the inherent limits of trying to evaluate the economic substance of related party transactions that may not be obvious on their face. Nevertheless, the auditor must determine an appropriate course of action, and design audit procedures which will seek to corroborate management's representations and the auditor's basic understanding.

10. Are the procedures regarding related party transactions required to be disclosed in the financial statements, or that are a significant risk appropriate? Are there other specific procedures that should be required?

The Committee notes that providing an option to state that a related party transaction is equivalent to prevailing third-party transactions may not be viable. Even in the case where a particular transaction seems to be at arm's length, its mere existence may affect the terms of other transactions with the same party.

The Committee also believes that inquiry of in-house counsel be added as a suggested step. This communication may be ineffective if such counsel invokes attorney-client privilege or attorney-work-product privilege, and accordingly, such attorney should be instructed by an appropriate member of management or the board of directors, that such privilege be waived, and so advise the auditor that no privilege is being claimed. Any restriction on communications provided the auditor could be viewed as a scope of audit exception.

11. Are the requirements in paragraph 16 of the proposed standard appropriate concerning the auditor's responsibilities regarding information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist?

The Committee believes the stated requirements are appropriate.

12. Are the requirements in paragraph 17 appropriate regarding the identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor?

The Committee recommends that Paragraph 17.h. be emphasized. If management did not disclose the related party information, can their other representations be accepted?

13. Are the requirements in the proposed standard regarding the auditor's evaluation of the company's financial statement accounting and disclosure of related party transactions appropriate?

The Committee believes the stated requirements are appropriate.

14. Are the proposed requirements for substantiating management assertions that a related party transaction was consummated on terms equivalent to those prevailing in arm's-length transactions appropriate? If not, what other requirements are appropriate?

The Committee does not believe the option to provide an arm's-length financial statement disclosure is appropriate for the reasons stated in our response to Question 10. above.

15. Are the requirements in the proposed standard for the auditor to communicate to the audit committee regarding relationships with related parties appropriate?

The Committee believes the proposed standard inappropriately places the primary burden of communicating such matters on the auditor, when such communications should be considered part of corporate governance requirements should also be considered. The audit committee should have procedures in place to evaluate management's controls over the identification of related party transactions and entering into transactions with related parties.

The Committee suggests that communication matters included in paragraph 20.a.,b., and d. are acceptable, but c. be removed for the reasons previously stated in the Committee's response to Questions 10 and 14 above. The Committee also suggests that an additional communication matter be added: "The refusal or inability of any party, inside or outside the entity, to completely respond to the auditor's inquiry, and whether the auditor was able to perform satisfactory alternative procedures".

16. Should the proposed standard change the auditor's responsibilities for the auditor's report regarding related party transactions? If so, how?

The Committee does not believe the auditor's report should be changed as a result of the proposed standard.

17. Are the proposed amendments regarding the auditor's identification of significant unusual transactions appropriate? If not, why not?

The Committee believes the proposed amendments are appropriate.

18. Are the proposed amendments regarding the auditor's evaluation of significant unusual transactions appropriate? If not, why not?

The Committee believes the sentence in bold type contained in the proposed replacement of paragraph 66 of AU sec. 316 "Consideration of Fraud in a Financial Statement Audit", which is presented on page A2-6 of Appendix 2 of the PCAOB Release, and which states: "Evaluating whether the business purpose for significant unusual transactions indicated that the transactions may have been entered to engage in fraud" be modified to eliminate the possible erroneous conclusion that the auditor is responsible for establishing the parties "intent" to commit fraud. At a minimum, the word "evaluate" should be replaced with the word "consider" along with clarifying language regarding the matter of "intent".

The Committee wishes to state that while auditors may be trained in identifying evidence that might indicate a potential fraud, they are not trained to establish the intent of the parties, which is best left to law enforcement and the courts. In addition, the auditor is generally not in a position to consider aspects of potential fraud against a third party; e.g., matters involving intellectual property rights, or the compliance with Medicare billing rules. The Committee notes that a significant unusual transaction may be a perfectly legal transaction, even if it is not a good business deal.

19. Are the proposed amendments to Auditing Standard No. 12 regarding a Company's financial relationships and transactions with its executive officers appropriate? If not, why not?

The Committee believes the proposed amendments are appropriate.

20. Are the other proposed amendments to PCAOB auditing standards appropriate? If not, why not?

The Committee believes the other proposed amendments are appropriate.

21. Are the proposed standard and proposed amendments appropriate for audits of brokers and dealers? If not, why not?

The Committee believes the proposed requirements are especially relevant to the audits of brokers and dealers, given the volume of business relationships between the parties who may be involved in executing trades, and the Maddoff and other scandals.

22. Are there additional procedures specific to audits of brokers and dealers that should be included in the proposed standard and proposed amendments?

The Committee does not have any additional procedures to suggest related specifically to the audits of brokers and dealers.

23. Should the auditor's communications to audit committees included in the proposed 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.

The Committee believes such communications should be made to all audit committees, or other equivalent body responsible for governance activities, in the event the broker or dealer does not have a standing audit committee.

24. Is the Board's anticipated effective date appropriate?

The Committee believes the effective date for adoption is reasonable, provided the PCAOB's deliberations and subsequent SEC approval process do not delay issuance of the new standard past August 31, 2012.

25. Does the proposed effective date allow sufficient time to incorporate the new requirements into their methodology, guidance and audit programs, and training for staff?

Refer to the Committee's response to Question 24 above.

The Committee would be glad to discuss our comments further should you have any questions or require additional information.

Very truly yours,

A handwritten signature in black ink that reads "Howard Sibel". The signature is written in a cursive, flowing style.

Howard Sibelman, Chair  
Accounting Principles and auditing Standards Committee  
California Society of Certified Public Accountants