GAO
Accountability * Integrity * Reliability
United States Government Accountability Office
Washington, DC 20548

May 31, 2012

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

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

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) proposed auditing standard, *Related Parties*, amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other amendments to PCAOB auditing standards.

We appreciate the PCAOB's efforts to strengthen the existing audit requirements for identifying, assessing, and responding to the risks of material misstatements that may be associated with a company's related party and significant unusual transactions. However, we do have concerns that the proposed standard does not provide adequate guidance concerning the nature and extent of the auditor's actions and procedures that are specifically related to the risk of material misstatements associated with an entity's related party or significant unusual transactions. Although we do not advocate a prescriptive approach, adequate guidance is important to effectively provide the terms and boundaries that define the auditor's responsibility and the procedures necessary to identify, assess, and respond to the risks of material misstatements that may be associated with a company's related party transactions. In addition, we believe that the auditor's procedures should be more generally focused on determining whether management has properly identified and reported related party transactions, including consideration of management's process and controls concerning the identification and reporting of related party transactions.

The proposed requirements are designed to focus the auditor's efforts on those areas that pose an increased risk of material misstatement to the financial statements and the auditor's responses to those risks. Accordingly, the objective of this standard should more closely align with the risk assessment requirements included in Auditing Standards Nos. 12 and 13. Paragraph 4 of the proposed standard states that auditors should take into account information obtained from the performance of risk assessment procedures in identifying related parties and obtaining an understanding of relationships and transactions with related parties. Paragraph 12 states that auditors should identify and assess the risks of material misstatement at the financial statement and the assertion level, including identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties. We suggest that both of these concepts be incorporated into the objective statement of the proposed standard. Incorporating these concepts into the objective statement would also improve consistency with the stated objective of the analogous standards of the International Auditing and Assurance Standards Board.

> The objective could be revised to: The objectives of the auditor are to (1) recognize risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risk of material misstatement, and conclude based on the audit evidence obtained whether the financial statements insofar as they are affected by those relationships and transactions achieve fair presentation; and (2) obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties that could have a material effect upon the financial statements have been properly identified, accounted for, and disclosed in the financial statements.

In addition to our comments regarding the objective statement, we also have comments regarding (1) the clarity of some requirements in the proposed standard and (2) redundant requirements.

Clarity of requirements

The proposed standard does not clearly articulate the auditor's responsibility in certain areas. The standard could be improved by providing guidance on both the purpose of each requirement and the auditor’s specific responsibilities. For example, we noted the lack of adequate guidance for the following requirements:

Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties

- Paragraph 3 of the proposed standard does not provide clear guidance concerning the nature, timing, and extent of audit procedures that the auditor should perform to identify related parties. However, specific requirements related to the identification of related parties are contained in the paragraphs beginning in paragraph 4. We suggest that the initial sentence in paragraph 3 parallel the language in paragraph 4 of Auditing Standard No. 12, such as follows:

Auditing Standard No. 12, paragraph 4, states that the auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud. This includes procedures to identify risks of material misstatements 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.

- Paragraph 7 of the proposed standard does not provide clear guidance concerning the extent of procedures to identify others within the company to whom inquiries should be directed. We believe that the identification of others within the company should be based on auditor judgment. Therefore, we suggest that the proposed standard indicate that such identification is based on auditor judgment.

Responding to the Risks of Material Misstatement

- Paragraph 14: The purpose of the requirement for the auditor to *"perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ"* is not clear, and the proposed standard does not provide guidance on the objectives or the nature, timing, or extent of procedures that the auditor should perform relative to intercompany account balances. The proposed standard could be improved by the addition of guidance on the procedures to be performed related to material intercompany balances, as well as guidance relative to when these procedures should be performed and some examples of the specific risks that are commonly associated with intercompany balances.

Communications with the Audit Committee

- Paragraph 20: The purpose of the requirement for the auditor to *"communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties"* should emphasize that previous communication of these matters to the audit committee by management may affect the form or timing of the auditor's communication. The proposed standard could be improved by the addition of guidance suggesting that the auditor's communication be focused on matters not previously communicated by management and any other areas requiring significant auditor judgment.

Redundant requirements
Further, we believe the following paragraphs contain redundant requirements and should be revised. Specifically, the requirements that currently exist in other PCAOB standards should not be restated as separate requirements, but should instead refer directly to the other standard where the requirement is stated and explained.

Identifying and Assessing Risks of Material Misstatement

- Paragraph 12: The requirement that the auditor should *"identify and assess the risks of material misstatement at the financial statement level and the assertion level"* is a duplicated requirement of Auditing Standard No. 12, as noted in footnote 8 of the proposed standard. The paragraph should be restated to focus on the auditor's responsibility relative to related parties. As revised, the paragraph would appear as follows:

  Auditing Standard No. 12, paragraph 59, states that 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 with related parties and relationships and transactions with related parties.

Responding to the Risks of Material Misstatement

- Paragraph 13: The requirement that the auditor must *"design and implement audit responses that address the assessed risks of material misstatements"* is a duplicated requirement of Auditing Standard No. 13, as noted in footnote 9 of the proposed standard. The paragraph could be restated to focus on the auditor's responsibility relative to related parties. As revised, the paragraph would appear as follows:

  Auditing Standard No. 13, paragraph 3, states that the auditor must design and implement audit responses that address the assessed risks of material misstatement. This includes designing and performing audit procedures in a manner that addresses the assessed risks of material misstatement associated with related parties and relationships and transactions with related parties.

Evaluating Financial Statement Accounting and Disclosures

- Paragraph 18: The requirement that the auditor must *"evaluate whether the financial statements are presented fairly, in all material respects, in* *conformity with the applicable financial reporting framework"* is a duplicated requirement of Auditing Standard No. 14, as noted in footnote 14 of the proposed standard. The paragraph could be restated to focus on the auditor's responsibility relative to related parties. As revised, the paragraph would appear as follows:

Auditing Standard No. 14, paragraph 30, states that the auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. 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.

* * * * *

Overall, we support the general premise to strengthen the existing audit requirements relating to the risks of material misstatements that may be associated with a company's related party and significant unusual transactions. We thank the PCAOB for the opportunity to provide comments on this important project.

Sincerely yours,

James R. Dalkin
Director
Financial Management and Assurance