PCAOB
Public Company Accounting Oversight Board

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Jay D. Hanson, Board Member

Statement on Adoption of an Auditing Standard, *Related Parties*, and Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and a Company's Financial Relationships and Transactions with its Executive Officers

PCAOB Open Board Meeting
June 10, 2014

Good Morning,

Just over a year ago, in May 2013, we sought public comment on the re-proposal of a new auditing standard on related parties and amendments regarding significant and unusual transactions and a company's financial relationships with its executive officers. Since then, we have received 24 comment letters (in addition to the 37 previously received in response to the initial proposal), which were generally supportive of the Board's course of action. Today we are adopting Auditing Standard No. 18 on related parties and the proposed amendments largely as reproposed.

As I noted last year, the new standard and amendments address auditing requirements for areas that present high risks of financial misstatement. AS 18 will strengthen audit procedures for identifying, assessing and responding to the risks of misstatement arising out of a company's related party transactions. In addition, because the standard requires procedures that are currently optional under the existing standard, it will promote consistency in the audits of companies that have related party transactions. The amendments regarding significant and unusual transactions require the identification of such transactions and set forth procedures to provide the auditor with an understanding of the transactions and require the auditor to evaluate their business purpose.

Likewise, the amendments relating to transactions and relationships with executive officers are intended to give the auditor an understanding and opportunity to evaluate those transactions and relationships, with an eye toward understanding the compensation related incentives and pressures facing executives. Taken together, the new standard and amendments are intended to ensure that auditors take a comprehensive look at certain relationships and transactions that involve an increased risk of material misstatements, whether due to error or fraud.

I support the new standard and amendments and would like to thank the staff in the Office of the Chief Auditor, including Greg Scates, Brian Degano, Nick Grillo, John Powers, and Karen Burgess, as well as members of the Office of General Counsel, the Office of Research and Analysis and the Division of Registration and Inspections for their hard work in getting us to this point.

I would like to mention just briefly a few aspects of the standards that I believe merit particular attention.

First, it may be useful to manage expectations about the changes that AS 18 will drive. It is my understanding that many of the largest auditing firms already perform many, if not most, of the procedures required by the new related parties standard. Thus, the incremental benefit of the new standard, as well as any associated costs, likely will accrue largely to the audit clients (and their respective investors) of small- and medium-sized firms that do not already consistently perform the optional procedures in the existing related parties standard. We believe this is an important improvement, but it is not one that is likely to have significant effects on the audits of the largest companies.

Second, the new standard and amendments will be effective for the audits of financial statements for fiscal years beginning on or after December 15 of this year. Thus, in most cases, auditors will begin to implement the new auditing requirements during 2015, as they begin to plan and perform their fiscal year 2015 audits. We believe, and comments received from a number of firms suggest, that this timing is reasonable.

One commenter, however, expressed concern about the effectiveness of the new requirements of AU sec. 722 for the reviews of interim financial information, which will take effect during the first quarter of 2015. Because the new requirements in AU sec. 722 complement the auditor's planning and performance of the fiscal year audit, I believe it is appropriate for those requirements to become effective for the first quarter of the first year during which the full suite of standards and amendments will take effect. In addition, I would note that the scope of the amendments to AU sec. 722 is relatively limited, conforming to the new related party standard the requirements for certain management inquiries conducted and representations obtained in connection with quarterly reviews.

Economic Analysis

Finally, let me say a few words about the economic analysis underlying the Board's decision to adopt this standard.

I appreciate all the hard work by the staff that went into the economic analysis relating to the standard and amendments we are adopting today. Economic analysis is still a new challenge for us, and it is likely that our efforts will continue to evolve over time.

Those of us at the PCAOB who are not economists are working hard on understanding the relevant economic concepts and their applicability to audits and audit regulation. At the same time, our economists are learning more about auditing. Thus, I expect that our analysis will become more substantive and comprehensive as we gain more experience. In the past, PCAOB standard setting has focused mostly on the potential benefits of proposed changes to standards – though such benefits are, of course, difficult to quantify. Potential costs have been less of a focus, and I anticipate that, with the help of our economists, we can begin to provide a more complete picture going forward. The costs involved extend far beyond the audit fee charged, since that is just an indicator of the allocation of incremental costs to the auditor. I believe we need to better understand and incorporate into our economic analysis the costs incurred by auditors, issuers, audit committees and others.

In connection with this standard and amendments, our focus on economic analysis also picked up mid-stream during the standard setting process due to the timing of the project. Going forward, my hope is to incorporate economic analysis into all stages of the standard setting process. The enhanced attention to economic considerations in the early stages of standard setting projects, before a project is even added to our standard setting agenda, should allow us to make the best decisions possible about whether and how to drive changes in audit practice.

With regard to AS 18 and the amendments related to significant unusual transactions and executive compensation arrangements, the economic analysis in Appendix 5 to the release includes a lengthy discussion about the new requirements, how they compare to and interact with existing standards, and how they may affect audit practice and the financial markets. Boiled down to its (admittedly somewhat simplistic) essence, however, the economic analysis could be condensed into something like this:

- The standard and amendments will require auditors to enhance their efforts in areas that pose increased audit risks and which historically have been associated with financial statement misstatements.
- Because the requirements should improve the likelihood that financial statement misstatements will be detected, it could lead to improvements in accounting and disclosures.
- We believe that the new requirements could result in more accurate, reliable, or clearly disclosed information being provided to the market and therefore reduce the “information asymmetry” between investors and management.
- Reducing information asymmetry, in general, will lead to efficiencies in capital allocation and formation.
- Though they are meaningful, the newly required procedures are not anticipated to be overly burdensome or costly.

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For these reasons, I believe that the standard and amendments present an appropriate balance of potential benefits and likely burdens, and I am pleased to support their adoption.

Again, I extend my appreciation to our staff for their diligent efforts, as well as to the staff of the SEC for their thoughtful input.