Rps6914final

Related Parties Adopting Standards Statement
June 10, 2014

Thank you, Chairman Doty.

I support the adoption of the auditing standard before us today on related parties and the amendments regarding significant unusual transactions and executive officer compensation. The financial scandals of the past decades, many of which involved related party transactions, undermined investor confidence and resulted in dramatic losses to investors. Today, I believe the Board is taking an important step in strengthening the auditor's performance requirements in those areas, which will further the public interest and enhance investor protection.

One of the many changes that will occur with the adoption of these requirements is that auditors will now scrutinize more closely company transactions with close associates, shareholders, contractors, executive officers, board members and their families – because these related party transactions have historically been tied to financial reporting fraud and abuse.

Related Parties

One need only consider the financial reporting scandals that led to the passage of the Sarbanes-Oxley Act of 2002 to understand that such transactions have the potential to pose significant risk to investors and undermine confidence in the audit. Company insiders at the now defunct Enron Corporation, Tyco International Ltd., and Adelphi Communications Corporation, to name just a few, used related party transactions to disguise the true financial condition of their companies.

For example, at Adelphi, some executive officers and members of the board of directors entered into numerous undisclosed related party transactions with the company that resulted in more than $300 million of company funds being diverted to senior management.[1] Recent SEC enforcement actions against China-based companies whose securities are traded in the United States further highlight how such transactions have harmed investors.[2]

Despite past egregious related party transactions, our Inspections division continues to find problems with audit quality in this area.

The new standard contains clear procedures, which should help auditors better identify, evaluate, and respond to the higher than normal risk of fraud, material misstatement and asset misappropriation that such transactions may present. In this way, the standard we are adopting today is an improvement over the current

audit requirements for related parties (AU sec. 334), which have not changed substantively since 1983.

It is worth noting that this standard addresses a number of issues that have consistently arisen in the Board's disciplinary orders.[3] Indeed, just two months ago, the Board brought a settled disciplinary proceeding against a registered firm and its sole owner for, among other things, failing to take any steps to evaluate the nature of payments and stock issuances made to or on behalf of the issuer's officers, including the CEO, over the course of several audit years.[4]

There have also been similar SEC enforcement actions against audit firms. For example, in September 2013, the SEC announced that it had charged a New Jersey-based accounting firm, and one of its founding members, in connection with the botched audits of a China-based company that failed to disclose related party transactions.[5]

Significant Unusual Transactions

Significant unusual transactions[6] have been used by unscrupulous company managers to obfuscate a company's true financial condition. For example, at Enron, executives engaged in transactions with special purpose entities to incorrectly move millions of dollars of debt and troubled assets from Enron's financial statements in order to mislead investors.[7]

Similarly, in 2005 the Chief Executive Officer of what was then a well-regarded brokerage firm, Refco, Inc., disguised billions of dollars of losses to appear as debt owed to the company by an affiliated holding company. [8]

The amendments relating to significant unusual transactions require the auditor to understand the business purpose of the transactions. This knowledge will assist auditors in identifying difficult "substance-over-form" questions and whether a particular transaction was executed in order to obscure the financial results of a company.

Executive Officer Compensation

Finally, executive officers are in a unique position to influence a company's financial performance. This, in turn, may create incentives and pressures that could increase the risk that some executive officers may manipulate their company's financial statements for personal gain.

Studies suggest that executive officers with equity-based compensation packages have, in the past, influenced earnings to inflate the value of their compensation. These studies examined a variety of industries and explored situations involving the alteration of revenues, accruals and reserves.[9]

In addition, as noted in a May 2010 academic study sponsored by the Committee of Sponsoring Organizations, the desire to increase one's compensation served as the most commonly cited motivation to falsify financial results in all SEC fraud enforcement actions from 1997 to 2007.[10]

The amendments we are adopting today would require auditors to focus on the potential opportunities and motivations for executive officers to exaggerate gains, or minimize losses and to consider any effect compensation incentives might have on the reliability of the financial statements. Without getting into the issue of the reasonableness of the compensation arrangements, auditors now will be required to obtain an understanding of the company's financial relationships and transactions with its executive officers. The amount and type of compensation paid to executive officers are matters best left to the compensation committees or boards of directors.

Taken together, I believe that the new related parties standard and the accompanying amendments promote audit quality and investor protection and will provide our Inspection and Enforcement divisions with enhanced tools to monitor and — when necessary — investigate the work of auditors in the areas of related parties, significant unusual transactions, and executive compensation.

Differences from International Auditing and Assurance Standards Board (AASB) and Auditing Standards Board (ASB) Standards

Before concluding, I want to highlight a few of the differences between the rules we are adopting today and the analogous standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board. Unlike the IAASB and ASB standards, our proposal:

- Contains requirements for the auditor to focus on the business purpose of a company's related party relationships and transactions;

- Requires the auditor to make inquiries of the audit committee (or its chair) regarding the committee's understanding of, and any concerns about, related parties and transactions; and

- Requires the auditor to gain an understanding of the compensation package of a company's executive officers.

Standard-Setting Economic Analysis

Finally, I would note that the economic analysis contained in Appendix 5 was performed in accordance with the PCAOB's new *Staff Guidance on Economic Analysis in PCAOB Standard Setting*. As discussed in this appendix, the Board carefully considered the benefits and costs associated with the standard and amendments, including commenters input in this area.

Conclusion

In conclusion, the changes in auditing standards being adopted today require auditors to perform a minimum set of procedures in these three critical areas to provide investors with reasonable assurance that management has properly accounted for and disclosed its transactions with related parties. This assurance is designed to enhance investor confidence in issuer disclosures, and promote the efficient formation and allocation of capital throughout our financial markets.

These new requirements, I believe, will improve audit quality and benefit investors by appropriately targeting areas that pose increased audit risks stemming from incentives and opportunities for company management to pursue their own interests at the expense of investors.

In closing, I join you, Mr. Chairman, and others in thanking Marty Baumann, Greg Scates, Brian Degano, Nick Grillo, Karen Burgess and John Powers, along with the staff of the Office of the General Counsel and the Office of Research and Analysis for their work on this project.

---

[1] *See* Securities and Exchange Commission ("SEC") Accounting and Auditing Enforcement Release ("AAER")No. 1599, *SEC v. Adelphia Communications Corporation, John J. Rigas, Timothy J. Rigas, Michael J. Rigas, James P. Rigas, James R. Brown, and Michael C. Mulcahey*, 02 Civ. 5776 (KW) (S.D.N.Y.) (July 24, 2002).

[2] *See, e.g.,* SEC AAER No. 3447, *SEC v. Keyuan Petrochemicals, Inc. and Aichum Li*, Civil Action No. 13-cv-00623 (D.D.C.) (Feb. 28, 2013). See also related SEC Complaint at: www.sec.gov/litigation/complaints/2013/comp-pr2013-30.pdf.

[3] *See*, *e.g.*, *In the Matter of Turner Stone & Company, LLP and Edward Turner, CPA*, PCAOB Release 2006-010 at ¶ 9 (Dec. 19, 2006); *In the Matter of Jaspers + Hall, PC, et al.*, PCAOB Release No. 105-2008-002 at ¶ 29 (Oct. 21, 2008); *In the Matter of The Blackwing Group, LLC, and Sara L. Jenkins, CPA*, PCAOB Release No. 105-2009-007 at ¶ 11 (Dec. 22, 2009); *In the Matter of Robert T. Taylor, CPA and Robert T. Taylor, CPA*, PCAOB Release No. 105-2010-006 at ¶ 10 (Apr. 27, 2010).

[4] *See In the Matter of Patrick Rodgers, CPA, and Patrick E. Rodgers, CPA*, PCAOB Release No. 105-2014-002 (Mar. 6, 2014).

[5] *See* SEC AAER No. 3500, *In the Matter of Patrizio & Zhao LLC and Xinggeng (John) Zhao, CPA* (September 30, 2013).

[6] Significant unusual transactions represent transactions that are outside the normal course of business for a company or that otherwise appear to be unusual due to their timing, size or nature.

[7] *See Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002* (January 24, 2003) at 30.

[8] *See* SEC AAER No. 2853, *SEC v. Phillip R. Bennett*, 08-cv-1631 (GEL) (S.D.N.Y. filed Feb. 19, 2008) (July 30, 2008). See also related SEC Complaint at: http://www.sec.gov/litigation/complaints/2008/comp20460.pdf.

[9] *See* Gaver, J. J., K. M. Gaver, and J. R. Austin, 1995, Additional Evidence on Bonus Plans and Income Management, *Journal of Accounting and Economics*, 19: 3-28; Eckles, D., M. Halek, E. He, D. Sommer, and R. Zhang. 2011. Earnings Smoothing, Executive Compensation, and Corporate Governance: Evidence From the Property-Liability Insurance Industry. *The Journal of Risk and Insurance* 78:761-90.

[10] *See* M. Beasley, J. Carcello, D. Hermanson, and T. Neal, *Fraudulent Financial Reporting 1998-2007 An Analysis of U.S. Public Companies*, available at: http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf. This study examined in detail SEC accounting and auditing enforcement releases from 1998 to 2007, and noted that either the CEO or CFO was named in 89 percent of the fraudulent financial reporting cases brought by the SEC during that period.