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Public Company Accounting Oversight Board  
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By E-mail: [comments@pcaob.org](mailto:comments@pcaob.org)

May 15, 2012

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Dear Mr. Baumann,

**Re.: PCAOB Rulemaking Docket Matter No. 038: PCAOB Release No. 2012- 001, February 28, 2012  
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 IDW would like to thank you for the opportunity to comment on the PCAOB's Proposed Auditing Standard – Related Parties and Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions And Other Proposed Amendments to PCAOB Auditing Standards (hereinafter collectively referred to as the "proposed standard") released February 28, 2012.

Since the PCAOB's interim standard dealing with related parties dates from 1983, we certainly support the PCAOB dealing with related parties on the one hand and significant unusual transactions on the other, as these important areas have often been a common feature in recent fraud cases. Consequently, we also support the idea that specific other PCAOB auditing standards be amended at this stage, where appropriate. We recognize that the revisions mean that the PCAOB's standards will be brought further in line with the IAASB's fraud and related party standards, which were revised during its recent clarity project. Nevertheless, we continue to have concerns as to the differences between the two sets of standards.

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In this letter we have not responded to individual questions raised, but comment instead on those areas with which we have concerns. We submit our comments as follows:

### ***Alignment with Auditing Standards Promulgated by the IAASB***

As we had previously commented in a number of letters to the PCAOB, we welcome the updating of the PCAOB's interim standards, and particularly welcome the efforts made to align the proposed standard with the relevant ISAs as a measure towards the international convergence of auditing standards needed for international capital markets. In this context, we would like to refer to our previous letters in which we addressed this issue more fully, as we have chosen not to repeat our comments. We nevertheless confirm our previously stated views.

Indeed, our main areas of concern in respect of this proposed standard revolve around the issue of compatibility with the respective IAASB standards dealing with related parties, which we discuss in more detail below.

### ***Potential Drawbacks of the PCAOB Approach***

In comparing the proposed standard with the IAASB's corresponding standards we note a number of instances where the relevant ISAs require the auditor to perform procedures directed toward a certain aim, but provide flexibility by guiding the auditor with application material suggesting possible ways in which it might be appropriate for the auditor to tackle this, rather than prescribing a list of procedures to be performed. In contrast, the proposed standard often specifies outright certain, or all, of these possibilities as required procedures.

We would like to point out one example in which we suggest this approach may result in over-prescription:

According to the discussion in Appendix 4, the PCAOB is proposing the auditor identify any incentives and pressures management might face that could lead management to manipulate financial reporting, by requiring, in a new paragraph (paragraph 10A of AS-12), that the auditor always perform specific work – including reading employment and compensation contracts – in regard to compensation arrangements with all executive officers. We note that the PCAOB is proposing to retain the extant flexible approach of paragraph 11 of AS-12 only in regard to compensation arrangements in respect of those members of senior management other than the executive officers.

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It is not clear to us why the PCAOB is proposing to add this particular stringent requirement as a further procedure designed to identify risks of material misstatement, when the PCAOB has already specified that management override is a significant risk<sup>1</sup>.

In our opinion, adding this “additional” risk recognition procedure as a requirement in all audits will not lead to an increase in audit quality, since the auditor is already required to treat management override as a significant risk. There may, however, be circumstances in which the auditor considers the procedures necessary in deepening his or her understanding of the particular company’s circumstances, and as such we believe the current more flexible approach of extant paragraph 11 remains appropriate.

In our view there are further potential drawbacks to taking such a rules-based approach in the area of related parties, including the effect thereof on the expectations gap between what the public expects of an auditor and what an auditor has the power to achieve in practice. The rules based approach adopted by the PCAOB may leave the impression to the public that auditors are in a position to obtain virtually absolute assurance in relation to related parties. This applies in particular in regard to the identification of related parties, as we discuss below. In our opinion, the PCAOB standard should be quite clear in acknowledging the fact that management and not the auditor is responsible for the identification of related parties, and that while the auditor can perform procedures to seek to recognize fraud risk factors that may be associated with related parties, an audit cannot involve extensive or unlimited “fishing expeditions” to identify all related parties. An audit is an assertion-based engagement rather than a direct engagement and the auditor is therefore responsible for obtaining audit evidence as to whether the assertions made by management in respect to its financial statements are appropriate or not.

We note that the IAASB has included information in paragraphs A16 and A18 of ISA 550 on this aspect by clearly stating in the last sentences of A18 that in the absence of effective controls over related parties, an auditor may even be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions, which would require the auditor considering implications for the auditor’s report. In the absence of such information in the proposed standard, we believe there is a danger that public expectations may remain un-

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<sup>1</sup> In line with ISA 240.31, paragraph 69 of AS-12 states: “The auditor’s identification of fraud risks should include the risk of management override of controls.” and the note in paragraph 71b of AS-12 states “A fraud risk is a significant risk.”

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realistic. In our opinion, the inclusion of a note similar to that included under paragraph 19 of the proposed standard regarding arms length transactions would be appropriate.

### ***Purpose and Scope of the Objective***

We agree with the statement on page A4-4: “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. 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.”

However, in order to achieve this “benefit” in terms of the auditor’s use of professional judgement, as well as reinforce the references within the standard to fraud, we would like to suggest that the objective also make reference to fraud risk factors, since this is a significant aspect in the auditor’s considerations on related parties. Indeed, while we accept that changes are being proposed to the PCAOB’s fraud standards too, the fact that only two references to fraud are made in the proposed standard may detract from this aspect. This could lead to public perceptions that related party relationships and transactions form a relatively straightforward aspect of an audit.

### ***Responsibility for the Identification of Related Parties***

There is a mismatch within the text of the proposed standard in regard to what the auditor is required to do in the context of related party identification.

The introduction of the proposed standard in paragraph 1 states that the standard establishes requirements regarding the auditor’s evaluation of a company’s identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. Paragraph 11 of the proposed standard requires that the auditor should evaluate whether information that comes to the auditor’s attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

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In contrast, paragraph 3 of the proposed standard requires, among other things, the auditor to “perform procedures to identify the company’s related parties, ...”. Paragraph 4 starts by saying “In identifying related parties and obtaining and understanding of....., the auditor should.....”.

We suggest the Board amend the wording of these requirements as well as the subheading preceding paragraph 3, to recognize that the management of a company is the party that is responsible for the identification of related parties, not the auditor. In contrast, the auditor is responsible for identifying risks of material misstatement, including any risks of material misstatement associated with related party relationships and transactions. We suggest the wording in paragraph 3 be revised to read “As part of the auditor’s risk assessment procedures required by AS-12 (specific mention of related parties could then be included in paragraph 5 of AS-12), the auditor should perform procedures to evaluate management’s identification of the company’s related parties, ...” Paragraph 12 could then be deleted. We further suggest that all other references to the auditor’s identification be likewise amended to reflect the nature of the auditors’ responsibilities in this area.

### ***Definitions***

We appreciate the fact that the PCAOB has chosen not to define the term related party within the proposed standard, but instead to require the auditor to look at the SEC requirements applicable to the company subject to audit. This approach allows sufficient flexibility for any future developments in financial reporting applicable to issuers.

Text amending paragraph 66 of AU Sec 316 includes a definition of the term significant unusual transactions: “Significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature (“significant unusual transactions”)...”. We suggest this definition be more prominent by clearly identifying it as a definition.

We note that this term is used elsewhere in this as well as in other standards, where it is either not explained or explained in an inconsistent way. For example the text of the Note under paragraph 13 of the proposed standard Related Parties states: “...for related party transactions that are also significant unusual transactions (e.g., significant related party transactions outside the normal course of business)”. It is thus unclear whether the PCAOB intends there to be a difference here or not, i.e., whether it intends to specifically exclude related party transactions that, although within the normal course of business, otherwise

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appear to be unusual due to their timing, size, or nature. Although we do not believe any such differentiation is intended, the inclusion of a definition of the term would be helpful.

***Areas that Would Benefit From Guidance***

In specific areas, we see a need for the PCAOB to provide additional guidance. For example, paragraph 14 of the proposed standard requires the auditor perform procedures on intercompany balances. Matters such as the expected extent of such procedures, how they might vary according to the auditor's assessment of risk of material misstatement are not addressed. We suggest the PCAOB provide guidance in this area. The requirement of paragraph 15d. of the proposed standard for the auditor to perform other procedures as appropriate would similarly benefit from additional guidance in the final standard (currently this issue is discussed giving examples in the additional discussion in Appendix 4).

If you have any further questions about our comments, we would be pleased to discuss our comments with you.

Yours very truly,

Klaus-Peter Feld  
Executive Director

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