

*Auditing Standards Committee Auditing Section
American Accounting Association*

Re: Invitation to comment on Release 2013-004, Related Parties.

July 3, 2013

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on Release 2013-004, Related Parties, which was recently developed and published by PCAOB.

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that you found our comments useful for your deliberations and incorporate some of our insights into the final version of the standard. Please, feel free to contact our committee chair if you have questions or need further clarifications.

Respectfully submitted,

Auditing Standards Committee
Auditing Section – American Accounting Association.

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Responses to Specific Questions in the Invitation to Comment

Re: Question 1, Are the requirements of the repropoed standard appropriate? Why or why not?

Furthermore, under certain conditions research suggests that 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 when 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 sets the auditor default to "yes" for many basic audit procedures/activities and appropriately 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 (See, 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 explicitly state that additional procedures or communications or activities are required as the auditor deems necessary. Omitting an explicit reference to "other" procedures or 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.

Re: 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 paragraphs 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.

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Re: Question 5, Is the requirement in the repropose 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 repropose standard. Although the repropose 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 inquire perform inquiries of the potentially-related party's auditor if deemed necessary either (1) to obtain understanding of the company's relationships and transactions with related parties or potentially-related parties or (2) to evaluate whether the company has identified its related parties.

Re: Question 6, Does the repropose standard appropriately allow for the use of auditor judgment? Why or why not?

Conceptually the repropose standard does appropriately allow for the use of auditor judgment. However, the repropose standard as written seems to supplant required procedures for auditor judgment in some sections. In a study of fraud and related-party transactions, research by Louwers et al. (2008) supports more focus on "brainstorming sessions" as required by SAS No. 99 (AICPA 2002). Although the repropose standard obviously does not undermine auditor judgment, it should more explicitly support the judgment component of the "scaled approach". The repropose standard should either be more explicit in its Introduction about requirements versus judgments or place open-ended requirements in more or all of the repropose standard's sections. That is, add explicit references to other procedures or activities as deemed necessary by the auditor. For example on page A1-3 paragraph 5 could add 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."

Re: Question 7, Are the auditor's responsibilities for the examples of information and sources of information contained in Appendix A to the repropose standard clear? Are there other examples that should be included in the repropose standard?

The auditor should be required to search public information. On page A4-12 of the repropose, the Board explains that in response to comment and discussion with SAG it declined to include a requirement to search public information because it might result in unnecessary costs and, furthermore, that existing Auditing Standard No. 12 (PCAOB 2010) required a search of public information. Given that the purpose of the repropose is in part to bolster investor confidence and that investor confidence is rattled 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 repropose standard in paragraph no. 14. Appendix A3 bullet one should be changed from "...other relevant company filings..." to "...other relevant filings and communications..", as a large part of regulatory information is

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contained in regulatory examination reports that are not filings but typically are readily available to the auditor.

Re: 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 parties transactions lack commercial substance. Such an evaluation may require use of specialists (e.g. valuation appraisals) and may be put an auditor in a significantly adversarial position vs. 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, etc.). 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 possibility 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 new Auditor Report model, released by the Board last year.

Re: 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 potentially unclear nature of the related parties’ 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.

Re: Question 18-19, Understanding of Compensation Arrangements

We believe that the requirement on the part of the auditor to obtain deeper understanding of transactions with the senior management is a very important element of an audit which should significantly improve auditors’ assessments of fraud risk. Going back to Watts and Zimmerman (1986), accounting research literature has long maintained that meeting compensation targets

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increases managers' incentives to make opportunistic accounting choices, and in the light of this, auditors' better understanding of compensation arrangements will improve auditors' overall assessment of audit risk. This idea ties back to our previous comment that we believe that it would be highly beneficial to audits to *explicitly* incorporate the analysis of opportunistic incentives into the audit programs and discuss these incentives in the audit reports. It would also be beneficial to communicate such analyses to firms' Audit Committees.

Re: Question 21, Effects on Sustaining Audit Opinions/Professional Skepticism

In our view, deeper analysis of related parties transactions would significantly improve the audits' effectiveness and informational value. Historically, financial statement analysis textbooks and related literature (e.g. Schilit and Perler, 2010) identify related parties transactions as serious factors affecting firms' overvaluation and potential to commit fraud. This view is supported by some academic research (e.g. Gordon and Henry, 2005, Kohlbeck and Mayhew, 2004). However, it is important to bear in mind that presence of related parties 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 parties' transactions on their audit conclusions and use of audit reports by investors is critical.

Re: 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 the 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.

Re: Question 28, Costs to Audit Firms

In our mind, the largest costs to be incurred by audit firms in implementing the standard relate to training audit staff in their analysis of related parties' transactions and potential need to employ specialists in the analysis of those transactions. There could also be additional demand on time of partners and managers in analysis of more complex related parties' transactions (as discussed in AC 3 below).

Additional Comments:

- 1) Par. 2, p. 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.”

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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 vs. 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 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." (par. 1). Finally, par. 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 auditor's 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 micro-managing in this uncertain area. We are not aware of any empirical evidence that would address this issue directly but believe that the case of auditing standard N 2 (hereafter, AS N 2) might serve as an important reminder. In particular, the combination of simultaneous specificity and ambiguity of AS N 2 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 give plenty of particular examples for the auditors to avoid potential misunderstandings and unnecessary audit efforts. Such extended guidance is especially crucial in the areas where 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) Par 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

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company to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding:..."

No specific advice is given to auditors with respect to par. 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 on potential management motivations that we mention earlier, to avoid unnecessary audit effort.

2) Par. 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 the 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 the necessary information about the related party. While client is related to the related party and might have ability to exercise some control over the actions of the related party, it does not automatically mean that client management can dictate related party to provide any documentation to its auditors. None of such requirements exist in the current standard on the related party. Regulators should consider extending guidance in this area by advising the auditors how to decide whether the help of the evaluation specialist is warranted, what are the channels through which auditors can persuade related party to cooperate fully, what are the confidentiality obligations of the auditors to the related party, etc.

3) Par 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 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 the auditors to collect the additional evidence that those transactions are consummated at arm's-length *if management want to include such statement in financial statements*. There are several potential consequences of these and similar requirements: 1) management will try to avoid the relationships with the related parties all together because of the additional problems and costs that they create in compliance area, 2) management will not claim that those relationships at arm's length even if they are, or 3) audit costs will go up since auditors will need to perform more work if an organization conducts significant related party business at arm's length term, and management wants to stress this point. In all cases, the requirement

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might have some real negative economic consequences for many shareholders while we are not aware of the empirical evidence that such 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 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 global and interconnected world. The second outcome (e.g., no claims that related party transactions are at arms-length) will create the perception that most of related party transactions are not at arm's-length. It remains the empirical question how such perception will affect the shareholders' behavior and market reactions in certain industries. As for the third outcome, more audit work will automatically lead to higher audit cost, that will be eventually bore by the shareholders.

The proposal's approach in this area departs significantly from current auditing standards that state cautiously in par 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 section 508.35 and .36)." We recommend that PCAOB will provide more guidance for the auditors on what constitute the sufficient evidence that these transactions were performed at the arms-length in such circumstances. Auditors might lack the prior experience of such evaluation due to different nature of assurance requirements in the current standards. This lack of experience in the absence of the precise guidance might lead to unnecessary audit costs and inefficient audit.

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