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Via e-mail: comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Release No. 2012-001, Rulemaking Docket Matter No. 038, *Proposed Auditing Standard – Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards*

Dear Members and Staff of the Public Company Accounting Oversight Board:

BDO USA, LLP welcomes this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) release, *Proposed Auditing Standard – Related Parties* (Proposed Standard), *Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards* (Proposed Amendments) (the Release). We support the Board's overall objective to strengthen existing audit procedures for identifying, assessing, and responding to the risks of material misstatement associated with a company's related party transactions and the auditor's evaluation of significant unusual transactions, including transactions with executive officers, as part of the risk assessment process.

After careful consideration of the Proposed Standard, the Proposed Amendments, and the explanatory material provided within the Release, we provide the following comments for your consideration as you work to strengthen the existing standards. We believe the changes we propose below will enhance the clarity and ultimately the effectiveness with which the Proposed Standard and the Proposed Amendments are implemented.

For your convenience, a reference to the relevant questions posed in the Release is shown parenthetically, where applicable.

Authority of Objective
(Question 2)

The objective of the Proposed Standard explains that "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." While the setting of objectives has been part of the PCAOB's standard setting process since the issuance of Auditing Standard No. 7, *Engagement Quality Review*, the status and meaning of the objective within the standards has not been sufficiently explained or set out in an overall standard.

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With respect to this Proposed Standard, Appendix 4, page A4-4, explains the use of the audit objective as follows:

> Providing an overarching concept as an audit objective for the auditor to take into account while performing the procedures required by the proposed standard can assist the auditor in performing those procedures, including developing other procedures as required, and evaluating the results of those procedures. An overarching concept can be especially helpful when judgment is required, for example, when designing additional procedures not specifically required by the proposed standard. New auditing standards issued by the Board include an objective, and this standard is following the same format.

While we agree with the description of the status and meaning of the objective as stated above, we believe that this description should be included in an overall standard that applies to each of the Board's standards. This would clarify how an auditor is intended to use the objective, not only in this standard, but for all of the Board's auditing standards that contain an objective. Further, while the excerpt above provides some guidance to the auditor about how the objective should be considered, we believe it is incomplete in that it does not explain how the requirements relate and support the objective. For this reason, we suggest adding guidance that explains:

1. how the requirements included within the standard are expected to provide a sufficient basis for the auditor's achievement of the objective; and
2. that since circumstances differ in each audit, it is impossible to anticipate every situation or outcome and, for this reason, the objective is provided in the standard to ensure that sufficient appropriate evidence is obtained in each circumstance.

Fraud Considerations and the Importance of the Use of Professional Skepticism

The introduction to the Release explains that transactions with related parties can pose significant risks of material misstatement, as their substance might differ materially from their form. The Release also explains that related party transactions not only may involve difficult measurement and recognition issues that can lead to errors in financial statements, but also, in some instances, related party transactions have been used to engage in financial statement fraud and asset misappropriation. To focus the auditor's attention on risks associated with related parties, specifically as they relate to the risk of fraud, we recommend including a discussion in the introduction to the Proposed Standard of these matters that would provide context to the requirements within the standard.

Moreover, as related party relationships present a greater opportunity for collusion, concealment, or manipulation by management, the ability of the auditor to detect material misstatements in this context is lessened due to the inherent limitations of an audit. For this reason, we suggest also including additional introductory guidance emphasizing the importance of the use of professional skepticism in this area, given the potential for undisclosed related party relationships and transactions.

**Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties
(Questions 3 and 4)**

The Proposed Standard has been written with little or no explanatory guidance included. We believe the effectiveness of the implementation of the Proposed Standard will be negatively impacted without the benefit of such material to assist in the proper and consistent application of the requirements.

For example, paragraph 3 of the Proposed Standard explains that the auditor should perform procedures to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties, and understand the terms and business purpose (or lack thereof) of the types of transactions involving related parties. However, by itself this requirement is vague. It is unclear whether this requirement is referring to the procedures set out in paragraphs 4 through 11 of the Proposed Standard, or whether procedures other than those set out in the Proposed Standard are contemplated. This lack of clarity increases the likelihood that the requirement will be applied inconsistently or ineffectively. For this reason, we believe the explanatory guidance in Appendix 4, page A4-5, that explains that the auditor should perform the procedures set out in paragraphs 4 through 11 should be reflected in paragraph 3.

In addition, we believe paragraph 3 should more clearly explain the relationship between the foundational risk assessment requirements, including those related to fraud risks, and the procedures included within the Proposed Standard, by referencing the risk assessment concepts discussed in Appendix 4, beginning on page A4-13, within this paragraph. We believe revising the paragraph in this way will help alleviate any perception that inquiry alone is sufficient to meet the objective of the Proposed Standard. Accordingly, we suggest modifying paragraph 3 as follows: (additions are shown in bold italics and deletions in strikethrough text)

> ***As part of the risk assessment procedures and related activities that Auditing Standard No. 12***, ***Identifying and Assessing Risks of Material Misstatement, requires*** ~~T~~***t***he auditor ***to perform during the audit, the auditor*** should perform ***the*** procedures ***set out in paragraphs 4 through 11,*** 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 lack thereof) of the types of transactions involving related parties. The procedures performed should be designed to identify likely sources of potential material misstatements***, including risks of material misstatement due to fraud,*** in the financial statements that may arise from the company's relationships and transactions with related parties, including related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Another area where additional explanatory material may be helpful is with respect to paragraph 4 of the Proposed Standard that requires the auditor to take into account information obtained from the performance of risks assessment procedures. The additional discussion in Appendix 4, page A4-6, explains that:

> The procedures performed should be sufficient to identify likely sources of potential material misstatements regarding related party transactions, and to identify fraud risk factors associated with related party transactions. 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 by agreeing to have the company temporarily pay down its related party debt prior to the balance sheet date while having an undisclosed side agreement to subsequently borrow the same or a comparable amount shortly after period end.
>
> Understanding the nature of relationships and transactions with related parties is important for the auditor's evaluation of the company's accounting for and disclosure of related party transactions. Further, this understanding is critical to determining whether related parties might be involved in transactions indirectly through the use of an intermediary.

Performing Inquiries

Paragraph 6 of the Proposed Standard requires the auditor to inquire of management regarding specific aspects of related party relationships and transactions. The first two inquiries listed in paragraph 6 both seem to relate to obtaining information about the identity of the related parties, including changes from the prior period. To allow for the use of professional judgment in determining the nature and extent of information needed in this regard, we recommend combining paragraphs 6.a. and 6.b. and revising as follows:

> The auditor should inquire of management regarding:
> 6.a. The identity of the entity's related parties, including changes from the prior period (e.g., names of related parties, background information concerning related parties such as physical location, industry and number of employees, etc.);

Further, to provide for the exercise of auditor judgment in determining whether inquiry of others is necessary in the circumstances, we recommend adding the phrase, "as applicable" to the end of the first sentence of paragraph 7 of the Proposed Standard. If this revision is made, the second sentence would also need to be revised as follows:

> The auditor ~~should~~ identif~~y~~***ies*** others within the company to whom inquiries are to ~~should~~ be directed and determine***s*** the extent of such inquiries by considering whether such individuals are likely to have additional knowledge regarding…

Responding to the Risks of Material Misstatement
(Questions 10 and 12)

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

Paragraph 15.d. of the Proposed Standard requires the auditor to 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. While we recognize that the performance of other procedures, as appropriate, to obtain sufficient audit evidence is consistent with the use of the objective in the standard, we believe that the addition of examples, as described in Appendix 4, page A4-20, would provide helpful guidance in assessing when such procedures may be necessary and the nature of those other audit procedures. Accordingly, we suggest incorporating the examples from Appendix 4 into the final auditing standard as a note to paragraph 15.d.

The Exercise of Professional Judgment and Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor

The use of professional judgment is a critical and essential element to the performance of an effective audit. Due to the nature of related party relationships and transactions, the exercise of professional judgment takes on greater importance. The discussion in Appendix 4, page A4-4, emphasizes the importance of this aspect of auditor performance when it explains that "given the increased risk of material misstatement associated with transactions with related parties, avoiding a mechanical approach could improve audit quality and potentially address concerns regarding the auditor's consideration of related party transactions."

Accordingly, we believe that paragraph 17 of the Proposed Standard should be modified to allow for the exercise of auditor judgment in determining whether a previously undisclosed related party transaction rises to a level of significance that would warrant the performance of all the procedures detailed in paragraph 17. For example, paragraph 17.e. requires that any previously undisclosed related party relationship or transaction identified by the auditor should be treated as a significant risk, and that the auditor should perform the procedures required by paragraph 15 of the Proposed Standard. We believe there may be situations when the auditor could determine that a previously undisclosed related party transaction is not a significant risk through the performance of some, but not necessarily all, of the procedures described in paragraph 17. Emphasizing the importance of the exercise of auditor judgment in determining the most effective response to the identification of a previously undisclosed related party or relationship or transaction with a related party would align the audit response with the significance of the risk of material misstatement.

Proposed Amendments to Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement

With respect to the proposed amendments to Auditing Standard No. 12 (AS 12), *Identifying and Assessing Risks of Material Misstatement*, we note that the additional paragraph proposed, paragraph 10A, requires the auditor to perform certain procedures with respect to the company's executive officers. While the term "executive officer" is proposed to be defined in paragraph A3A, it is unclear 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. While we understand that the proposed amendment does not change the existing requirement to consider obtaining an understanding of compensation arrangements with senior management or that the existing requirement in AS 12, paragraph 11, applies to a larger population than just a company's executive officers, we note that the explanatory material in Appendix 4 explains that the population for the proposed procedures required by paragraph 10A is the list of executive officers disclosed in the securities filing or the executive officers included on Schedule A of Form BD. To enhance clarity we suggest revising the first sentence of paragraph 10A to state:

> The auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers ***as disclosed in the securities filing or Schedule A of Form BD for brokers and dealers*** (e.g., executive compensation, including perquisites, and any other arrangements). The procedures should be designed to identify risks of material misstatement and should include, but are not limited to (1) reading employment and compensation contracts and (2) reading 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.

Additional Comment

We note that paragraph 6 of the Proposed Standard requires the auditor to make certain inquiries of management relating to the period under audit. While we agree that such inquiries are appropriate, we believe that this guidance should be clarified to include inquiries 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. To address this risk, we suggest amending AU Section 560, *Subsequent Events,* paragraph 12b, to specifically address related party transactions.

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We would be pleased to discuss our comments with you at your convenience. Please direct any questions to Chris Smith, Audit and Accounting Professional Practice Leader, at 310-557-8549 (chsmith@bdo.com) or Susan Lister, National Director of Auditing, at 212-885-8375 (slister@bdo.com).

Very truly yours,

/s/ BDO USA, LLP

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