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Office of the Secretary
PCAOB
1666 K Street, NW
Washington DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 038

Ladies and Gentlemen:

Thank you for the opportunity to provide comments on the Board's proposed Auditing Standard on *Related Parties*.

We recognize the Board's concern regarding related parties and audits of related party relationships and transactions. The Board could not have been clearer in its emphasis, as noted on page 9 of the Release:

> Relationships and transactions with related parties have been a contributing factor in prominent corporate scandals, as discussed in the SEC study of five years of enforcement actions and in major enforcement cases, such as Enron Corporation, Tyco International, Ltd., and Refco, Inc. [Footnotes omitted.]

Although we share your concerns, UHY LLP cannot support the proposed Auditing Standard as written.

Background

When FASB Statement No. 57, *Related Party Disclosures*, was issued in March 1982, the Statement, like all other FASB Statements, included a "materiality box" after its effective date stating, "The provisions of this Statement need not be applied to immaterial items." In addition, paragraph 2, went even further than most standards, noting that "financial statements shall include disclosures of <u>material</u> related party transactions" [our <u>emphasis</u>]. Today, FASB ASC 105-10-5 paragraph 6 states, "the provisions of the Codification need not be applied to immaterial items."

Undisclosed Relationships or Transactions

We discuss the notion of materiality because of the Board's proposed requirement in paragraph 17e of the standard on related parties. This paragraph proposes to treat any related party relationships or transactions previously undisclosed by management as a significant risk and subject to the requirements of paragraph 15. We believe that requiring undisclosed matters to *automatically* be treated as a *significant risk* is inappropriate because it precludes the auditor's use of professional judgment. While we understand the reason for heightened rigor in this situation, we note that in *all* other instances:

> The auditor should use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of the inquiries about risks of material misstatement. [AS 12, *Identifying and Assessing Risk of Material Misstatement*, paragraph 55]

We believe that the auditor—as a professional—should always be provided the opportunity to assess the nature and materiality of related party relationships/transactions, to consider the reason for management's failure to disclose them, to consider the environment in which the relationships/transactions take place, and to assess the resulting risk of material misstatement. If the PCAOB wishes, given its concerns cited earlier, to establish a *higher standard* for undisclosed related party relationships/transactions, we suggest that the Board consider shifting the emphasis to the documentation required when an auditor encounters this situation. For example, it could require that undisclosed related party relationships/transactions be included in the auditors' communications with the issuer's audit committee without regard to materiality or other considerations. And, it could suggest—as discussed in footnote 4—that materiality assessments for related party relationships/transactions must be based on qualitative factors, not on quantitative factors.

Certainly, if an auditor using his or her professional judgment has a sense that the failure to disclose was willful or has some suspicious quality, it is appropriate for the failure to be treated as a significant audit risk. But, we believe that decision should be made by the auditor who has spent a significant amount of time assessing the issuer's operating environment and control structure, who has—as a professional—considered management's integrity and has established his or her audit plan accordingly. While we are not fond of using clichés to express our views, we can imagine no other change in professional auditing standards that would create a more "slippery slope." Once the PCAOB begins to mandate the audit procedures required to be applied to specific relationships/transactions it will only be a matter of time until auditors will be found mechanically completing checklists and putting aside their professional judgment. We doubt this was the Board's intended outcome. While we agree that undisclosed related parties/relationships/transactions deserve special scrutiny, auditors should not be prohibited from using their professional judgment to determine which of these undisclosed matters constitutes a significant audit risk.

Completeness

We support the Board's proposal to modify AU sec. 333 to require management to make more complete representations about related parties. At the same time, we note that *current* AU sec. 334, paragraph .04 states, in part:

> An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered. Nevertheless, 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 for which FASB Statement No. 57 [AC section R36] requires disclosure even though there are no transactions. [Our emphasis added.]

Given the current proposal's *omission* of any concept similar to the first sentence above, does the PCAOB reasonably expect that the audit procedures it proposes will result in *all* related party transactions being discovered? AS No. 15, *Audit Evidence*, establishes the financial statement assertion of completeness. But, it is *management's* implicit or explicit assertion that all transactions and accounts that should be presented in the financial statements are so included, not the auditor's. While we recognize that it is not the norm for auditing standards to include such a statement, we believe the PCAOB should—at a minimum—clarify its expectations in this regard somewhere within the final standard.

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Should you have any questions, please feel free to contact me at (203) 401-2101.

Very truly yours,

Paul Rohan

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