



## PCAOB Adopts Auditing Standard and Amendments to Increase Auditor Focus on Areas Vulnerable to Material Misstatement

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On June 10, 2014, the Public Company Accounting Oversight Board (“PCAOB”) adopted a new auditing standard, as well as amendments to its existing auditing standards, designed “to strengthen auditor performance requirements in three critical areas that historically have represented increased risks of material misstatement in company financial statements,” whether due to fraud or error.<sup>1</sup> These critical areas are:

- Relationships and transactions between a company and its related parties<sup>2</sup>;
- Significant transactions that are “outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature” (“significant unusual transactions”); and
- Financial relationships and transactions between a company and its executive officers.

New Auditing Standard No. 18 (the “Standard”) and the PCAOB’s amendments require the auditor’s heightened attention throughout the audit to these three types of relationships and transactions. Accordingly, the PCAOB believes that the Standard and amendments will increase the likelihood that an auditor will discover potential risks of material misstatement. According to the PCAOB, the Standard and amendments will “better address issues pertinent to fraudulent reporting” and will thus “promote audit quality and investor protection.”

If approved by the SEC, the Standard and amendments will apply to all audits performed pursuant to PCAOB standards and will go into effect “for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of interim financial information within these fiscal years.”

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<sup>1</sup> See “[Auditing Standard No. 18 – Related Parties, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Amendments to PCAOB Auditing Standards](#),” PCAOB Release No. 2014-002 (June 10, 2014).

<sup>2</sup> For purposes of “the auditor’s evaluation of a company’s identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties,” Auditing Standard No. 18 refers the auditor “to the requirements of the U.S. Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term ‘related parties’ and the financial statement disclosure requirements with respect to related parties.” *Id.* at A1-1, A1-1 n.1.

## I. RELATIONSHIPS AND TRANSACTIONS WITH RELATED PARTIES: AUDITING STANDARD NO. 18

Auditing Standard No. 18 is intended “to strengthen auditor performance requirements by setting forth specific procedures for the auditor’s evaluation of a company’s identification of, accounting for, and disclosure of relationships and transactions with its related parties.” According to the PCAOB, the Standard enhances the existing requirements for auditing relationships and transactions with related parties (found primarily in AU sec. 334) and requires the auditor to perform certain specific procedures, including:

- specific procedures to “obtain an understanding of the company’s relationships and transactions with its related parties, including an understanding of the nature of the relationships between the company and its related parties and of the terms and business purposes (or lack thereof) of transactions involving related parties”;
- specific procedures to evaluate the “accuracy and completeness” of management’s identification of related parties;
- specific procedures to investigate information indicating the existence of undisclosed relationships or transactions with a related party (and additional procedures upon confirming the existence of previously undisclosed relationships or transactions); and
- specific procedures “regarding each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk.”

The Standard also requires the auditor to provide the company’s audit committee with “the auditor’s evaluation of the company’s identification of, accounting for, and disclosure of its relationships and transactions with related parties,” as well as other significant related issues arising from the audit.

## II. SIGNIFICANT UNUSUAL TRANSACTIONS

The PCAOB adopted amendments to AU sec. 316 and other existing auditing standards in order to strengthen auditing requirements for identifying and evaluating significant unusual transactions. These amendments primarily require the auditor to perform specific procedures to identify significant unusual transactions and to understand and evaluate “the business purpose (or lack thereof) of identified significant unusual transactions.” The amendments also offer additional “factors for the auditor to consider in evaluating whether significant unusual transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.”

### III. FINANCIAL RELATIONSHIPS AND TRANSACTIONS WITH EXECUTIVE OFFICERS

The PCAOB adopted amendments adding required procedures to the auditor's risk assessment that are aimed at providing the auditor an understanding of the company's financial relationships and transactions with its executive officers. According to the PCAOB, these new procedures "are intended to heighten the auditor's attention to incentives or pressures for the company to achieve a particular financial position or operating result, recognizing the key role that a company's executive officers may play in the company's accounting decisions or in a company's financial reporting."<sup>3</sup>

### IV. PRACTICE POINTERS FOR PUBLIC COMPANIES

- The Standard and the amendments regarding financial relationships and transactions with executive officers serve as a good reminder of the importance of a properly drafted policy on related party transactions. Given the PCAOB's new and amended standards, now may be an opportune time for companies to revisit their policies to ensure that they are current and robust.
- The amendments requiring auditors' increased attention to significant unusual transactions highlight the importance of involving auditors early on with regard to such transactions, as well as, more generally, building and maintaining an open and transparent relationship with the auditors, so as to develop mutual trust.

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<sup>3</sup> The new procedures do not require the auditor to assess the appropriateness of executive compensation arrangements.

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