

Audit Research Summaries

Ook deze maand presenteren wij weer enkele “Audit Research Summaries” uit de database van de American Accounting Association (www.auditingresearchsummaries.org).

De eerste samenvatting betreft de studie met de titel “*Auditing Related Party Transactions: A Literature Overview and Research Synthesis*”. Deze studie verschaft een overzicht van onderzoek naar de controle van Related Party Transactions (RPTs). Een interessante bevinding luidt dat in geval van fraude die een accountant niet heeft weten te ontdekken, vaak de nodige RPTs hebben plaatsgevonden. Ook wordt geconstateerd dat in de gevallen dat RPTs gepaard gaan met een gebrekkige corporate governance, het risico op fraude relatief groot is.

De studie “*Auditor Communications with the Audit Committee and the Board of Directors: Policy Recommendations and Opportunities for Future Research*” geeft een aantal aanbevelingen voor aard en inhoud van communicatie tussen de accountant en de Board over financiële verslaggeving, interne beheersing en het optreden van de accountant. Zeer actueel is de aanbeveling dat het bestuursverslag meer aandacht zou moeten krijgen in de discussies tussen audit committee en accountant.

“*A Summary of Research and Enforcement Release Evidence on Confirmation Use and Effectiveness*” schetst onderzoeksresultaten met betrekking tot het gebruik van saldovestigingen met als – primair – doel het bestaan van posten in de jaarrekening vast te stellen. Zo blijkt het gebruik hiervan soms te leiden tot een lage respons en worden de bevestigingen soms - al dan niet bewust - onjuist ingevuld. De onderzoekers merken op dat door voortgaande automatisering alternatieven ontstaan voor het versturen van de standaard papieren bevestiging waardoor de effectiviteit van de controleprocedure wordt verbeterd.

De laatste samenvatting is getiteld “*Group judgment and decision making in auditing: Past and future research*”. Deze studie brengt in kaart hoe de interactie tussen accountants plaatsvindt. Het betreffende literatuuronderzoek richt zich op de volgende processen: het hiërarchische reviewproces, brainstorming over het frauderisico en consultatie binnen de accountantsorganisatie. Naast een uitgebreide samenvatting van bevindingen worden suggesties gedaan voor toekomstig onderzoek. Onderzoek naar “within-firm group interactions” zou zich moeten richten op de effectiviteit van “shared mental models”, audit team diversiteit en interacties met derden zoals audit committees. ■

research summary

Title:	Auditing Related Party Transactions: A Literature Overview and Research Synthesis
Practical implications	In this paper, the authors link academic research and other pertinent literature to issues raised in the PCAOB briefing paper on auditing related party transactions. Overall, the authors believe that the findings in academic research and the significance of related party transactions in recent prominent fraud cases are consistent with the PCAOB's reconsideration of auditing of related party transactions.
Citation:	Gordon, E. A., E. Henry, T. J. Louwers, and B. J. Reed. 2007. Auditing Related Party Transactions: A Literature Overview and Research Synthesis. <i>Accounting Horizons</i> 21 (1): 81-102.
Keywords:	related party transactions, arm's length transactions, corporate governance, financial disclosure
Purpose of the Study:	<p>Related party transactions are difficult to audit for a number of reasons:</p> <ul style="list-style-type: none"> • Related parties and transactions warranting examination may be difficult to identify. • Auditors must rely on management to provide detailed information on related parties and related party transactions. • Despite the increased internal control requirements imposed by the Sarbanes-Oxley Act of 2002, internal controls have difficulty tracking related party transactions. This difficulty arises because of the wide variety of parties and types of transactions and because some transactions may not be given accounting recognition, e.g., receipt of free services from a related party. <p>The authors examine research relevant to auditing related party transactions to contribute to the PCAOB project on this topic and to provide other policy makers, auditors, and academics with an overview of relevant literature. Specifically, they report on the challenges associated with the identification, examination, and disclosure of related party transactions. Additionally, they address issues and research evidence related to nondisclosure and reliance on management assertions, risk assessment, materiality, fraud detection, the effect of related party transactions on corporate governance, and international auditing issues.</p>
Design/Method/ Approach:	To prepare PCAOB Standing Advisory Group (SAG) members for discussion of these issues, the PCAOB staff prepared a briefing paper posing 13 broad questions for consideration by the SAG. The authors contribute to the PCAOB project by reviewing pertinent literature and providing appropriate insights from academic research relevant to auditing related party transactions. They highlight instances where existing research addresses the questions raised in the briefing paper.
Findings:	<p>The primary conclusions from the literature review are:</p> <ul style="list-style-type: none"> • The definition of related parties varies across regulatory bodies. • Related party transaction disclosures are present in the Securities and Exchange Commission (SEC) filings of most publicly held companies. • While listed as a fraud risk factor in authoritative literature, related party transactions do not appear to be more common in companies committing fraud than in companies in which no fraud has been detected. Accordingly, but in opposition to authoritative guidance, survey research indicates that the presence of related party transactions alone does not appear to significantly increase external auditors' client risk assessments. • Although related party transactions in isolation may not be a significant indicator of fraud, when fraud does exist, the presence of related party transactions is one of the top reasons cited for audit failures. The willingness of auditors to tolerate greater misstatement in footnotes may help partially explain this apparent contradiction. • Related party transactions should be assessed in the context of the company's overall governance structure, particularly given the importance of managements' assertions about the existence and nature of these transactions. <p>Related party transactions often impact the corporate governance of the company by creating gray directors, i.e., directors who are neither insiders nor totally independent of the company. Whether gray directors differentially impact a board's monitoring effectiveness may depend on the specific board committee (audit, compensation) or may depend on the specific type of gray director.</p>

research summary

Title:	Auditor Communications with the Audit Committee and the Board of Directors: Policy Recommendations and Opportunities for Future Research.
Practical Implications:	The review identifies insights for practice and opportunities for research on communication issues between the auditor, the audit committee, and the board. The authors strongly believe that the academic and the practice communities must have a continual dialogue so that standards reflect research, and research is directed to issues with the greatest potential to positively affect public policy. These implications should interest the PCAOB, the SEC, other standard-setters, and regulators that focus on issues related to corporate governance and financial reporting quality.
Citation:	Cohen, J., L. M. Gaynor, G. Krishnamoorthy, and A. M. Wright. 2007. Auditor Communications with the Audit Committee and the Board of Directors: Policy Recommendations and Opportunities for Future Research. <i>Accounting Horizons</i> 21 (2): 165-187.
Keywords	board of directors, communication between audit committees and external auditors, corporate governance, financial reporting quality, internal control reports
Purpose of the Study	In 2004 the Public Company Accounting Oversight Board (PCAOB) began considering a standard to improve guidance on the communication process between external auditors and audit committees. The Sarbanes-Oxley Act of 2002 expands and emphasizes the role of audit committees in ensuring the quality of reported financial results. This increased responsibility requires improved and expanded dialogue between audit committees and external auditors. In this paper, the authors review the extant academic literature to address relevant issues pertaining to communications between external auditors and audit committees on matters relevant to the integrity of the financial reporting process as well as to the PCAOB-developed discussion questions (DQs). Specifically, they examine literature regarding communications pertaining to overall financial reporting quality, internal controls, the external auditor's job performance, the form of communications (oral or written), and communications pertaining to the Management's Discussion and Analysis (MD&A) section of the annual report. For each major area, they discuss the implications of the academic research for standard-setters and identify future research opportunities for the academic community.
Design/Method/ Approach	The literature review primarily features research published in academic accounting and auditing journals. In an effort to capture the latest research available—as well as research on emerging topics, such as many of those precipitated by the passage of SOX—the authors also include working papers submitted to major archiving services. The authors searched electronic databases such as Ingenta, ABI/Inform, and American Accounting Association (AAA) Electronic Publications using keywords or combinations of keywords related to the various topics and subtopics discussed in this paper. They also searched Social Science Research Network (SSRN) and scholar.google.com to identify relevant working papers.
Findings	<ul style="list-style-type: none"> • Financial Reporting Quality: <ul style="list-style-type: none"> • Frequent communications with a well-informed, financially sophisticated audit committee and communications among the audit committee, the auditor, and the full board improve financial reporting quality. • Internal Controls: <ul style="list-style-type: none"> • The nature and the extent of communications between the auditor and the audit committee should be sensitive to whether a control weakness or deficiency relates to entity level controls or account-level controls, given the differentially serious implications of these two types of weaknesses. • Firm-specific factors (e.g., financial distress, company size) should influence communications and may require the auditor to report directly with the board on matters related to internal control. • The audit committee and the external auditor should discuss the quality of the internal audit function and the extent to which the external auditor is able to rely on the work performed by internal audit. • The audit committee should discuss with external auditors their policy to protect whistle-blowers. • External Auditor Performance: <ul style="list-style-type: none"> • It is important for the auditor to communicate to the audit committee all relationships with the client, the fees and nature of all services provided, and the extent to which any nonaudit services are beneficial to the audit. • The auditor should report all issues and proposed adjustments to the audit committee and the process used for resolving contentious issues. • The auditor should also report to the board its evaluation of the quality, effectiveness, and authority of the audit committee in discharging its responsibilities. • Other Issues: A review of the literature suggests that the MD&A should be more emphasized in the discussions between the audit committee and the auditors.

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research summary

Title:	A Summary of Research and Enforcement Release Evidence on Confirmation Use and Effectiveness.
Practical Implications:	The review of AAERs identified failure to authenticate responses, collusion between auditee management and customers, and concealed side agreements and special terms as specific problem areas. These findings have several implications for standard setters, practitioners, and academic researchers. First is a need to improve response rates, as well as authenticate responses. Technology, perhaps involving third-party intermediaries, can help address these issues. Second, depending on the circumstances and identified risks, auditors may need to confirm the existence of side agreements and special terms. Auditors may also need to consider the possibility of collusion in their testing strategies. In addition, confirmation requirements may need to be extended to other accounts, at least in some circumstances.
Citation:	Caster, P., R. J. Elder, and D. J. Janvrin. 2008. A Summary of Research and Enforcement Release Evidence on Confirmation Use and Effectiveness. <i>Auditing: A Journal of Practice & Theory</i> 27 (2): 253-279.
Keywords:	AAER evidence, audit confirmations, audit evidence, confirmation reliability
Purpose of the Study:	Confirmations are extensively used and are often perceived by practitioners to be one of the most persuasive forms of audit evidence. Yet academic research has found limitations that restrict confirmation effectiveness for many management assertions. In addition, a number of problems with false and forged confirmations are identified in Accounting and Auditing Enforcement Releases (AAERs). The Public Company Accounting Oversight Board (PCAOB) and the International Auditing and Assurance Standards Board (IAASB) have put confirmation evidence on their respective agendas. Academic research indicates that receivable confirmations can be effective evidence for the existence assertion. Low response rates, as well as respondent errors and directional bias in detecting errors, are key barriers to confirmation effectiveness. This study provides a synthesis of academic and practitioner research on confirmation use and effectiveness.
Design/Method/ Approach:	The authors conducted a review of the academic literature on confirmations. They found few current papers examining confirmations. Most prior research addressed the effectiveness of confirmation of accounts receivable. To provide additional evidence relevant to questions in the SAG briefing paper involving confirmation of other accounts, they reviewed AAERs and practitioner literature. They identified 113 confirmation-related AAERs involving 51 auditees.
Findings:	<p>The authors' primary findings are:</p> <ul style="list-style-type: none"> • Currently, some auditors choose not to confirm accounts receivable without justifying how they met one or more of the criteria in Statement on Auditing Standards (SAS) No. 67 for not confirming the accounts. • Generally, confirmations are relatively effective in testing the existence assertion for accounts receivable. However, low response rates have a negative impact on confirmation effectiveness. • Anecdotal evidence and some research suggest confirmation response rates are declining. Research has identified several methods to improve response rates. • Confirmations are also somewhat effective in examining the valuation assertion for accounts receivable. However, confirmees fail to detect many seeded errors in controlled experiments and are more likely to detect and report errors that are unfavorable to the confirmee rather than favorable errors. • Collusion between auditee management and the confirmee was a problem area in receivables confirmations identified from AAERs. The relationship between management and the confirmee calls into question the perception by auditors of confirmees as "independent" third parties. • Fictitious responses provided by auditee management were a problem area identified from a review of AAERs for accounts receivable and cash balance confirmations. Current auditing standards do not require auditors to authenticate responses. • Enforcement actions described in the AAERs indicated problems with bank confirmations. With the exception of accounts receivable, U.S. auditing standards related to confirmations do not provide explicit guidance for specific accounts, such as cash, marketable securities or other account balances, as well as confirmation of special terms or side agreements. <p>Considerable evidence exists that electronic confirmations and other forms of electronic database queries (i.e., defined views of supplier and/or customer databases) are becoming more prevalent. Technology offers alternatives to standard paper confirmations that may provide for authentication and improve confirmation effectiveness.</p>

research summary

Title:	Group judgment and decision making in auditing: Past and future research.
Practical Implications:	The insights highlighted in this paper from research on audit groups/teams inform one's understanding of how best to design group interactions between auditors within the firm and with professionals outside the audit firm, including management, audit committees, and inspectors. These insights are important given the criticism audit firms have faced from regulators and inspectors over the past decade and the multi-person setting present in auditing. Further, while a large literature exists on single-person decision-making, these studies may not generalize to multi-person settings. The review also highlights the need for continued research in this area and the importance audit practitioner involvement with future research efforts.
Citation:	Trotman, K., T. Bauer, and K. Humphreys. 2015. Group judgment and decision making in auditing: Past and future research. <i>Accounting, Organizations and Society</i> 47: 56-72.
Keywords:	Review process, brainstorming, consultation
Purpose of the Study:	This paper examines experimental research on audit groups/teams. The paper focuses on three main areas: 1) the hierarchical review process, 2) brainstorming as part of the fraud detection planning process, and 3) consultation within firms. The authors define research on audit groups/team as those papers where two or more individuals within the audit firm interact with one another face-to-face, electronically, or where one person prepares/reviews working papers for another. In addition to summarizing research to date in each of the three areas, the authors suggest directions for future research within the three areas as well as future research on within-firm group interactions. These areas include shared mental models, audit team diversity, and interactions with groups outside the audit firm, such as audit committees.
Design/Method/ Approach:	The paper summarizes research on group audit JDM experimental studies published in <i>Accounting, Organizations, and Society</i> , <i>Contemporary Accounting Research</i> , <i>Journal of Accounting Research</i> , and <i>The Accounting Review</i> from 1970 through 2015. Relevant working papers are also discussed.
Findings:	<p>Note: Given the breadth of this review paper, only select subsections are summarized below.</p> <ul style="list-style-type: none"> • Hierarchical review process: <ul style="list-style-type: none"> • What performance gains result from the review process? <ul style="list-style-type: none"> • The review process generally improves audit effectiveness. • However, it is not always effective as biases may not be mitigated by the review process, such as the recency effect. • Alternative forms of the review process: Includes research on comparing reviews with and without discussion, specialized versus all-encompassing reviews, and electronic versus face-to-face reviews. • Effects of the preparer on the review process: <ul style="list-style-type: none"> • Studies investigate the attributes of the preparer and the effects of preparer stylization on the review process. • Overall, preparer attributes and stylization have a significant impact on the review process. • Brainstorming: <ul style="list-style-type: none"> • Face-to-face interacting versus nominal brainstorming: Nominal groups generate more unique ideas than face-to-face interacting groups, due to process losses (e.g., production blocking) occurring in the face-to-face interacting context. • Interacting face-to-face brainstorming compared to alternate brainstorming formats: While unstructured face-to-face brainstorming is the most common method used by audit firms, other methods (e.g., providing guidelines or instructions) outperform this unstructured method with respect to the quantity of fraud risks identified and fraud hypotheses generated. • Electronic brainstorming: <ul style="list-style-type: none"> • Positive consequences of electronic brainstorming include minimizing production blocking and evaluation apprehension, however social loafing is a potential negative consequence. • Evidence supports the claim that electronic brainstorming is superior to face-to-face interaction, however as with non-electronic brainstorming, nominal electronic brainstorming outperforms interacting electronic brainstorming. • Consultation within firms: <ul style="list-style-type: none"> • Willingness to follow consulting advice: Auditors tend to incorporate advice received, however receiving advice can increase the tendency to follow aggressive client preferences. <p>Willingness to seek consulting advice: In general, auditors are more likely and willing to consult when related risk is high.</p>

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