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Auditors' Duty to Detect Related Party Transactions, to be Professionally Skeptical, and to Detect Fraud: A Case Study of Aegean Marine Petroleum Network, Inc.

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ABSTRACT: This is a case study of Aegean Marine Petroleum Network, Inc. (Aegean). Aegean's founder and former CEO was the mastermind of several fraud schemes which pilfered $300 million from the company. During 2006-2018, Aegean's Big 4 auditors, Deloitte and Price Waterhouse, failed to detect the fraud and issued clean, unqualified opinions year after year. After the fraud was discovered by Aegean's audit committee in 2018, a group of Aegean's stockholders filed a securities fraud lawsuit in New York City against the former CEO and the two auditors, and it will come to trial in the near future. U.S. Public Company Accounting Oversight Board (PCAOB) standards require an auditor to be professionally skeptical during an audit. He must maintain a questioning mind and make a critical objective assessment of audit evidence. In the Aegean case, the court held if the auditors had been more professionally skeptical, they may have been able to discover the massive fraud. PCAOB standards also require an auditor to search for related party transactions and to disclose them. In the Aegean case, the court noted it is inexcusable that the auditors were not aware that the former CEO owned Oil Tank, Inc., a firm which siphoned off millions of dollars from Aegean during the oil storage facility construction project. If they had been aware of this relationship, they might have been able to uncover the massive fraud. PCAOB standards also require an auditor to search for fraud. In the Aegean case, the former CEO engaged in several fraud schemes, yet the auditors were ignorant of them and issued unqualified audit opinions. This led the court to conclude that the auditors exhibited "willful blindness."

KEYWORDS: auditor, duty, detect, fraud, related, party, professional, skepticism

I. AUDITORS' DUTY TO BE PROFESSIONALLY SKEPTICAL

In 2002, the U.S. Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB). The PCAOB is charged with the responsibility of issuing and enforcing standards for auditors of firms whose stock is traded on a public stock exchange (Sarbanes-Oxley Act, 2002).

PCAOB standards require due professional care to be exercised in the planning and performance of the audit and in the preparation of the audit report. Due professional care requires the auditor to exercise "professional skepticism." Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor uses the knowledge, skill and ability required by the public accounting profession to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence (PCAOB, AS 1015.07).

Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit engagement, an auditor should be professionally skeptical during the audit. The auditor does not assume that management is dishonest, but neither does he assume that management is unquestionably honest. In exercising professional skepticism, an auditor should have persuasive evidence in order to justify his assessment that management is honest (PCAOB, AS 1015.08-.09).

II. AUDITORS' DUTY TO DETECT AND DISCLOSE RELATED PARTY TRANSACTIONS

PCAOB standards also require the auditor to obtain sufficient evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements (PCAOB, AS 2410.02)

An auditor must obtain an understanding of the client's relationships and transactions with its related parties. Toward that end, the auditor must first attain an understanding of the firm's procedures for identification of related parties, its transactions with them, and disclosure in the financial statements. Next, the auditor must make inquiries of management and the audit committee regarding related parties. After obtaining related party information, the auditor should communicate with the audit engagement team on-site so they can follow up if necessary (PCAOB, AS 2410.03-.09).

After gaining an understanding of the client's related parties and relevant transactions, the auditor must identify and assess the risk of material misstatement posed by related party transactions at both the financial statement level and the assertion level. Next, the auditor must design and implement audit responses that address the identified and assessed risks of material misstatement. For each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should determine: (a) the business purpose of the transaction; (b) whether it was authorized in accordance with the client's policies and procedures; and (c) the financial ability of the related party to pay significant uncollected balances or comply with other contractual obligations. The auditor also perform audit procedures on intercompany accounts (PCAOB, AS 2410.10-.13).

Next, the auditor must: (a) determine whether the client has properly identified its related parties and its transactions with them; (b) evaluate the client's financial statement accounting methods and disclosures; and (c) determine whether transactions with related parties were conducted on terms equivalent to those prevailing in arm's-length transactions (PCAOB, AS 2410.14-.18).

The auditor's conclusions must be communicated to the client's audit committee. The audit committee must be informed about: (a) related parties identified during the audit which were previously undisclosed to the auditor; (b) related party transactions that were not authorized by the firm's policies or procedures; (c) related party transactions for which exceptions to the firm's policies or procedures were granted; (d) the inclusion of any note in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction, and the evidence obtained by the auditor to support or contradict such an assertion; and (e) related party transactions that do not appear to have a business purpose (PCAOB, AS 2410.19).

III. AUDITORS' DUTY TO DETECT AND DISCLOSE FRAUD

Auditors have a responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement, *whether due to error or fraud*. (Emphasis added.) Absolute assurance is unattainable, so there is no guarantee that even a thorough audit will uncover a fraud (PCAOB, AS 2401.01, .12). Notwithstanding the auditor's fraud responsibility, management is ultimately responsible for the design and implementation of programs and controls to prevent and detect fraud (PCAOB, AS 2401.04).

Fraud is defined as "an intentional act that results in a material misstatement in financial statements" (PCAOB, AS 2401.05). Two types of misstatements are relevant to the consideration of fraud: those due to fraudulent financial reporting and those due to misappropriation of assets (PCAOB, AS 2401.06).

Management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information (PCAOB, AS 2401.08).

Fraud is usually concealed (PCAOB, AS 2401.09), but these conditions may be indicative of fraud: missing significant documents, subsidiary ledgers not reconciled to control accounts, or unexpected results of analytical procedures (PCAOB, AS 2401.11).

An auditor should recognize the possibility that fraud may exist, despite a general belief that management is honest. The auditor should be professionally skeptical and have an ongoing questioning of whether evidence gathered during the audit is indicative of fraud (PCAOB, AS 2401.13).

The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each relevant account and disclosure (PCAOB, AS 2401.52).

Audit procedures relating to fraud include: surprise inventory counts or cash counts, counting inventories at or near the end of the fiscal year, making oral inquiries of customers and suppliers in addition to written confirmations, performing substantive analytical procedures using disaggregated data, interviewing personnel working in locations with heightened fraud risk,[1] and overseeing the fraud-related work of auditors in other subsidiaries, branches or divisions of the firm being audited (PCAOB, AS 2401.53).

The audit procedures performed in response to a fraud risk relating to misappropriation of assets will be directed toward those assets that are most susceptible to misappropriation (PCAOB, AS 2401.56).

Audit procedures should also be developed to address the risk of management override of internal controls. These include: examination of journal entries for any evidence of material misstatement due to fraud (PCAOB, AS 2401.57-.62); reviewing accounting estimates for biases that could result in material misstatement due to fraud; and evaluating whether the business purpose for significant unusual transactions indicates those transactions may have been entered into as part of a fraud scheme (PCAOB, AS 2401.66, .67, .67A).

The auditor is responsible for communicating about possible fraud to management, the audit committee, the Securities and Exchange Commission, and others (PCAOB, AS 2401.79-.82).

Finally, the auditor has a duty to document all of the evidence uncovered pertinent to fraud (PCAOB, AS 2401.83).

IV. REVIEW OF THE LITERATURE

Feleaga (2016) discussed the disclosure of related party transactions by companies listed on the Bucharest Stock Exchange. Yilmaz (2016) studied how the new securities trading law in Oman requires transparency in related party transactions and the approval of the audit committee and the board of directors. Kang (2017) found that the presence of related party transactions had a significant positive correlation with auditors' acceptance of the earnings figures initially proposed by clients' managers. Vann (2018) studied how related party transactions and professional skepticism are related to auditors' ability to curb earnings management of clients. She found that Big 4 auditors are more adept at curbing earnings management that non-Big 4 auditors. Baah (2018) researched issues relating to audit quality (which encompasses the issue of related party transactions), in three countries: USA, UK and Ghana. Miculescu (2018) covered the prevalence of related party transactions in Romania and how an auditor should search for them during an audit. Elbayoumi (2019) considered the impact of related party transactions on the accounting and auditing professions in Egypt. Mehenthiran (2020) covered the prevalence of related party transactions in Chilean companies. He recommended a greater degree of periodic rotation of audit partners in order to facilitate the attainment of better financial statements by compelling restatement when related party transactions are discovered.

Missing from the literature is a case study of a recent legal case pertaining to an auditor's duties to: (a) be professionally skeptical; (b) detect and disclose related party transactions; and (c) detect and disclose fraud. This study will fill that void.

V. RESEARCH METHOD: A CASE STUDY OF AEGEAN MARINE PETROLEUM NETWORK, INC.

A. Facts of the Case

Dimitris Melissanidis (M) founded Aegean Marine Petroleum Network, Inc. (Aegean) in 1995 as a single bunkering station in Piraeus, Greece. Aegean grew into a marine fuel logistic company that supplied and marketed refined fuel and lubricants to ships in port and at sea. Aegean also owned and operated a fleet of bunkering tankers, which supplied fuel for use by ships. In 2005, Aegean was incorporated under the laws of the Marshall Islands, but it maintained its headquarters in Piraeus, Greece and also opened an office in New York City. M served as CEO of the new corporation from 2005 until 2006. During 2006-2018, M continued to serve Aegean as Head of Corporate Development and he exercised significant control over Aegean due to his large holding of Aegean stock (Aegean case, pp. 7-9).

On June 4, 2018, Aegean issued a press release announcing that a recently re-constituted audit committee had discovered $200 million of fictitious Accounts Receivable on the company's books that had to be written off. The Accounts Receivable had been improperly recorded as part of M's scheme to facilitate and conceal an extensive misappropriation of company assets channeled to Oil Tank, Inc. (a firm owned by M), but accounted for as transactions with shell companies (Aegean case, pp. 13-15).

On November 2, 2018, Aegean issued another press release announcing that M had fraudulently misappropriated $300 million of cash and other assets from the company. The scheme had involved the creation of forged bank statements, audit confirmations, contracts, invoices and third party certifications. Aegean admitted that its internal controls over financial reporting had been materially ineffective. As a result of the massive fraud, Aegean was forced to declare bankruptcy (Aegean case, pp. 13-15).

During 2006-2016, Deloitte Greece (Deloitte) had served as Aegean's auditor. During 2016-2018, Price Waterhouse Greece (PW) had served as Aegean's auditor. Both of these Big 4 auditors issued unqualified, clean audit opinions throughout their respective tenures (Aegean case, p. 12).

In 2018, a group of Aegean's stockholders filed a lawsuit against M and the two auditors in federal court in New York City. The complaint is grounded in securities fraud, and it alleges that the parties made "misstatements and omissions" regarding Aegean's financial position to the detriment of Aegean's shareholders. M and the auditors filed a Motion to Dismiss the lawsuit. On March 29, 2021, the court denied the Motion to Dismiss. M and the auditors will have to stand trial in the federal court in New York City in the near future (Aegean case, p. 13).

B. M's Fraud Schemes

M used several schemes to defraud Aegean of $300 million. They are: (a) the Oil Storage Facility Scheme, in which the cost of the oil storage facility in the UAE was fraught by cost overruns and resulted in huge payments to Oil Tank, Inc., a company owned by M; (b) the Fake Accounts Receivable Scheme, through which M caused Aegean to overstate its Accounts Receivable by $200 million during 2015-2017 by entering into contracts with four shell companies; (c) the Stock Repurchase Scheme, in which M arranged for Aegean to purchase his 22% stake in Aegean for $100 million, an inflated valuation, in 2016; and (d) the HEC Europe, Ltd. Acquisition Scheme, a company owned by M and through which M attempted to regain voting control of Aegean; this acquisition was ultimately enjoined when a group of shareholders filed for a temporary restraining order in 2018 (Aegean case, pp. 103-104).

C. Thirteen "Red Flags"

The court noted there were thirteen warning signals, or "red flags," that should have grabbed the auditors' attention and led to the detection of M's Fraud Schemes. They are:

1. M had a criminal background and a history of legal issues;
2. M owned a large amount of the outstanding common stock of the firm and was able to exert control over it;
3. The purchase of the storage facility in the United Arab Emirates, including the 2010 transaction in which Aegean assumed control of a property in that country under a 25-year lease for no consideration and subsequent payments for the construction of the facility to Oil Tank, Inc., a related party owned by M;
4. A 2005 marine fuel supply service agreement between Aegean and a related party, Aegean Oil S.A.;
5. Freight service agreements between Aegean and a related party, Aegean V;
6. A 2006 Registration Rights agreement between Aegean and a related-party, Leveret International, Inc. whereby Aegean agreed to pay some of Leveret's administrative expenses;
7. An increase in Aegean's Accounts Receivable between the fiscal years of 2015 and 2017, which turned out to be a fictitious increase;
8. Related party Aegean Shipping Management S.A.'s failure to make payments owed to Aegean on sales of marine petroleum in 2015 and 2016;
9. The failure of several companies in the United Arab Emirates to make payments due under contracts with Aegean;
10. Unpaid bills and financial losses at related party General Maritime Corporation, a firm with which Aegean transacted and for which Deloitte's U.S. division performed audits;
11. The Repurchase of the CEO's stock by Aegean at an inflated price in August, 2016;
12. The liquidity crisis Aegean faced after it repurchased M's shares in Aegean; and
13. Material weaknesses in Aegean's internal controls that Aegean management identified and disclosed in its 2014 Form 20-F, which were not addressed in Deloitte's FY 2015 clean audit or PW's FY 2016 clean audit (Aegean case, pp. 74-76).

D. Legal Issues in the Case

1. According to PCAOB standards, were the auditors sufficiently professional skeptical in this case?

No. The court held that auditors should be professionally skeptical during an audit, and that this requires the employment of a "questioning mind" in the "gathering and objective evaluation of evidence, including management representations. In this case, the CEO's reputation and history, the cost overruns at the new UAE storage facility, related-party transactions, and escalating Accounts Receivable called for "heightened scrutiny" by the auditors. The court concluded that if either of the auditors had conducted "any kind of audit at all, it would have seen the potential problems and the need to investigate further" (Aegean case, p. 80, citing PCAOB, AS 1015.07-.08).

2. According to PCAOB standards, did the auditors sufficiently search for related parties and take them into account during the audit?

No. Ordinarily, the presence of a related party transaction is not automatically considered to be a red flag of fraud. However, in this case the related party transactions should have grabbed the auditors' attention because they were instrumental in M's fraud schemes. For example, during the construction of the oil storage facility in the UAE, M siphoned off a huge amount of funds and

deposited them in his company, Oil Tank, Inc. The auditors had no knowledge that Oil Tank was M's company; this is inexcusable (Aegean case, p. 77).

3. According to PCAOB standards, should the "red flags" have put the auditors on notice that a Fraud Scheme might exist?
Yes. The auditors did not encounter the red flags in isolation. The auditors themselves acknowledged that the PCAOB standards requires them to assess the thirteen red flags together.
The auditors were presented with a significant number of related party transactions, unpaid accounts, a large increase in Accounts Receivable, and a founder and former CEO who still maintained significant control over the company and who benefitted from the expensive share buyback, which led to liquidity issues at the company. The court did not hold that all of the red flags were necessary to put the auditors on notice of the possibility of a Fraud Scheme. However, at the very least, the list of red flags should have "prompted further investigation" on the part of the auditors. (Longwei Case, p. 6). The court held that the auditors' failure to undertake an investigation supports a strong inference that the auditors intentionally or recklessly ignored the red flags. (Aegean case, p. 78).

The Court also stated that the magnitude of the fraud in this case--$300 million—shows circumstantial evidence of the auditors' scienter. "While a fraud's large size, standing alone, is insufficient to show the auditors' recklessness, the magnitude of the fraud does support an inference of scienter, just as failing to detect a large boulder in front of your face qualifies as circumstantial evidence of blindness" (Aegean case, p. 83).

4. Overall, did the court find that the auditors had complied with their professional obligations in this case?
No. The court held that the auditors' arguments made in this case amounted to a "virtual abandonment of their professional obligations." The auditors contended they were not required to investigate what was disclosed by Aegean, and they also contended they could not investigate what Aegean failed to disclose! Given the thirteen "red flags" that something was amiss, the court also held that the auditors "exhibited **willful blindness** in the face of numerous indications that something may have been awry" (Aegean case, pp. 79, 87, emphasis added).

E. Outcome of the Case
The auditors' Motion to Dismiss the case was Denied. M and the two auditors will have to stand trial in the federal court in New York City.

VI. CONCLUSIONS AND IMPLICATIONS FOR AUDITORS
A. An auditor must be professionally skeptical during an audit. He must maintain a questioning mind and a critical objective assessment of audit evidence. An auditor should not assume that management is dishonest, but neither does he assume that management is unquestionably honest. In the Aegean case, if the auditors had been more professionally skeptical and had maintained a more questioning attitude, they may have been able to discover the massive fraud.

B. An auditor has a duty to detect and disclose related parties and related party transactions. In the Aegean case, it is inexcusable that the auditors were not even aware that M owned Oil Tank, Inc., a firm which siphoned off millions of dollars from the oil storage facility construction project. If they had been aware of this relationship, they might have been able to uncover the massive fraud.

C. An auditor has a duty to detect and disclose fraud. In the Aegean case, M engaged in several fraud schemes, yet the auditors were completely unaware of those frauds and issued clean, unqualified opinions year after year. The court was correct when it concluded that the auditors exhibited "willful blindness."

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