

COMMENTARY

Comments of the Standards Committee of the Auditing Section of the American Accounting Association on PCAOB Reproposed Auditing Standard on Related Parties

Participating Committee Members and Other Contributors:

Natalia Mintchik, Mikhail Pevzner, and Gregory Sierra

SUMMARY: On May 7, 2013, the Public Companies Accounting Oversight Board (PCAOB) solicited public comments on its repropoed exposure draft of the *Auditing Standard on Related Parties* (Docket 038: *Proposed Auditing Standard on Related Parties and Related Amendments to PCAOB Auditing Standards*). The two-month comment period ended on July 8, 2013. This commentary summarizes the contributors' views on this exposure draft.

Data Availability: The exposure draft and other related information is available at: <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx>

RESPONSES TO SPECIFIC QUESTIONS IN THE INVITATION TO COMMENT

Question 1. Are the requirements of the repropoed standard appropriate? Why or why not?

Research suggests that, under certain conditions, judgment can be subject to outside influence and, in such circumstances, required audit procedures may be warranted. For example, [Cohen et al. \(2008\)](#) find in an experiment that, even in a high-risk setting, CEOs can adversely influence auditor adjustments. Many related party transactions are opaque, and firm insiders could unduly influence auditor judgment. The repropoed standard's required procedures appropriately set the auditor default to "yes" for many basic audit procedures/activities and appropriately

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requires an affirmative support of many basic conclusions. In addition, many of the required procedures or other required activities in the repropoed *Related Parties* standard is enhanced by explicitly requiring auditor judgment of whether to perform additional procedures.

A potential weakness of a required-procedures approach is that auditors and management over rely on the set of required procedures and underutilize judgment when assessing the need for further procedures (e.g., [Gordon et al. 2007](#)). The repropoed auditing standard alleviates some of these concerns where it explicitly leaves lists of procedures open ended. For example, in A-7, Paragraph 12 (e), the standard explicitly states, “Perform other procedures as necessary.” However, other sections of the repropoed standard do not state explicitly that additional procedures, communications, or activities are required, as the auditor deems necessary. Omitting an explicit reference to “other” procedures, communications, or activities in one section and including them in another may leave the unintended impression that lists of requirements in the repropoed standard are exhaustive. If this is what the PCAOB intended, research does not support this view. Instead, the required activities should be augmented with an “other” option in each section to be clear that the auditor must continue to exercise professional judgment with respect to additional audit work.

Question 4. Would the procedures required by the repropoed standard improve the auditor’s understanding of a company’s relationships and transactions with its related parties? Why or why not?

In the title of the section before Paragraph No. 3 of the repropoed standard, the Board should consider replacing the term “Related Parties” with “Related Parties and Potentially Related Parties.” This distinction becomes vital later in the repropoed standard in Paragraph Nos. 14–16, where the auditor’s requirements to assess the company’s proper identification of related parties are discussed. A potentially related party that the company deemed not to be related is likely to require a much different audit approach from a related party that was never identified by the company.

Question 5. Is the requirement in the repropoed standard to evaluate whether the company has properly identified the company’s related parties and relationships and transactions with its related parties appropriate? Why or why not?

The auditors of related parties or potentially related parties are a seemingly overlooked source of information in the repropoed standard. Although the repropoed standard does not require nor prohibit communication with the auditor of a related party or potentially related party, the Board should consider explicitly requiring communication between the auditors of potentially related parties either as an addition to Paragraph No. 9 of the standard or as a new Paragraph No. 10. If the Board concludes that such a requirement is excessive, it should, at a minimum, add that auditors should perform inquiries of the potentially related party’s auditor if deemed necessary either to (1) obtain an understanding of the company’s relationships and transactions with related parties or potentially related parties; or (2) evaluate whether the company has identified its related parties.

Question 6. Does the repropoed standard appropriately allow for the use of auditor judgment? Why or why not?

Conceptually, the repropoed standard appropriately allows for the use of auditor judgment. However, the repropoed standard, as written, seems to supplant required procedures for auditor judgment in some sections. In a study of fraud and related party transactions, [Louwers et al. \(2008\)](#) support more focus on “brainstorming sessions” as required by SAS No. 99 ([AICPA 2002](#)).

Although the repropoed standard obviously does not undermine auditor judgment, it should more explicitly support the judgment component of the “scaled approach.” The repropoed standard should either be more explicit in its Introduction about requirements versus judgments or place open-ended requirements in more or all of the repropoed standard’s sections. That is, consider adding explicit references to other procedures or activities as deemed necessary by the auditor. For example, on Page A1-3, Paragraph 5, consider adding a subparagraph (g) stating, “Other inquiries of management deemed necessary to obtain an understanding of the company’s relationships and transactions with its related parties and potentially related parties.”

Question 7. Are the auditor’s responsibilities for the examples of information and sources of information contained in Appendix A to the repropoed standard clear? Are there other examples that should be included in the repropoed standard?

The auditor should be required to search public information. On Page A4-12 of the repropoed standard, the Board explains that, in response to comment and discussion with the SAG, it declined to include a requirement to search public information because it might result in unnecessary costs and, furthermore, existing Auditing Standard No. 12 ([PCAOB 2010](#)) requires a search of public information. Given that the purpose of the repropoal is in part to bolster investor confidence, and that investor confidence is shaken when, subsequent to a clean audit opinion, journalists are able to find evidence of audit failure in the public domain, the Board should reconsider its decision and should require a search of public information to the repropoed standard in Paragraph No. 14.

Appendix A3, Bullet 1, should be changed from “other relevant company filings. . .” to “other relevant filings and communications. . .” because a large part of regulatory information is contained in regulatory examination reports that are not filings, but typically are readily available to the auditor.

Question 12. Appropriateness of the Auditor’s Evaluation of Business Purpose of Related Parties’ Transactions.

We believe that the Board is taking on a very important task in requiring auditors to be more vigilant in evaluating business purpose, economic substance, and potential opportunistic incentives of related parties’ transactions. As stated, we agree with the goals of this evaluation. One concern we have is whether the auditors currently have sufficient expertise to evaluate whether significant related party transactions lack commercial substance. Such an evaluation may require the use of specialists (e.g., valuation appraisals) and may put an auditor in a significantly adversarial position versus the client, especially if the auditor does not have significant expertise in the economic evaluation of a transaction in question. In addition, it would be beneficial to more explicitly state achievement of which economic targets the auditor may consider (e.g., meeting analyst expectations, avoidance of violations of debt covenants, meeting earnings growth targets). The Board may consider requiring auditors to explicitly incorporate in their audit plans an evaluation of firms’ economic incentives to meet certain targets, as mentioned above.

One possible requirement that could significantly benefit investors is for the Board to require auditors to provide their overall assessment of managerial incentives to meet market or other stakeholders’ expectations in the “Auditor Discussion and Analysis,” which had been proposed under the Board’s recent Auditor Report proposal.

Question 16. Use of Auditor’s Judgment.

As proposed, the standard allows for sufficient use of the auditor’s judgment. One concern we have is whether, given the potentially unclear nature of related party transactions, the auditor could

unduly rely on the client's explanations for those transactions. The Board may want to consider release of additional interpretive guidance on how auditors exercise judgment in their analysis of the related parties' transactions.

Questions 18–19. Understanding of Compensation Arrangements.

We believe that the requirement should significantly improve auditors' fraud risk assessments. Going back to [Watts and Zimmerman \(1986\)](#), accounting research has long maintained that meeting compensation targets increases managers' incentives to make opportunistic accounting choices and, in light of this, auditors' better understanding of compensation arrangements will improve auditors' overall audit risk assessment. This idea ties back to our previous comment that we believe it would be highly beneficial for audits to *explicitly* incorporate the analysis of opportunistic incentives into the audit programs and discuss these incentives in the audit reports. It also would be beneficial to communicate such analyses to firms' audit committees.

Question 21. Effects on Sustaining Audit Opinions/Professional Skepticism.

In our view, deeper analysis of related party transactions would significantly improve the audit's effectiveness and informational value. Historically, financial statement analysis textbooks and related literature (e.g., [Schilit and Perler 2010](#)) identify related party transactions as serious factors affecting firms' overvaluation and potential to commit fraud. This view is supported by some academic research (e.g., [Kohlbeck and Mayhew 2004](#); [Gordon and Henry 2005](#)). However, it is important to bear in mind that the presence of related party transactions alone should not be construed as increasing fraud risk ([Gordon et al. 2007](#)). Therefore, requiring auditors to more explicitly consider the effects of related party transactions on their audit conclusions and use of audit reports by investors is critical.

Question 23. Communicating with Audit Committee.

We believe that the success of the implementation of this standard critically hinges upon the auditors' ability to have a direct channel of communication with the audit committee. This is because related party transactions represent a potentially very contentious area of the audit work, whereby auditors could be exposed to additional pressures from upper management. We believe that expanded discussion of related party transactions by the auditor in their report to the audit committee should be given special prominence.

Question 28. Costs to Audit Firms.

We believe that the largest costs that could be incurred by audit firms in implementing the standard relate to training audit staff in their analysis of related party transactions and the potential need to employ specialists in the analysis of those transactions. There also could be additional demands on partners' and managers' time in the analysis of more complex related party transactions (as discussed in "Additional Comments (3)" below).

ADDITIONAL COMMENTS

Paragraph 2, Page A1-1 of the standard states:

The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

As written, this statement is somewhat unclear. It might be broadly interpreted as the requirement to obtain sufficient appropriate audit evidence that focuses explicitly on the identification and disclosure of the related parties and transactions with such parties in the

financial statements. It does not clarify who is responsible for such identification (i.e., confusion of auditors versus management responsibilities), and it does not include any notion of materiality. In this connection, we recommend that the regulators make the description of the objective more precise to avoid such interpretations and consequent confusions.

We also want to draw regulators' attention to the possibility that the proposed guidance with respect to related party transactions increases responsibilities of financial auditors in this area in comparison with those imposed by the current standards. In particular, in many areas, the proposal suggests the significant shift in auditors' responsibility from providing *negative* assurance (e.g., lack of evidence that management assertions related to the related parties are false) to the higher level of *positive* assurance (e.g., sufficient evidence that such assertions are true). For example, the current standards focus on audit procedures that *should be considered* by the auditor. So, there is no unconditional requirement in the current standards for auditors to perform those procedures, just the presumptively mandatory requirement to *consider*. In addition, current standards stress that "The procedures set forth in this section should not be considered all inclusive. Also, not all of them may be required in every audit" (Paragraph 1). Finally, Paragraph 4 of the current standards states, "An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered."

In other words, current standards do not presume auditors' responsibility to identify *all* related party transactions. Current standards also allow more flexibility for auditors' professional judgment in this area. While we applaud the regulators' efforts to increase audit quality and recognize the crucial role of the related party transactions in prior accounting scandals, we are wary about potential risks of micromanaging in this uncertain area. We are not aware of any empirical evidence that would address this issue directly, but we believe that the case of Auditing Standard No. 2 (PCAOB 2004; hereafter AS2) might serve as an important reminder. In particular, the combination of simultaneous specificity and ambiguity of AS2 guidance increased the volume of account-level work and, hence, audit costs, but the link between this increased audit effort and audit effectiveness was lacking. In this connection, we would advise the regulators to proceed with caution and to commission more studies to explore how this significant change in audit responsibility affects the audit process, its costs, and effectiveness. We would also recommend that, if regulators decide to be specific in their requirements, they also should be as precise as possible and provide plenty of particular examples for the auditors to avoid potential misunderstandings and unnecessary audit efforts. Such extended guidance is especially crucial in the areas in which the proposal significantly changes the current established relationships between the parties involved in the audit process.

Below are several examples where such additional explanations are warranted:

(1) Paragraph 6:

The auditor should inquire of others within the company regarding their knowledge of the matters in Paragraph 5 of this standard. The auditor should identify others within the company to whom inquiries should be directed, and determine the extent of such inquires, by considering whether such individuals are likely to have knowledge . . .

No specific advice is given to auditors with respect to Paragraph 6 to guide them in "identifying others to whom such inquiries should be directed." Regulators should consider extending guidance in this area, including the guidance concerning potential management motivations that we mention earlier, to avoid unnecessary audit effort.

(2) Paragraph 12, Point d:

For each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should: Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any.

This statement presumes that auditors have sufficient expertise to evaluate the financial capability of the party, but auditors are not credit loan experts. In addition, as was stated in several comments to the original proposal, auditors often lack the access to necessary information about the related party. While the client is related to the related party and might have the ability to exercise some control over the actions of the related party, it does not automatically mean that client management can force the related party to provide any documentation to its auditors. None of these requirements exist in the current standard on related parties. Regulators should consider extending guidance in this area by advising auditors on, for example, how to decide whether the help of the evaluation specialist is warranted, what the channels are through which auditors can persuade related party to cooperate fully, and the confidentiality obligations of the auditors to the related party.

(3) Paragraph 18:

If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.

Similar to the prior discussion, this requirement assumes that auditors possess a distinct expertise beyond that of financial reporting—now, that of the market specialist—and imposes the requirement for auditors to collect additional evidence to ensure that those transactions are consummated at arm's length *if management wants to include such a statement in the financial statements*. There are several potential consequences of these and similar requirements: (1) management will try to avoid the relationships with the related parties altogether because of the additional problems and costs that they create in the compliance area, (2) management will not claim that those relationships are at arm's length even if they are, or (3) audit costs will increase because auditors will need to perform more work if an organization conducts significant related party business at arm's length, and if management wants to stress this point. In all cases, the requirement might have some real negative economic consequences for many shareholders while we are not aware of the empirical evidence that such a requirement will decrease fraud risk. In particular, the first outcome (e.g., management tries to avoid any related party transactions) might deprive the shareholders of valuable synergies created through a variety of inter-company connections. Thus, the requirement that is put in place to mitigate earnings management might instead create incentives for myopic managerial behavior, given the global and interconnected world. The second outcome (e.g., no claims that related party transactions are at arm's length) will create the perception that most of related party transactions are not at arm's length. It remains an empirical question how such a perception will affect shareholder behavior and market reactions in

certain industries. As for the third outcome, more audit work will automatically lead to higher audit costs, which eventually will be borne by the shareholders.

The proposal's approach in this area departs significantly from current auditing standards that state cautiously in Paragraph 12, "Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. If such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, he should express a qualified or adverse opinion because of a departure from generally accepted accounting principles, depending on materiality (see Sections 508.35 and .36)." We recommend that the PCAOB provide more guidance for auditors on what constitutes sufficient evidence that these transactions were performed at arm's length in such circumstances. Auditors might lack prior experience making such evaluations because of the different nature of assurance requirements in the current standards. This lack of experience in the absence of precise guidance might lead to unnecessary audit costs and inefficient audits.

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