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Ms. Phoebe W. Brown, Secretary
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

PCAOB 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 Ms. Brown:

Ernst & Young LLP (EY) is pleased to submit comments on the Public Company Accounting Oversight Board's (PCAOB or Board) proposed auditing standard - related parties, proposed amendments to certain PCAOB auditing standards regarding significant unusual transactions and other proposed amendments to PCAOB auditing standards (the Proposal). We support the Board's efforts to update its interim standards and believe that updating the requirements of AU Section 334, *Related Parties,* and adopting other proposed amendments have the potential to improve audit quality. However, we have some concerns with certain aspects of the Proposal that are addressed below.

Fraud risk and related party transactions

The Proposal could be read to create a presumption that all related party transactions are indicative of significant risks. This is in contrast to paragraph 2 of International Standard on Auditing No. 550 (ISA 550), which refers to transactions with related parties as transactions that *might* lead the auditor to identify a significant risk (or fraud risk) based on the transaction. ISA 550 also states that many related party transactions occur in the normal course of business and, in such circumstances, they may not carry a higher risk of material misstatement than similar transactions with unrelated parties. We do not believe that there should be a presumption that all related party transactions represent significant risks. To provide this helpful context, we recommend that the Board include a statement similar to paragraph 2 of ISA 550 as a note to paragraph 3 or 4 of the Proposal. We believe that this view is consistent with the intent of the Board's risk assessment standards.

In addition, we believe that the addition of footnote 4 to paragraph 3 of the Proposal creates an implication 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. Depending on the facts and circumstances, this may be the case for certain related party transactions. However, we do not believe that it is the case for *all* related party transactions. Because Auditing Standard No. 11, *Consideration of materiality in planning and performing an audit* (AS11), applies to the audit as a whole, we believe that the footnote reference to AS 11 in paragraph 3 of the Proposal is unnecessary and could be misleading. We recommend that the

Board remove footnote 4.

Related party transactions previously undisclosed to the auditor

We recommend that the Board include appropriate thresholds for applying procedures to relationships or transactions with related parties previously undisclosed to the auditor. As the proposed standard is written, we believe that the procedures in paragraphs 16 and 17 of the Proposal would apply to *all* related party relationships or transactions previously undisclosed to the auditor. As discussed above, we do not believe that all related party transactions should be considered significant risks. We believe that auditors should be required to evaluate the risk of material misstatement related to any related parties or related party transactions previously undisclosed to the auditor. However, we believe the response described in paragraph 17 of the Proposal inappropriately establishes a presumption that such undisclosed related parties or related party transactions are significant risks. We further believe that the audit response to the identification of previously undisclosed related parties or related party transactions should be tailored to the auditor's evaluation of the facts and circumstances.

We recommend that the Board limit the procedures in paragraph 16 to previously undisclosed transactions with related parties that the auditor determines are or may be significant. We also recommend that the Board delete paragraph 17.e. and include it as a note to paragraph 17.d. (i.e., the auditor would be required to perform the procedures required by paragraph 15 only if the auditor determined that the undisclosed transactions represented a significant risk). This would be consistent with the requirements in paragraph 15 of the Proposal and the application of Accounting Standards Codification Section 850, *Related Party Disclosures* (ASC 850).

Interaction of certain requirements with the accounting framework

While we appreciate the Board's intent to strengthen its standards in the area of related party transactions, we believe that the substance-over-form issues discussed in Appendix 4 of the Proposal[1] are issues that have been addressed by the accounting standard setters. In fact, there are a number of transactions that are, under US GAAP, accounted for based on their legal form. ASC 850 provides requirements related to management's disclosure of transactions with related parties. It does not provide requirements related to recognition or measurement of transactions with related parties, and the accounting for related party transactions often does not differ from the accounting for transactions with third parties.

We urge the Board to work within the parameters established by accounting standard setters and to avoid any requirements that could alter the accounting for related party transactions, some of which are appropriately accounted for based on their legal form. We are concerned that some of the language in Appendix 4 could result in auditors being required to challenge the appropriateness of the accounting standards. While we have not commented on changes to Appendix 4 that we think would be appropriate, we believe the following two suggested changes may reduce the likelihood of any possible misconception about accounting requirements for related party transactions. We recommend

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[1] *See*, for example, pages A4-6, A4-13 and A4-26 of the Proposal.

these changes because we believe that the Board's risk assessment standards[2] and Auditing Standard No. 5, *An Audit of Internal Control that is Integrated with an Audit of Financial Statements,* provide an appropriate framework to identify and assess risks of material misstatement for all significant accounts, and that it is not necessary to separately identify related party transactions for purposes of risk assessment.

1. We recommend the following revision to paragraph 5.c.:

   ~~Account for and d~~ Disclose relationships and transactions with related parties in the financial statements.

2. We recommend the following revision to paragraph 12:

   The auditor should identify and assess the risks of material misstatement ~~at the financial statement level and the assertion level. This includes identifying and assessing the risks of material misstatement~~ associated ~~to~~ with related party ~~parties and relationships and transactions with related parties.~~ disclosures.

Requirement to perform other procedures to meet the objective of the standard

The requirement in paragraph 15.d. of the Proposal is for 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 the standard." To our knowledge, this is the first time that such an open-ended requirement has been included in one of the Board's auditing standards, and we encourage the Board to be more specific about the procedures that would be required. We are concerned that without clarity, such a requirement will be very difficult to meet and could result in additional and potentially unnecessary work being undertaken to avoid risk of subsequent regulatory or legal challenges to the sufficiency of audit procedures. We believe that the Board should be explicit about what additional procedures would be required to meet the Proposal's objective. The Proposal's objective provides context for understanding the requirements in the standard. However, the way paragraph 15.d. is currently written does not provide the auditor with a clear understanding of what other procedures would need to be performed to meet the objectives of the Proposal.

Evaluating financial statement accounting and disclosure

We are concerned that the requirement in paragraph 18 of the Proposal could be misleading regarding the auditor's responsibility for evaluating the fair presentation of the financial statements. While the auditor may conclude that the financial statements are materially misstated based on a missing or incomplete related party disclosure, we believe that such an evaluation is complex and must be made based on individual facts and circumstances. We do not believe that auditors are responsible for evaluating the fair presentation of related party transactions in isolation. Rather, we believe that auditors are responsible for evaluating whether the financial statements are presented fairly in all

[2] *See* Auditing Standards Nos. 8-12.

material respects, in conformity with the financial reporting framework. The second sentence of paragraph 18 implies that the auditor's evaluation of the fair presentation of the financial statements occurs in a piecemeal fashion and that we evaluate individual disclosures in isolation, which is not the case.

We recommend the following revision to paragraph 18:

The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable ~~whether the financial statements are presented fairly, in all material respects, in conformity with the applicable~~ financial reporting framework, including the appropriate disclosure of related parties and related party transactions. ~~This includes evaluating whether the financial statements contain the information regarding related party transactions essential for a fair presentation in conformity with the applicable financial reporting framework.~~

Definition of "executive officer"

Proposed paragraph 10A to Auditing Standard No. 12, *Identifying and Assessing Risks of Material* Misstatement (AS 12) (at A3-1), would require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers and to identify risks of material misstatements that relate to such relationships and transactions. The term "executive officer" would be defined in paragraph 3A to Appendix A of AS 12 using the Securities and Exchange Commission's (SEC) definition of executive officer. Further, Appendix 4 states that the population for which the proposed procedures would apply would be the list of executive officers disclosed in the company's filings with the SEC.

We are concerned that, over time, including the definition of executive officer in AS 12 will lead to an interpretation that auditors are responsible for auditing the completeness of the company's list of executive officers as determined in accordance with securities law. We believe this is a legal determination. We recommend that the Board amend the definition of executive officer to read, "The list of executive officers determined by the issuer or broker or dealer as included in their respective filings with the Securities and Exchange Commission."

Requirements related to the company's financial relationships and transactions with its executive officers

We recommend that the Board clarify its intent regarding the proposed requirements related to transactions with executive officers. We do not believe that the proposed procedures are intended to influence the design of executive compensation programs or to call into question the policies and procedures that companies have in place to direct executive compensation decision making. However, some have raised concerns that the Proposal would require the auditor to evaluate executive compensation arrangements, including whether the level of risk associated with the arrangements is appropriate. We understand that this is not the Board's intent and we do not read the Proposal in this manner, but we believe that it would be helpful for the Board to clarify its position in its adopting release.

Use of release text

We believe that it is important for the Board to provide insights into both its deliberations when drafting the standards and its rationale for creating the requirements in the standard in its proposing and adopting releases. The release text in Appendix 4 of the Proposal, in most cases, simply repeats the information provided in Appendices 1, 2 and 3 without further background, rationale or other explanation. Additional insight into the Board's considerations would help us provide meaningful comments to the Board and could help auditors execute audits in a manner consistent with the Board's expectations, thus supporting the performance of high quality audits.

To further enhance the usefulness of the Board's future standards, we also recommend that the Board consider including certain examples from the release text (Appendix 4) in the standards themselves. These examples would be helpful to auditors and we believe they would improve audit quality. Including these examples in the final audit standard would provide the auditor with ideas about how to apply the requirements without the need to find the original release text, which, in most cases, does not appear with the final standard on the Board's website. Some examples in Appendix 4 that we believe would be helpful to include in this Proposal are:

- Examples of matters regarding related parties that the engagement team might discuss
- Examples of when, in evaluating the management's and others' responses to inquiries, the auditor could take into account information obtained from different sources
- Examples of other procedures that might be appropriate for the auditor to perform, depending on the nature of the transaction and the risks of material misstatement to the financial statements

We do not believe that including examples in audit standards should necessitate those examples becoming performance requirements (i.e., "should" statements). Given the nature of the examples, they cannot capture all possible facts and circumstances. However, we believe they provide valuable context about considerations in the design and execution of specific audit procedures.

Gaining an understanding of "significant unusual transactions"

We would like to highlight an area of possible future misunderstanding in proposed paragraph 66A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Management does not have a term that is equivalent to "significant unusual transaction" in its literature (i.e., the applicable accounting framework, COSO or SEC management guidance). Transactions that are identified by the auditor as "significant unusual transactions" will likely be those transactions that management views as the result of its non-routine or estimation processes. Management's processes and related controls may not be different for "significant unusual transactions" than for other similar transactions. It may be helpful for the Board to clarify this point in a note to proposed paragraph 66A to limit any future misunderstandings between the auditor and management.

Additional comments

1. We recommend that the Board delete the phrase "(or the lack thereof)" from paragraphs 3,

6.d. and 15.a. of the Proposal. We understand the Board's intent in adding this concept to the performance requirements and agree that we should be aware of the possibility that transactions with related parties may not have a business purpose. However, we do not believe that the requirements as enumerated in the Proposal (i.e., inquiry and reading of documents to understand the business purpose of transactions) will provide the auditor with evidence about a lack of business purpose.

We acknowledge that similar language is included in paragraph 23 of ISA 550. However, ISA 550 includes the concept of a transaction lacking a business purpose in the context of the auditor's evaluation of significant related party transactions outside the normal course of business. We believe that the term is appropriate in this context and we would not object to the Board including a requirement for the auditor to evaluate, using information obtained through the performance of the auditor's procedures, the business purpose (or lack thereof) for identified significant related party transactions outside the normal course of business. We do not believe that the Proposal's inclusion of the phrase "(or lack thereof)" accomplishes the Board's intent.

2. We recommend that the Board not amend paragraph 6.l of AU Sec. 333, *Management Representations* (AU 333), because the proposed additional language would duplicate the language of proposed paragraph 11A to AU 333.

3. Page 30 of Appendix 4 of the Proposal mentions that a significant unusual transaction does not necessarily need to occur infrequently and that the transaction can occur quarterly or more frequently. We suggest that the Board provide examples of situations that would not occur infrequently and nonetheless be considered significant unusual transactions. This would help auditors apply the requirements of the standard as the Board intends.

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We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

Ernst + Young LLP