Office of Public Affairs
1666 K Street NW
Washington, DC 20006
Telephone: (202) 207-9227
publicaffairs@pcaobus.org
www.pcaobus.org

Jeanette M. Franzel, Board Member

Statement on the Adoption of Auditing Standard No. 18, *Related Parties*, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Amendments

PCAOB Open Board Meeting
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The new auditing standard and amendments we are considering today respond to a long-standing need for consistently stronger auditor performance, including heightened scrutiny, in the areas of related party transactions, significant unusual transactions, and companies' relationships and transactions with their executive officers. For many years, these areas have been associated with risks of fraudulent and erroneous financial reporting that, in too many cases, have been overlooked by auditors. The resulting scandals involving these critical areas caused significant losses for investors and undermined confidence in the accuracy of financial information used by investors and others in the capital markets.

The Board's release describes the risks associated with these critical areas in detail.[1] Auditing practice, in many respects, has not been up to the task of responding appropriately to these risks -- to the detriment of investors.

I fully support the adoption of Auditing Standard No. 18 and the amendments before us today. In my view, the improvements included in the new auditing standard and amendments will strengthen auditor performance in these risky areas and will contribute to investor protection, while avoiding unnecessary audit effort and related costs.

The Board's Approach to Responding to the Need for Stronger Professional Standards

The existing professional standards do not contain adequate required procedures and are not sufficiently risk-based to address the risks associated with these three

[1] *See*, for example, PCAOB Release No. 2014-002, at pages 9-13 and A5-4—A5-16.

areas.[2] As the Board recognized as early as 2004, performance of auditors under the existing standards has not been as consistently strong as investors deserve.[3]

PCAOB staff have worked closely with the Board throughout the life of this project to develop an understanding of the nature and extent of these risks and alternative approaches to responding to them through standard setting and other potential actions.[4] The Board's understanding has been informed through staff research and analysis, various outreach efforts, public comment on the Board's proposals, and the Board's related deliberations.[5] The Board's iterative process for developing and refining its policy objectives and approach to drafting the new standard and amendments are explained more fully in the adopting release.[6]

I agree with the overall approach of promoting the auditor's heightened scrutiny in these areas while providing opportunities for efficient implementation (i.e., avoiding unnecessary audit effort and related costs) by, among other things:

- aligning the new standard and amendments with the Board's risk assessment standards;
- addressing complementary audit areas;
- using existing concepts and procedures; and
- providing opportunity for a scaled approach to the audit.

In addition, over the course of the project, the Board responded to a variety of policy issues raised by commenters, including:

- expanding auditor judgment when determining the audit response to related party transactions that were previously not disclosed by management;
- clarifying that the auditor's responsibility to identify a company's related parties and relationships begins with information obtained from the company; and

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[2] *See* Release pages 1-13 and A5-21—A5-27 for a description of current audit practice and existing professional standards.

[3] PCAOB, Standing Advisory Group, *Related Party Transactions*, Sept. 8-9, 2004.

[4] Alternative approaches are discussed in the Release at pages A5-27—A5-29.

[5] In addition, as described in pages 12 and A5-45—A5-46 of the Release, the Board considered the actions taken by other auditing standard setters to update and revise their standards in these areas.

[6] *See* Release pages 15-18 and A5-30—A5-34.

- clarifying that the requirements regarding a company's financial relationships and transactions with its executive officers would be performed as part of the risk assessment process, and the auditor is not required to make any determination regarding the appropriateness or reasonableness of the company's compensation arrangements with its executive officers.

The new standard and amendments have been refined from the Board's proposal and reproposal to reflect thoughtful public comment and, more recently, enhanced analysis from staff economists. The adopting release describes in detail how the public comments and staff economic advice were treated by the Board.[7]

Recently, the Board has made significant investments in economic expertise to more fully assess the economic impact of standard setting and other regulatory activities. The new standard and amendments before us today have benefited from that investment.

The Improvements in the Standards Contribute to Investor Protection and Promote the Public Interest While Avoiding Unnecessary Costs

The new standard and amendments contribute to investor protection and promote the public interest by improving upon existing standards in several areas that have been associated with risks of fraudulent financial reporting and that may involve risks of error.

In the area of related parties, the new standard, among other things, adds basic requirements that are focused on the risks of misstatement and are aligned with the Board's risk assessment standards; enhances procedures for the auditor to understand the company's related party transactions; requires the auditor to evaluate both the accounting for and disclosure of related party transactions; and requires enhanced communications with the company's audit committee.

In the area of significant unusual transactions, the amendments, among other things, strengthen the procedures the auditor must follow to identify significant unusual transactions and to obtain an understanding of and to evaluate their business purposes (or lack thereof). They also emphasize the auditor's requirement to evaluate whether the company's financial statements contain the information regarding significant unusual transactions that are essential for a fair presentation.

[7] Treatment of public comments and economic considerations are addressed throughout the Release. Appendix 5 contains a more complete discussion of economic considerations.

Regarding relationships between a company and its executive officers, the amendments require the auditor, as part of the audit risk assessment process, to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers.
The strengthened procedures required by the new standard and amendments also complement each other by, for example, requiring the auditor to consider the linkage between a company's relationships and transactions with its related parties, significant unusual transactions, and its financial relationships and transactions with its executive officers.

The auditor's heightened scrutiny of transactions in these critical areas, along with related required communications with audit committees, should improve the quality of the audit and may result in improvements in companies' accounting and disclosures in these areas. Aligning the standard and amendments with the Board's risk assessment standards should improve the auditor's risk-based consideration of these areas, while providing opportunities for efficient implementation.

The adopting release describes the benefits that likely will be achieved through the new standard and the amendments and their potential cost impact. Our staff economists have enhanced the Board's ability to more fully consider those potential benefits and costs, including related issues raised in public comments on the Board's consideration of economic factors related to its reproposal.[8]

The use of economic analysis will be an important part of future Board standard setting, and I look forward to working with the staff as they begin to integrate economic analysis into the Board's key decision-making milestones throughout the life cycle of each project.[9]

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I would like to thank the staff of the Office of the Chief Auditor for their excellent work on this project, particularly Greg Scates, Brian Degano, Nick Grillo, John Powers, and

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[8] *See* PCAOB Release No. 2013-004, *Proposed Auditing Standard: Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards*, May 7, 2013.

[9] *See*, for example, *Staff Guidance on Economic Analysis in PCAOB Standard Setting*, February 14, 2014, at http://pcaobus.org/Standards/Pages/05152014_Guidance.aspx.

Karen Burgess. In addition, I would like to acknowledge the valuable contributions of the Office of the General Counsel and the Office of Research and Analysis.