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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Transmitted by e-mail to: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 038

We are pleased to respond in this letter to the Board's proposed standard (PS) entitled *Related Parties* that is included as Appendix 1 to its Release No. 2012-001 (the Release) of February 28, 2012. Our comments also relate in certain respects to other portions of the Release including Appendix 2, entitled "Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions."

We are pleased that the Board has decided to address these important areas of modern financial auditing and provide better guidance to auditors with respect to these sensitive risks. We are confident that the final standard will improve audit quality and, thus, be a valuable addition to our professional literature.

Our specific responses to the 25 questions posed by the Board in Appendix 4 to the Release are presented in the attachment to this letter. Our most significant concerns, however, are set forth in detail in the following paragraphs numbered 1-7, below (1-3 of which are overarching). The numbers are provided to facilitate back-referencing, wherever applicable, from our responses in the attachment.

1. The second foregoing paragraph notwithstanding, we believe that the overall tone of PS is too prescriptive because of numerous and excessive use throughout both the PS and the accompanying explanatory material contained in the Release of directives and other references that use terms that are designated in the Board's Rule 3101 as describing "unconditional" or "presumptively mandatory" responsibilities of auditors. As a result, in our opinion, the PS does not sufficiently encourage or even allow for the application of auditor judgment consistent with the risk assessment standards, and does not provide adequate guidance to auditors as to the application of such judgment in relation to scope determination in this area. This is particularly troublesome at this time when the dominant trend in standard-setting generally should be towards principles-based, and away from rules-based, standards.

2. In our opinion, the overly prescriptive, one-size-fits-all nature of the PS and the accompanying material in the Release is wholly inconsistent with the assertion that appears on p. A4-4 of Appendix A, section B, that the broad objective of the PS may effectively eliminate a mechanical approach, stated as follows:

> "A broadly stated objective to guide the auditor's actions also may eliminate a mechanical approach for examining relationships and transactions with related parties, which could result in the auditor not appropriately considering all the facts and circumstances in determining and performing audit procedures. 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."

In this regard, as set forth in Appendix 5 of the Release (p. A5-2), we take note that the analogous standards of both the ASB (clarity project) and IAASB both contain application guidance and explanatory material that does not impose requirements, *per se*, but "is relevant to the proper application of the requirements." We ask the Board to consider adopting a similar approach for many of the proposed so-called "requirements" now presented in the PS, itself. However, although it is apparent, nevertheless, that the IAASB standards do contain many unconditional and presumptively mandatory requirements that (in many cases, inappropriately, in our opinion) limit opportunities for auditor judgments regarding audit scope, we do not believe the conclusions of other standard-setting bodies should be allowed to control those of the PCAOB.

3. As noted in paragraph 1, above, the overall prescriptive tone of the PS and accompanying material is the direct result of the fact that the Release is replete throughout with (a) what appears to us to be extreme (and perhaps unintended) overuse of the term "requirement" (or alternatively, "require" or "must") all denoting unconditional responsibility, and (b) with similar overuse of the presumptively mandatory term "should." Although the tone is pervasively evident throughout Release, we are concerned primarily with the prescriptive language used in ¶s 6-8, 11, 15 and 17 of the PS. Despite a few somewhat vague references to risk considerations as triggering such responsibilities, we believe the unnecessary and excessive use of such terms will generate a perceived but unwarranted burden on auditors (1) to perform the procedures set forth in the PS or alternatives judgmentally deemed "sufficient to achieve the objectives of the standard," and (2) in the latter instance, to document judgments justifying the use of such alternatives, even when the risk of material misstatement is not deemed significant enough to warrant the procedures. We believe a one-size-fits-all approach will add unnecessary costs to many audits.

4. In addition, there are several references in the Release to so-called "requirements" of other standards, particularly in Appendix 4, Part C, *e.g.* AU sections 334.05 and .09, paragraphs 5 through 11 of PCAOB Auditing Standard (AS) No. 11, and paragraph 7 of AS No. 12, all of which exclusively use only the presumptively mandatory expressions, "should" and "should consider" and do not contain any unconditional responsibilities as are associated with the term "requirement" under Rule 3101. We believe use of the term "requirement" in this loose fashion in the Release is confusing and that it should be used more precisely in the final version of the release only when it is consistent with Rule 3101.

5. Accordingly, before issuing a final standard, we believe the Board and its staff should do the following two things.

   - First, carefully reconsider the use of the terms defined in Rule 3101, including in references to other standards, and judiciously step them down wherever warranted by the circumstances at least one notch to allow more auditor judgment, bearing in mind that even the term "should consider" may likely add a documentation burden to many audits that is unwarranted by the circumstances and, therefore, add unnecessary costs that do not contribute to audit quality. Alternatively, wherever appropriate, we believe the final standard should provide audit guidance using only expressions in reference to procedures like "may wish to," "might consider" or "that might be appropriate" (the latter being used in Appendix 4, on p. A4-37, none of which would present the costly Rule 3101 burden of creating self-serving, defensive documentation when otherwise unwarranted.

   - Second, add specific guidance to the final standard that is not present in the PS and that would assist auditors in identifying low inherent risk circumstances that could clearly be viewed as warranting neither performing nor considering procedures described in the final standard (or suitable alternatives).

6. We observe that AU sections 316.66-.67, in both their current and proposed amended versions (Appendix 2 to the Release) discuss the auditor's obligation to evaluate and understand the rationale for "significant unusual transactions" that could be indicative of fraud. Older versions of the auditing standards suggested that if unable to understand the business purpose of such transactions, the auditor may not be able to express an unqualified opinion. This suggestion seems to have devolved from the current and proposed versions of AU section 316. We believe it should be restored along with reporting guidance that would include examples at both the opinion qualification and disclaimer levels, depending on the significance of the matter.[1] We also believe the final standard should not focus with regard to significant unusual transactions solely on fraud risk (in the context of AU section 316) but rather also on the adequacy of disclosure in general with respect to transparency and the perceived needs of users.

7. Lastly, we note that in Appendix 3 to the Release (pp. A3-2 and A3-3), the Board proposes an amendment to AU section 315 that would state that a predecessor auditor "should ordinarily" permit a successor to review portions of audit documentation that likely involve significant matters of auditor judgment, including "those related to relationships and transactions with related parties, and "those related to significant unusual transactions." Professional standards in the U.S. have never laid any responsibilities in the lap of predecessors with regard to communications with successors, only *vice versa*. The use of the term "should" in the proposed amendment (to AU section 315) might suggest a presumptively mandatory responsibility under Rule 3101 but when coupled with the word "ordinarily" becomes muddy and confusing.[2] We believe it is time to address clearly such a responsibility on the part of predecessors, perhaps not only in an auditing standard but in an ethics standard as well. Similarly, although unrelated to the current proposal, we believe such obligations for unfiltered communications should be extended in AU section 543 to apply to those with principal auditors, particularly for auditors of equity method investees who are not subject to control by the reporting investor entity. We recommend the use of the presumptively mandatory expression "should" in such instances without qualification except to state that the only permitted exceptions would be unpaid fees or pending or threatened litigation against the predecessor or investee auditor with respect to the subject audit work.

Thank you for this opportunity to comment on this proposal. Once again, we hope the Board finds our comments useful in its deliberations on this important matter. Please contact the undersigned at hlevy@pbtk.com or 702/384-1120 if there are any questions about these comments.

Very truly yours,
Piercy Bowler Taylor & Kern, Certified Public Accountants

Howard B. Levy, Principal and
Director of Technical Services

Attachment

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[1] Auditors should be reminded in the final standard that even though the SEC may not accept such a report modification, the auditor's obligation is, nevertheless, to issue only the type of report that is warranted by the circumstances.

[2] Another example of the use of a directive noted in the Release that is confusing (*vis a vis* Rule 3101) and that we believe should be avoided is the inherently contradictory term "may be required," which appears in Appendix 4 on p. A4-12.

Q1. *Is the framework neutral approach described in the introduction of the proposed standard appropriate? If not, why not?*

A1. Yes. However, although we are aware of related party disclosure requirements under Rule 4-08(k) of Regulation S-X, we are unaware of any operative definition of "related parties" dictated by the SEC or its staff for financial reporting purposes (as footnote 1 to the PS appears to imply) other than the definitions contained in U.S. GAAP (FASB's *Accounting Standards Codification*, Master Glossary) or other accounting framework in use. We believe footnote 1, as it now appears in the PS, should be clarified to remove the confusing implication of an SEC definition.

Q2. *Is the objective of the proposed standard appropriate? If not, why not?*

A2. Although we concur with the basic substance of the objective set forth in ¶2 of the PS, we firmly believe that the term "determine whether" that is used in that paragraph is too absolute and should be replaced with "afford reasonable assurance that" since the term "reasonable assurance" is consistent with the most fundamental and deeply ingrained concept in our auditing standards.

Q3. *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?*

A3. Subject to **A2**, above, yes.

Q4. *Are the procedures for identifying related parties and obtaining an understanding of relationships and transactions with related parties appropriate?*

A4. Subject to our overriding concerns as set forth in paragraphs 1-3 and paragraph 5 of the main body of this letter, we believe the procedures for identifying related parties and obtaining an understanding of relationships and transactions with related parties that are set forth in ¶s 6-8 and 11 of the PS (and supplemented in Appendix A to the PS) appear appropriate but only when warranted by risk and materiality and other circumstantial considerations (see **A6**, below).

Q5. *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?*

A5. See **A4**, above. Of course additional examples could be presented in Appendix A, but since the lists would nevertheless still need to be characterized in ¶A1 of Appendix A, as not all-inclusive, we believe listing more examples would be unnecessary.

Q6. *Is paragraph 12 of the proposed standard appropriately aligned with the existing requirements regarding the identification and assessment of risks of material misstatement?*

A6. As we have suggested in paragraphs 1, 3 and paragraph 5 of the main body of this letter, we believe ¶s12-13 of the PS give only what might be characterized as limited and ineffective "lip service" to the applicability of risk and other judgmental factors with respect to scope determination in this area. Consequently, we believe the PS should be strengthened by providing more specific guidance as to how to relate risk, materiality and other circumstantial considerations to the selection of appropriate procedures to be employed relative to related party balances and transactions and significant and unusual transactions rather than the one-size-fits-all approach inherent in the PS.

Q7. *Are there other examples of fraud risks 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?*

A7. We believe that dominant influence is, in substance, not a single fraud risk factor but rather a convenient term that is useful for grouping several fraud risk factors together such as those identified as "factors that may signal dominant influence." in Appendix 4 of the Release (on pp. A4-14 and A4-15). We believe each of such factors should be identified in the body of the final standard as fraud risk factors, *per se*, in their own right.

Q8. *Are there particular related party transactions that should be deemed a fraud risk or other significant risk?*

A8. Semantically, we do not believe a transaction, itself, should be designated a fraud risk but rather that fraud risk is presented by and derived from certain perceived characteristics associated with some transactions. That said, we believe that coupled with AU section 316, the PS adequately describes the particular characteristics of certain related party transactions that, when observed, most commonly present heightened levels of fraud risk. We believe that the final standard should point out that (1) despite the fact that smaller, more closely-held issuers commonly engage in more frequent and significant related party transactions that are often less subject to controls executed by personnel who are not parties to these transactions, because of their significance, are ordinarily easier to detect by auditors with fewer procedures than would be "required" by the one-size-fits-all PS, and (2) that such transactions may, in fact, be legitimate and may not present fraud risks.

Q9. *Is paragraph 13 of the proposed standard appropriately aligned with the existing requirements regarding responding to the risks of material misstatement?*

A9. See **A6**, above.

Q10. *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?*

A10. Subject to our overriding concerns as set forth in paragraphs 1-3 and paragraph 5 of the main body of this letter, we believe the procedures that are set forth in ¶15 of the PS (and supplemented in Appendix A to the PS) appear appropriate but only when warranted by risk and materiality and other circumstantial considerations (see **A6**, above). However, if the Board discerns any specific circumstances where the objective of the PS (or any other auditing standard) is served by ¶14 of the PS, it certainly is not clear and should be articulated in the final standard.

Q11. *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?*

A11. Yes, subject to risk and materiality and other circumstantial considerations (see **A6**, above) and our other comments set forth in paragraphs 1-3 and paragraph 5 of the main body of this letter.

Q12. *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?*

A12. Subject to our overriding concerns as set forth in paragraphs 1-3 and paragraph 5 of the main body of this letter, we believe the procedures that are set forth in ¶17 of the PS (and supplemented in Appendix A to the PS) appear appropriate but only when warranted by risk and materiality and other circumstantial considerations (see **A6**, above).

Q13. *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?*

A13. Yes, with respect to ¶18 of the PS. (See A14, below, with respect to ¶19.)

Q14. *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?*

A14. Yes, except that we believe the first sentence in ¶19 of the PS should be extended by adding "in all material respects" at the end. In addition, we believe auditors should be reminded in the final standard that even though the SEC may not accept a report modification such as suggested by ¶19, the auditor's obligation is, nevertheless, to issue only the type of report that is warranted by the circumstances.

Q15. *Are the requirements in the proposed standard for the auditor to communicate to the audit committee regarding relationships and transactions with related parties appropriate?*

A15. We believe the requirements of the PS relative to audit committee communications are substantially appropriate. However, we also believe that part c of ¶20 of the PS should be removed from the final standard and be left as only a matter for responding to questions if asked of the auditor by the audit committee. In addition, we believe that part d should be expanded to include (with appropriate cross-references to the proposed amendments to AU section 316 and/or AS No. 12) significant unusual transactions that were not identified as involving related parties.

Q16. *Should the proposed standard change the auditor's responsibilities for the auditor's report regarding related party transactions? If so, how?*

A16. We do not support any changes in auditor's responsibilities for the auditor's report except to provide guidance for reporting auditor reservations about the business purpose of significant related party or unusual transactions, as discussed in paragraph 6 of the main body of this letter, and to suggest possible consideration (*i.e.*, not mandatory consideration) of an optional emphasis paragraph when related party matters are particularly significant.

Q17. *Are the proposed amendments regarding the auditor's identification of significant unusual transactions appropriate? If not, why not?*

A17. We believe the proposed amendments regarding the auditor's identification of significant unusual transactions appear appropriate.

Q18. *Are the proposed amendments regarding the auditor's evaluation of significant unusual transactions appropriate? If not, why not?*

A18. Subject to our comments in paragraphs 6 of the main body of this letter regarding expanding the focus beyond fraud risk to matters of general adequacy of disclosure, we believe the proposed amendments regarding the auditor's evaluation of significant unusual transactions appear appropriate.

Q19. *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?*

A19. We believe the procedures in the proposed amendments to AS No. 12 that are set forth in ¶10A of Appendix 3 to the Release appear appropriate and properly characterized as presumptively mandatory; however, we would add reading of the minutes of the governing board and its compensation committee, if any.

Q20. *Are the other proposed amendments to PCAOB auditing standards appropriate? If not, why not?*

A20. We have no issues with the amendments proposed to other PCAOB standards other than as stated elsewhere herein but have not undertaken to review all extant PCAOB auditing standards for purposes of identifying other amendments we might believe are advisable.

Q21. *Are the proposed standard and proposed amendments appropriate for audits of brokers and dealers? If not, why not?*

A21. Except as set forth below in **A23**, and subject to all of the foregoing comments, we believe there are no reasons to believe the PS and proposed amendments when finalized will not be appropriate for audits of brokers and dealers in securities.

Q22. *Are there additional procedures specific to audits of brokers and dealers that should be included in the proposed standard and proposed amendments?*

A22. No. See **A21**, above.

Q23. *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.*

A23. We believe the final standard should expressly recognize that many nonissuer securities broker-dealers, many of which do not maintain custody of customer securities nor do they clear customer transactions, are so closely-held as to have no financial oversight or functional governance bodies other than the owner-managers, nor do they have any outside users of their financial statements other than regulators, thus making unconditional or presumptively mandatory audit committee communication of no practical benefit to anyone. Therefore, we believe exceptions to these communication responsibilities should be provided in the final standard for such circumstances.

Q24. *Is the Board's anticipated effective date appropriate?*

A24. Unless the Board significantly reduces the number of procedures the performance or documented considerations of which would be unconditionally or presumptively mandatory, and depending upon the length of time to be incurred before a final standard is ultimately issued, we believe the proposed effective date would likely be too soon to enable the preparation of adequate practice aids and presentation of staff training or to acclimate clients to the additional costs to be associated with the requirements of the new standard.

Q25. *Does the proposed effective date allow sufficient time for firms to incorporate the new requirements into their methodology, guidance and audit programs, and training for staff?*

A25. See **A24**, above.