No. 2014-41
22 October 2014

To the Point

PCAOB — final guidance

Spotlight on transactions with related parties, significant unusual transactions and executives

Auditors will be required to perform additional procedures in these critical areas.

What you need to know

- The SEC approved a new PCAOB standard on auditing transactions involving related parties and amendments to existing standards on auditing significant unusual transactions and relationships and transactions with a company's executives.
- Auditors will be required to make additional inquiries, review more documents, obtain additional representations from management and make certain new communications to audit committees.
- While auditors will have to review executives' employment contracts to understand the compensation structure, they will not have to make any determination about the reasonableness of compensation arrangements.
- The requirements are effective for audits for fiscal years beginning on or after 15 December 2014, including reviews of interim financial information in those years.

Overview

The Securities and Exchange Commission (SEC) approved a new Public Company Accounting Oversight Board (PCAOB) standard on auditing transactions with related parties and amendments to PCAOB standards on significant unusual transactions and a company's transactions and financial relationships with its executive officers.

The standard includes new requirements for evaluating how a company identifies, accounts for and discloses its transactions and relationships with related parties. The amendments also require auditors to perform procedures to (1) help them identify and evaluate the business

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purpose of significant unusual transactions[1] and (2) obtain, during the risk assessment process, an understanding of a company's financial relationships and transactions with its executive officers by, among other things, reading their employment contracts.[2]

The PCAOB developed the standard and the amendments to focus the auditor's attention on areas that have been associated with risks of fraudulent financial reporting and error. The PCAOB's intent is to increase the likelihood that an auditor will identify material misstatements.

Auditing Standard (AS) No. 18, *Related Parties*, will supersede an interim auditing standard and is effective for audits of financial statements performed in accordance with PCAOB standards for fiscal years beginning on or after 15 December 2014, including reviews of interim financial information in those years.

Related parties

The standard is intended to strengthen auditor performance requirements for identifying, assessing and responding to the risks of material misstatements associated with a company's relationships and transactions with related parties. The PCAOB noted that the existing standard provides examples of procedures the auditor could perform but does not require specific procedures. As a result, the PCAOB said, procedures performed by auditors could vary widely.

The new standard requires auditors to perform procedures, including the following:

- Understand and evaluate the process the company has in place to identify, authorize, approve, account for and disclose related party relationships and transactions
- Perform specific inquiries of management and others within the company[3] regarding the company's related parties, including the nature of any relationships, transactions entered into and the business purpose (or lack thereof), and any unauthorized related party transactions (or transactions where exceptions to policies were granted)
- Communicate relevant information about related parties within the engagement team, including to other auditors, and make inquiries of any other auditors
- Consider whether information that comes to the auditor's attention during the audit indicates the existence of a related party or related party transaction that management did not disclose to the auditor
- Take certain actions when the auditor identifies related parties or transactions with related parties that the company didn't disclose to the auditor by considering whether the nondisclosure was due to fraud or illegal acts and whether it indicates a deficiency in the control environment, among other things
- Evaluate whether evidence obtained supports or contradicts a management assertion in the financial statements that transactions with related parties were conducted on the same terms as arm's-length transactions (i.e., do not rely solely on management representations, even if they're couched as "management believes")
    - Express a qualified or adverse opinion if the auditor is unable to gather sufficient appropriate audit evidence to support such an assertion and management does not modify the disclosure
- Obtain from management a representation that there are no related party transactions or relationships that it has not disclosed to the auditors

- Make inquiries of audit committee members about their understanding of and concerns about related party transactions and make additional communications to audit committees about the auditor's evaluation of the company's identification of, accounting for and disclosure of related party transactions
- Perform specific procedures for related party transactions that are required to be disclosed in the financial statements or represent a significant risk,[4] including:
  - Read the documents relevant to the transaction and understand the business purpose (or the lack thereof)
  - Determine whether the transaction has been properly authorized and approved and whether any policy exceptions have been granted
  - Evaluate the financial capability of the related party to fulfill the terms of the transaction

How we see it

Companies should revisit the controls they have in place to identify, account for and disclose related party transactions. If auditors identify a related party or related party transaction that management didn't identify, the auditor would have to assess the control implications and perform additional procedures.

To meet some of the new requirements, auditors will need management assistance. For example, for any related party transactions that require financial statement disclosure or represent a significant risk, the standard makes explicit that auditors will have to evaluate the ability of the related parties to meet any financial obligations (e.g., those involving significant uncollected balances or guarantees), and therefore, auditors may need to perform additional work.

The additional procedures are intended to help auditors evaluate whether transactions have been entered into to engage in fraud.

Significant unusual transactions

The new requirements for significant unusual transactions are intended to help the auditor identify, assess and respond to risks of material misstatement associated with these transactions and determine whether the transactions have been appropriately accounted for and disclosed in the financial statements.

The amendments broaden the definition of significant unusual transactions in current standards by requiring auditors to perform procedures on significant transactions that "appear to be unusual due to their timing, size or nature," not just those that are unusual. Auditors will be required to perform new procedures to evaluate and obtain an understanding of the business purpose (or lack thereof) of transactions that they determine are significant unusual transactions. Factors for auditors to evaluate when determining whether a transaction may have been entered into to engage in fraud are also provided.

Financial relationships and transactions with executives

The amendments regarding a company's financial relationships and transactions with its executive officers,[5] including compensation, are intended to heighten the auditor's focus on incentives and pressures to achieve a particular financial position or operating result.

For compensation arrangements with executive officers, auditors will, at a minimum, need to read employment and compensation contracts, proxy statements and other relevant filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with executive officers to identify risks of material misstatement.

The amendments also require auditors to consider making inquiries of the compensation committee chair and any compensation consultants engaged by the company about the structure of the company's compensation for executive officers and to obtain an understanding of the company's policies and procedures for authorizing and approving executive officer expense reimbursements.

These audit procedures do not require the auditor to make any determination regarding the reasonableness of compensation arrangements or to make recommendations regarding compensation arrangements.

How we see it

The amendments do not affect processes that compensation committees use to design executive compensation programs. However, auditors may choose to make inquiries of and meet with the compensation committee and compensation consultants.

The definition of "executive officers" is relatively broad and may include individuals whose compensation is not described in the proxy statement. The requirement for the auditor to perform specific procedures to obtain an understanding of financial relationships and transactions with executive officers that can motivate or affect company accounting or reporting decisions is new.

Endnotes:

[1] AS Nos. 12 and 16, and AU Sections 315-316, 330, 333-334, 336, 560, 722 and 9334.

[2] AS Nos. 5, 9, 12, 13 and 16 and AU Sections 316 and 722.

[3] The auditor should identify others within the company who may have related party knowledge, such as internal auditors, in-house legal counsel, the chief compliance/ethics officer or human resources director.

[4] AS No. 12 defines a significant risk as a risk of material misstatement that requires special audit consideration.

[5] For issuers, the president; any vice president of a company in charge of a principal business unit, division or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policy-making functions for the company. For brokers and dealers, the term "executive officer" includes the chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions.