

CAQ Alert #2009-93 – November 5, 2009

DEAR CENTER MEMBERS

CAQ Highlights of PCAOB's October 2009 SAG Meeting

The [Public Company Accounting Oversight Board](#) (PCAOB or the Board) held its annual [Standing Advisory Group](#) (SAG) meeting on October 14 and 15, 2009 in Washington, D.C. The SAG is composed of 32 people representing the auditing profession, public companies, investors, and others and was convened by the Board to advise them on the establishment of auditing and related professional practice standards. The archived [SAG meeting webcast](#) is available online.

Martin F. Baumann, *Chief Auditor and Director of Professional Standards*, opened the meeting and the following topics were discussed:

- Standard-Setting Activities and Emerging Issues
- Update on Proposed Standards and Concept Releases Issued
- Auditing Fair Value Measurements and Using the Work of a Specialist
- Communications with Audit Committees
- Related Parties

Standard-Setting Activities and Emerging Issues

Following SAG introductions, Daniel Goelzer, *Acting Chairman of the PCAOB*, communicated to the SAG members that the PCAOB is embarking on a new phase in standard-setting and has an ambitious standard-setting agenda for the upcoming year. Mr. Goelzer expressed that the standard-setting presentation will make clear that the PCAOB will be focusing on the “nuts and bolts” of auditing issues. Specifically, on issues that were highlighted through the inspections program as areas where standards need to be improved or modernized.

To begin the presentation, Mr. Baumann introduced the following documents as reference materials to be discussed during the standard-setting activities and emerging issues meeting session:

- [Status of Previous SAG Standards-Setting Discussion Topics](#)
- [PCAOB Standards-Setting Activities – October 2008-2009](#)
- [Office of the Chief Auditor \(OCA\) Standards-Setting Agenda](#)

SAG Operations

Mr. Baumann discussed feedback regarding SAG operations based on his individual discussions with SAG members shortly after his appointment to Chief Auditor earlier this year. Mr. Baumann indicated that in general, the feedback was positive and members noted that the meetings were well run and organized, discussions were of high quality, and important matters were being brought before the SAG for discussion. However, Mr. Baumann also noted some feedback he received where there were opportunities for improvement such as:

- Greater continuity on matters discussed.
- Improved dialogue at the SAG meetings, including with PCAOB representatives.
- A faster pace for standard-setting.
- Improved transparency around the standard-setting process and requests for input from the profession and other constituencies earlier in the process.

Status of Previous SAG Standard-Setting Discussion Topics

In response to feedback received requesting a need for greater continuity on matters discussed at SAG meetings, the PCAOB issued a document on the [Status of Previous SAG Standards-Setting Discussion Topics](#). This document provides a list of standard-setting topics previously discussed with the SAG and the current status of each discussion topic.

PCAOB Standard-Setting Activities

The PCAOB described the standard-setting activities that had occurred over the past 12 months. For a list of these [standard-setting activities](#), please refer to the respective link.

OCA Standard-Setting Agenda

SAG members were presented with OCA's current standard-setting agenda, including proposed issuance dates for concept releases or proposed standards, and proposed adoption dates. The agenda notes that there is a possibility for re-proposal periods on certain projects depending upon the comments received and that the timetable for each project is contingent upon Board determination whether the staff should continue to pursue the standard-setting project.

The table below summarizes twelve projects the PCAOB intends to pursue over the next two years. Seven of the twelve projects are pending the Board's decision on whether or not to proceed. The project activities scheduled to occur during the fourth quarter of 2009 and/or the first quarter of 2010 are noted in the table below. The entire OCA [agenda](#), including projected standard-setting activities through 2011 for each project, is accessible at the respective link.

Project	Q4 2009	Q1 2010
1. Risk Assessment, including fraud risk assessment	Re-propose for public comment.	No planned quarterly activity.
2. Audit Confirmations	No planned quarterly activity.	Issue proposed standard for public comment.
3. Signing the Auditor's Report	Board to determine whether to proceed with proposal.	Issue proposed amendments to standards for public comment.
4. Application of the Sarbanes-Oxley Act's Provision on "Failure to Supervise"	Issue release, including request for comment on possible related rules or standards.	Board to consider whether to propose related rules or standards.
5. Accounting Estimates, Fair Value Measurements, Specialists	No planned quarterly activity.	No planned quarterly activity.
6. Communications with Audit Committees	No planned quarterly activity.	Issue proposed standard for public comment.
7. Related Parties	No planned quarterly activity.	Issue proposed standard for public comment.
8. Global Quality Control Standards, Including Control Over Work of Affiliated Firms	No planned quarterly activity.	Board to determine whether to proceed with a standard-setting project.
9. Principal Auditor	No planned quarterly activity.	Board to determine whether to proceed with a standard-setting project.
10. Going Concern	No planned quarterly activity.	Board to determine whether to proceed with a standard-setting project.
11. Subsequent Events	No planned quarterly activity.	Board to determine whether to proceed with a standard-setting project.

12. Applicability of SECPS Requirements to all Registered Firms	No planned quarterly activity.	Board to determine whether to proceed with a standard-setting project.
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In addition to the twelve projects listed above, OCA is also considering “other projects” that were not included within the agenda of projects to be pursued by the Board over the next two years. These other projects include recommendations relating to standard-setting from the U.S. Department of Treasury [Advisory Committee on the Auditing Profession](#) (ACAP) and the U.S. Securities and Exchange Commission (SEC) [Advisory Committee on Improvements to Financial Reporting](#) (CiFIR) as follows:

- ACAP Final Report, VII. Firm Structure and Finance - [Recommendation No. 5](#), Improvements to the Auditor’s Standard Reporting Model
- ACAP Final Report, VIII. Concentration and Competition - [Recommendation No. 4\(a\)](#), Compiling the SEC and PCAOB Independence Requirements Into a Single Document
- CiFIR [Recommendation III.E](#), Clarifying Guidance on Financial Restatements and Accounting Judgments

Below are highlights of comments made during the meeting by SAG members regarding the PCAOB’s standard-setting agenda, SAG member operations, and the status of discussion topics from prior SAG meetings.

- The Board should step back and take a look at an overall framework project that defines audit quality and what it means to protect investors.
- The standard-setting agenda should consider ACAP recommendations, including but not limited to defining audit quality indicators, partner’s signature on the audit report and the creation of a fraud center ([CAQ Alert #2008-56](#)). The PCAOB was urged by several SAG members to go back and take a look at these recommendations.
- The PCAOB was encouraged by members to have the inspections team and standard-setting team work together in order to drive and inform the standard-setting process. In response, the PCAOB noted that inspections are an important consideration in the standard-setting process. PCAOB inspection findings help inform the PCAOB of any need to address certain standard-setting projects further, which helps to develop the agenda.
- As a strategy, it was recommended that the PCAOB use the international auditing standards as a starting point when creating new or amending existing interim standards. This will create a common platform that will help eliminate the creation of different standards.
- Within the PCAOB’s *Status of Previous SAG Standards-Setting Discussion Topics* it was noted that several items have a status of “pending review of interim standards.” The PCAOB should work to harmonize the standards of the PCAOB and the [Auditing Standards Board](#) (ASB). It was further noted that the issue of two separate standards is unique to the United States and internationally one set of auditing standards is utilized. Harmonization would enable firms to train their staff on one rather than two different audit methodologies.
- In response, a SAG member noted that Congress made the decision that public companies would be subject to a separate set of rules created by the PCAOB. Therefore, it cannot be

expected that there will be one set of rules. However, it would be preferable for the PCAOB to catch up to the ASB and assume the standard-setting leadership role for which it was formed.

- An inquiry was made to the PCAOB about the status of the plan to review the interim auditing standards, as indicated during the October 2008 SAG meeting. The PCAOB responded, noting that the Board decided there were higher priorities than reviewing the interim auditing standards for a consistency format and feel that the critical items have been addressed from a consistency perspective. The PCAOB noted they will be focusing on the critical standards by looking at significant audit issues that create the most audit risk.
- SAG members complimented Mr. Baumann on his openness in soliciting feedback to make improvements to SAG operations, which would ultimately improve the effectiveness of the standard-setting process.
- It was suggested that the PCAOB consider mirroring the [Financial Accounting Standards Advisory Council's](#) (FASAC) process in developing and prioritizing its standard-setting agenda.
- A common theme throughout the PCAOB's briefing papers contained a notion of defaulting to additional procedures due to a fraud risk presumption, which may result in the development of prescriptive auditing standards. The PCAOB was advised to be cautious about going down such a path.

Update on Proposed Standards and Concept Releases Issued

The PCAOB provided an update on the proposed standards, *The Auditor's Assessment of and Response to Risk*, as well as the concept releases on *Audit Confirmations* and on *Signing the Auditor's Report*. This update included a summary of comments received for these proposals and their status. As presented by the PCAOB, the key themes of the comment letters, included:

Proposed Standards on Risk Assessment – Key Themes in Comment Letters

- Support for improving standards for risk-based audits.
- Support for integration of the proposed standards for assessing and responding to risk with the standard for audit of internal control over financial reporting.
- Divergent views on integrating the auditor's consideration of fraud into the proposed standards.
- Suggestions for greater alignment with standards of the [International Auditing and Assurance Standards Board](#) (IAASB) and ASB.
- Other general comment letter topics:
 - Extent and nature of requirements.
 - Use of terms to describe the auditor's responsibilities.
 - Organization and style of the proposed standards.
 - Effective date of standards.

Audit Confirmations Concept Release – Key Themes in Comment Letters

- Support for a revised standard.

- Standard should be principles-based.
- Confirmation should be a function of risk assessment.
- Support alignment with [International Standard on Auditing \(ISA\) 505, External Confirmations](#) and the ASB's Proposed Statement on Auditing Standards.
- Support for revising the definition of confirmation to include direct online access and exclude oral responses.
- Requirement to request confirmation.
 - Divergent views on expanding the presumption beyond accounts receivable.
- Disclaimers and restrictive language.
 - Clarify auditor's responsibility to evaluate.
 - Provide more guidance on how language affects audit evidence.
- Negative confirmations should be permitted as audit evidence.

Signing the Auditor's Report – Key Themes in Comment Letters

- Opposing views on whether the engagement partner should sign the audit report.
- Opposing views on whether requiring the engagement partner to sign the audit report will enhance audit quality and investor protection.
- Opposing views on whether such a requirement would improve the engagement partner's focus on his or her existing responsibilities.
- Opposing views on whether the transparency of requiring the engagement partner to sign the audit report would be useful to investors, audit committees, and others.
- Opposing views on whether requiring the engagement partner to sign the audit report would allow users of audit reports to better evaluate or predict the quality of a particular audit.
- Some comments stated that requiring the engagement partner to sign the audit report could lead to inaccurate conclusions about audit quality under some circumstances.
- Some commenters stated that there are potential unintended consequences of requiring the engagement partner to sign the audit report.
- Some commenters stated that there could be an effect on the engagement partner's potential liability in private litigation.

Some SAG members provided general comments regarding these topics, however discussion was limited given that comments were previously submitted during each of the respective exposure periods.

Auditing Fair Value Measurements and Using the Work of a Specialist

Below are highlights of comments made during the meeting by SAG members regarding *Auditing Fair Value Measurements and Using the Work of a Specialist*. Gregory Fletcher, PCAOB Associate Chief Auditor introduced this discussion topic and provided an overview of the background information included within the [briefing paper](#). The PCAOB sought feedback from the SAG members with respect to questions identified in the briefing paper, including but not limited to the following:

- *Should there be a requirement for the auditor to presume that a fair value measurement with a high degree of measurement uncertainty is a fraud risk? Would such a requirement enhance the auditor's ability to identify the types of material misstatements that could occur?*
- *Would a requirement for the auditor to perform specific procedures, similar to those contained in AU 316 concerning revenue recognition and management override of controls, in response to the risks related to fair value measurements with a high degree of measurement uncertainty improve the auditor's ability to identify the types of material misstatements that could occur? If so, what should those procedures be?*
- *Given the movement towards more qualitative disclosures about assets and liabilities measured at fair value and the related risks and disclosures about the sensitivity of certain assumptions, is there a need for additional requirements for evaluating the adequacy of disclosures? If so, how could the requirements for evaluating the adequacy of disclosures be improved?*
- *Should the same requirements apply for using an outside specialist and an employee specialist? If so, should those requirements reflect the AU 311 approach, the AU 336 approach, or a combination of both? Are there situations in which it would be impractical to impose the supervision requirements in AU 311?*
- *What additional direction should a standard provide when evaluating the work of the auditor's specialist, given that the auditor engages a specialist since he or she does not have the requisite specialized knowledge or skills?*

Three break-out groups were formed to discuss the three topics outlined in the briefing paper. A PCAOB representative presented comments from each break-out group with respect to the identified topics as follows:

Identifying and Assessing Risks of Material Misstatement

- Auditors should give fair value measurements with a high degree of measurement uncertainty and a higher degree of inherent risk additional audit attention, however those measurements should not be considered a de-facto fraud risk. There is concern that by presuming it to be a fraud risk, there could potentially be other risks that auditors are not focused on.
- If you consider fair value measurements with a high degree of measurement uncertainty to be a fraud risk, then other accounting estimates with a high degree of uncertainty should also be considered a fraud risk. Examples provided included loan loss estimates, environmental liabilities, litigation contingencies, etc.
- It is premature to mandate specific procedures because many of the estimates are unique and carry different risks within themselves. However, some of the members noted that there are some procedures in [International Standard on Auditing \(ISA\) 540, \(Revised and Redrafted\), Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures](#), that talk about estimation uncertainty and it was thought that perhaps some of those procedures would be appropriate.
- In an effort to improve the auditor's ability to identify the types of material misstatements that could occur, some members developed a recommendation of specific procedures for the auditor to perform in response to the risks related to fair value measurements with a high degree of measurement uncertainty. The recommended procedures included:
 - Evaluating the track record of management in making accurate estimates;

- Evaluating if a model is being used and determine if the model is generally accepted;
- Considering alternative assumptions in place of management's assumptions and use those alternative assumptions to calculate a point in order to evaluate management's range of estimates; and
- Obtaining third party verification of the information.
- There needs to be a higher level of professional skepticism for fair value measurements that have a high degree of measurement uncertainty.

Evaluating the Adequacy of Fair Value Disclosures

- As footnote disclosures move further away from providing more details of amounts that are already recognized in the financial statements, the process for collecting that information may not be as robust and there could be room for improvements in those processes. As a result, auditors could probably use more direction on evaluating the quality and nature of disclosures.
- The issue of qualitative disclosures goes beyond fair value measurement disclosures. The existing auditing standards were created largely when footnotes were detailed disclosures of amounts recognized in the financial statements. Given the proliferation of additional required footnote disclosures, preparers might focus largely on the point estimate that is ultimately recognized in the financial statements while not giving the requisite attention to the sensitivity analysis. This may require auditors to obtain more information regarding the disclosures in order to obtain sufficient competent evidence, and could result in the identification of additional material weaknesses.
- When looking at SEC and PCAOB enforcement actions there have not been many enforcement proceedings with an emphasis on disclosures or lack of disclosures. Therefore, there is the possibility auditors view disclosures as a lower risk because they are not seeing many penalties being given for disclosures that are perhaps less than adequate. One step that the SEC and PCAOB may consider taking is to alert auditors and preparers as to the importance of those disclosures. This could be done through a practice alert.

Scope of a Proposed Standard on Using the Work of a Specialist Engaged or Employed by the Auditor

- The objectives should be the same for both outside and employee specialists. The auditor should similarly supervise and evaluate the work of an employee specialist, as well as an outside specialist.
- The auditor should be required to have a greater level of understanding of the assumptions and methods of the auditor's specialist, whether engaged by or employed by the auditor, than currently exists today. Auditors cannot treat the specialist's report as a black box. The auditor should determine if the results contained in these specialists' reports are reasonable.
- An auditor engages a specialist because of the expertise that is needed for an auditor to gain sufficient competent audit evidence. The auditor needs to take responsibility for the specialist's work since they do not make reference to a specialist in the auditor's report.

The Board has previously discussed the topic of auditing fair value measurements and using the work of a specialist with the SAG at the following meetings:

- June 21, 2007 [Meeting](#) – [Briefing Paper](#) – *Auditing Accounting Estimates and Fair Value Measurements*
- February 9, 2006 [Meeting](#) – [Briefing Paper](#) - *Using the Work of a Specialist*
- September 8-9, 2004 [Meeting](#) – [Briefing Paper](#) – *Auditing Fair Value*

Communications with Audit Committees

Below are highlights of comments made during the meeting by SAG members regarding *Communications with Audit Committees*. Barbara Vanich, PCAOB Associate Chief Auditor introduced this discussion topic and provided an overview of the background information included within the [briefing paper](#).

Opening comments for this discussion were provided by three panelists including:

- Jamie S. Miller, VP, Controller and Chief Accounting Officer, General Electric Company
- Margaret M. Foran, Vice President, Chief Governance Officer and Corporate Secretary, Prudential
- Lynn Turner, Senior Advisor and Managing Director, LECG

After opening comments were provided the PCAOB sought feedback from the SAG members with respect to questions identified in the briefing paper, including but not limited to the following:

- *Are there any structural or cultural impediments to audit committees obtaining the information they need to fulfill their responsibilities to oversee the work of the auditor?*
- *Given the previous comments raised by SAG members that the auditor communications are sometimes boilerplate in nature and not robust enough, in what way can audit committee communications be improved?*
- *What should the Board consider including in the auditing standard to encourage more effective, robust auditor communications?*
- *Should the required communication regarding management's judgments and estimates be enhanced to report additional information on management's judgments and estimates? If so, what information would be useful to audit committees?*
- *Should the auditor be required to discuss his or her assessment of the quality of disclosures in the financial statements with the audit committee?*

Due to time restrictions the SAG was unable to discuss the following topics on the agenda related to *Communications with Audit Committees*: *Interim Financial Information* and *Information on Firm and Engagement Leadership*.

Opening Comments - Communications with Audit Committees

Jamie Miller – Ms. Miller noted that given the events of the last year, it may be appropriate to evaluate whether audit standards on audit committee communications can be improved. She noted that existing rules could be construed as requiring one-way, boilerplate communication. The most

informative discussions come from dialogues not necessarily a list of required communications. There is an opportunity to change the rules to require a robust dialogue for communications and when such communications should occur. The real challenge is driving behavior to ensure communications are robust given rules are carried out by people with different company cultures, personalities, etc.

Margaret Foran – Ms. Foran noted the focus should be on achieving the best qualitative dialogue through effective and robust two-way communication. She believes existing requirements could be enhanced but was not convinced that written communications would produce better results. She noted that current communications including slides may be considered boilerplate, however, the substance of a good dialogue does not need to be. She expressed that stronger encouragement for auditors and audit committees to engage in conversation is necessary. Additionally, she suggested topics for such conversations could include what auditors found during the audit, any new auditing issues that have been noted in the current year compared to prior year and communication of information on audit engagement leadership.

Lynn Turner – Mr. Turner noted that audit committee reports are boilerplate and have not lived up to expectations. He highlighted the importance of providing more useful information which may include items such as scheduled audit hours, audit adjustments, changes to scheduled hours, changes in scope, conservatism of significant accounting policies, or other issues encountered.

Views of SAG Members – Communications with Audit Committees

The purpose of this discussion was to solicit ideas on how the PCAOB can enhance effective, two-way communications between auditors and audit committees. SAG members expressed the following views:

Effective, Robust Two-way Communications

- Written audit committee materials can provide an important outline for the discussion, however dialogue is more important. Some sort of written communication should be required but it is more important that the appropriate dialogue occurs. Such boilerplate written communications for compliance should not prohibit a good dialogue.
- Based on this discussion it seems the objective around each standard has not only been achieved but surpassed in that audit committees are obtaining the information they need based on the current standards. Additional required documentation will not improve audit committee communications. The best dialogue is informal.
- A standard template will likely result in more boilerplate audit committee communications.
- Litigation may become a concern if certain communications become required in writing.
- It would be a challenge for the PCAOB to inspect the appropriateness of audit committee communications if there is no written documentation by the auditor and/or the minutes for audit committee meetings are not detailed.
- Perhaps there is a need for audit committee best practices to be issued in addition to improvements to the auditing standards. Additionally, enhancements to the standards on the types and timing of discussions and communications may be helpful.
- Audit committee best practices may be helpful in this area however this is not the responsibility of the PCAOB. Private sectors issue best practices and regulators should regulate.
- It is the responsibility of the audit committee chair to set ground rules on how to obtain

information. It is the regulators responsibility to deal with any reluctance by the auditor to communicate too far beyond what the CEO and CFO are comfortable with.

- There has been a real improvement in communications over the past few years. Audit committee members have not expressed that they are not getting what they need. The auditor should be able to reach out to see if audit committees are getting what they need and if they are, the PCAOB may be trying to solve a problem that does not exist.
- Often the audit committee has a much closer relationship to management at smaller public companies. If the auditor believes that audit committee members are not getting the information they need, auditors should proactively educate and assist the members in areas that the auditor believes are what they should be looking for and requesting.
- If changes are to be made to the existing standards, consideration should be given to changing wording from “inform” to “discuss” which may encourage more dialogue around issues.

Enhance the Existing Communication Requirement Related to Management's Judgments and Estimates

- Additional communications may be useful such as: 1) the status of management efforts in remediating material weaknesses, significant deficiencies and management letter comments, 2) evaluations of CEO, CFO, internal audit, etc, 3) more detailed disclosure discussions, 4) proxy statements, 5) earnings releases, 6) observations on risk management, 7) management incentives. Such items may not need to be required within the standard.

Additional Requirements for Discussion of Disclosures

- The auditor and audit committee should discuss footnote disclosures in further detail.

The Board has previously discussed the topic of communications with audit committees with the SAG at the following meetings:

- October 5-6, 2005 [Meeting](#) – [Briefing Paper](#) – *Panel Discussion – Communications with Audit Committees*
- June 21-22, 2004 [Meeting](#) – [Briefing Paper](#) – *Potential Standard – Communications and Relations with Audit Committees*

Related Parties

Below are highlights of comments made during the meeting by SAG members regarding *Related Parties*. Brian Degano, PCAOB Associate Chief Auditor introduced this discussion topic and provided an overview of the background information included within the [briefing paper](#). The PCAOB sought feedback from the SAG members with respect to questions identified in the briefing paper, including but not limited to the following:

- *Should a proposed standard require the auditor to presume that the following are fraud risks:*
 - *A significant related party transaction that is outside the ordinary course of business?*
 - *A significant transaction with a related party that is not audited?*

- *The creation of a variable interest entity in which a company's economic interest (its obligation to absorb losses or its right to receive benefits) is disproportionately greater than the company's stated power?*
- *The existence of a dominant influence exerted by a related party?*
- *Are there other relationships or related party transactions that should ordinarily be presumed to be a fraud risk?*
- *Should a proposed standard include a presumption that a financial relationship with management that creates a significant incentive for achievement of short-term performance goals is a fraud risk? Are there other ways in which a proposed standard could assist auditors in obtaining an understanding of financial relationships with management (e.g., management compensation)?*
- *What types of procedures could auditors perform to obtain an understanding of the company's financial relationship with management? For example, should the Board consider a requirement for an auditor to gain an understanding of executive compensation arrangements through a review of contracts and agreements?*
- *Should a proposed standard require procedures that the auditor should perform to determine the existence of undisclosed related party transactions? If so, what procedures should be performed?*
- *Should a proposed standard require auditors to consider relationships, that do not meet the definition of a related party, but that might pose similar risks (e.g., relationships with entities managed by former officers of the company, significant customers and suppliers, competitors, or strategic alliances)? What considerations are appropriate (e.g., concerns about substance over form or about obtaining terms that might not be available to a clearly independent party)? Are there other examples of such relationships that auditors should consider?*
- *Should a proposed standard include a presumption that an assertion that a material related party transaction was consummated on terms equivalent to those that prevail in an arm's-length transaction is a significant risk?*
- *What type of evidence can an auditor obtain to support an assertion that a related party transaction was consummated on terms equivalent to those that prevail in an arm's-length transaction?*

SAG members had the following feedback relevant to the discussion topics below:

Assessing the Risks Associated with Related Party Transactions

- Certain related party transactions should be considered significant risks and special attention should be paid to those areas. It would not be helpful to presume related party transactions are a fraud risk since not all related party transactions are created equal. Additionally, to presume a fraud risk for all may create unnecessary work.
- The PCAOB should tailor the auditing standard to the types of related parties and the type and nature of related party transactions where fraud is more likely to exist.
- Auditor judgment needs to be exercised in determining whether a related party transaction is a significant risk or a fraud risk. Such treatment should not be uniformly presumed.
- There should be a heightened level of sensitivity for related party transactions. Such transactions should be a red flag indicator and require auditors to do more work.

- The structure of related party transactions should be considered. If part of the transaction is not audited or audited by others it may be difficult to see the entire nature of the transaction.
- The fraud risk in regards to related party transactions is the failure to identify those that are not talked about or fully documented.

Financial Relationships with Management

- It could be argued that auditors are already evaluating this issue under [Statement on Auditing Standards No. 99](#), *Consideration of Fraud in a Financial Statement Audit*. Shouldn't the auditor be considering this under existing standards?
- The auditor should have a working knowledge of the compensation plans and should be aware of how the compensation plans are affected by financial results.
- Having short-term management incentives could result in a fraud risk and the auditor should be aware of where that risk could manifest itself in the financial statements.
- The majority of public companies have management incentives for achievement of performance goals. The PCAOB should be careful in determining whether this should be a presumed fraud risk and the implication of such a conclusion on the audit.
- The combination of management incentives to meet performance goals and an unnatural ability to meet them should trigger a potential fraud risk.
- This risk will be pervasive everywhere. Perhaps this should be considered in a fraud standard rather than a related party standard.

Identifying Undisclosed Related Party Transactions and Relationships

- When someone really wants to hide such transactions this can become a very difficult area to audit.
- Auditors should look at the effectiveness of whistleblower hotlines. Also, there needs to be a system in place at the company to monitor where reports that are not submitted through the whistleblower hotline are going and the resolution of such issues.

Considering Other Relationships That Might Pose Risks Similar to Related Party Transactions

- Auditing standards should have a reasonably broad scope, but be sensitive to resource allocations when reviewing such areas.
- Auditors should be alert for such transactions. The existence of such transactions should heighten auditor concern. [ISA 550](#), *Related Parties* has examples of the areas that are indicative of these issues.
- Such relationships should not be presumed to be a fraud risk; rather unusual transactions could be just an accounting risk.
- Perhaps the issue of other relationships that might pose risks similar to related party transactions should be a separate standard, as it may get lost within the related party standard.

Management Assertions Regarding Equivalency with Arm's-Length Terms

- Auditors should apply judgment and determine whether accounting is equivalent to substance. Related party transactions that management asserts are arm's-length should not be presumed a significant risk. Auditors should determine appropriate disclosure and accounting that corresponds to substance of the transaction.
- Existing standards require that when the client makes the assertion that the related party transaction is arms-length then management has to be able to support that conclusion.

The Board has previously discussed the topic of related parties with the SAG at the following meetings:

- June 21, 2007 [Meeting](#) – [Briefing Paper](#) – *Related Parties*
- September 8-9, 2004 [Meeting](#) – [Briefing Paper](#) – *Related Party Transactions*

Other Related Resources

[CAQ Alert #2009-90](#) PCAOB Announces October 14-15th SAG Meeting Agenda, October 12, 2009

[CAQ Alert #2007-32](#) Highlights of the PCAOB's June 2007 SAG Meeting, June 27, 2007

[CPCAF Summary](#) CPCAF Summary of PCAOB February 9th SAG Meeting

[CPCAF Alert #76](#) CPCAF Summary of PCAOB October 2005 SAG Meeting, October 21, 2005

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