

PCAOB Pushes for More Scrutiny of Related-Party Transactions

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Auditors will soon have to follow new rules requiring them to dig deeper into transactions that appear out of the ordinary and to scrutinize business dealings with executives' family members, large shareholders, former executives, and other related-party transactions.

The Public Company Accounting Oversight Board has issued a second draft of its proposal for a new standard on how auditors are expected to study transactions with related parties and other business transactions that fall outside the normal course of business. The standard would replace the existing rule, AU Section 334, Related Parties, which the board adopted as an interim standard from accounting profession literature that existed before the PCAOB was formed in 2003.



Carmichael

Doug Carmichael, an accounting professor at Baruch College and a former chief auditor for the PCAOB, says an update is long overdue, since the present standard was written in the 1970s. “At that time there was a tendency to write standards in a way that provided auditors with what they used to call ‘wobble room’ in deciding whether certain procedures needed to be done,” he says.

Indeed, auditors wiggled right through any rigorous audit work in epic failures like Enron, Tyco, Refco, Adelphia, and others that exposed big problems with financial reporting, including disclosure of related-party transactions, and inspired the passage of the Sarbanes-Oxley Act and the advent of auditing regulation. “Refco was probably the best illustration of why this standard was necessary,” he says. “There were a lot of red flags in that case, particularly with significant unusual transactions. The audit work and the audit evaluation just failed entirely.”

The existing standard sets a low bar for auditor performance, agrees Brian Mayhew, associate professor at the University of Wisconsin in Madison. “Almost from the get go, it says these things are hard to find so if you don't find it, it's not your fault,” he says. “The proposed new standard gets rid of the old ‘don't worry too much about this’ mentality and replaces it with ‘you have a responsibility to look for this stuff.’”



Doty

Transactions with related parties can have legitimate business purposes, but they carry an increased risk of fraud or mis-statement, says the PCAOB. “Once such transactions are subjected to enhanced focus and appropriate scrutiny, auditors are able, reliably, to differentiate between those transactions that have questionable business utility and those that are legitimate mechanisms to provide for financing or asset disposition,” said Chairman James Doty in proposing the standard. “The focus and scrutiny here can help to avert the corporate failures and job losses we read about all too often once it's too late to do so.”



Hanson

The PCAOB first proposed the standard in early 2012. The current proposal takes into account feedback on the original proposal, but it doesn't change the core expectations, said PCAOB member Jay Hanson. The new rule would require auditors to obtain an understanding of who a company's related parties are, meaning individuals or business entities that have close ties to the company, suggesting business perhaps may not take place at arm's length.

It also requires auditors to scrutinize transactions with those parties to get a sense of whether they seem to have a legitimate business reason, as well as any other transactions that look unusual or abnormal for the company. In addition, the standard would require auditors to evaluate whether a company has properly identified its related parties and transactions, and it would require auditors to communicate with the audit committee regarding its findings.

More Compensation Scrutiny

As an added area of focus, the PCAOB also wants auditors to study executive compensation agreements and consider where and how they might give management incentives to engage in transactions that would improve their earnings. That was part of the board's original proposal, and feedback raised concerns that it gave auditors new responsibility to assess the appropriateness of a company's compensation arrangements with its executives. The new proposal clarifies, said Hanson, that auditors should evaluate those arrangements as part of their risk assessment process and not to pass judgment on them. “These procedures are designed to identify any incentives and pressures for executive officers to meet financial targets, which can result in risks of material mis-statements,” he said.



Fornelli

Cindy Fornelli, executive director of the Center for Audit Quality, says the profession has been moving in the direction of the proposed standard as a result of inspection scrutiny and a suite of new standards on how auditors are to evaluate and respond to risks. “This probably codifies best practices that have been occurring out there,” she says. The requirement for auditors to discuss

related-party relationships and transactions with audit committees may be new for many auditors. “That’s one of the good things we see coming out of this proposal,” she says.

Carmichael says the PCAOB may be inking a related-party standard long after the landmark failures that inspired it because standard setting is inherently slow and there was much for the board to accomplish before it could focus on individual standards for improvement. “There’s a process that this has to go through, and they have a lot of hurdles to get over,” he says. Added to the standard-setting process, the PCAOB also is required as a result of the JOBS Act to perform an economic analysis of its proposed standards and demonstrate the cost and benefit, particularly for the sake of emerging-growth companies.



Louwers

Tim Louwers, a professor at James Madison University who has studied related-party issues, says the proposed standard will increase responsibilities for auditors, but it will still be difficult for auditors to find abusive transactions if management is committed to hiding them. “They are all over the place” in terms of the types of transactions that might present the greatest risk, he says.

“You find them in sales, purchases, loans, all kinds of transactions, so it can be really difficult to figure out.

Related-party transactions are so common.”



Smetenka

Rick Smetenka, a partner with smaller audit firm Haskell & White, says the proposed new standard would inspire auditors to ask more questions. “This is absolutely going to get a higher degree of scrutiny from the auditor,” he says. On the other hand, he echoes Fornelli’s observations: “We’re kind of doing a lot of this stuff already,” he says.