

Why Your Auditors May Be Asking Your Board About Related Party Transactions and Executive Compensation

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The SEC has [approved Auditing Standard No. 18](#), adopted by the PCAOB in June. The standards become effective for audits of financial statements for fiscal years beginning on or after December 15, 2014, including for emerging growth companies (ECGs).

We previously discussed the three areas of focus for Auditing Standard No. 18 in a [prior post](#). Related party transactions, significant unusual transactions and financial relationships and transactions with executive officers (such as executive compensation and perks) will be under increased scrutiny. The new auditing standards subject these types of transactions to additional risk-based procedures that are designed to assist the auditors in identifying red flags that may cause material misstatements. Companies should also be aware that the auditing standard opens up possible new lines of inquiries from auditors to boards of directors.

Related Party Transactions and the Audit Committee. The revised standard includes a requirement that the auditors communicate to the audit committee their evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, as well as significant matters arising from the audit regarding the company's relationships and transactions with related parties. This includes whether all transactions (a) were disclosed to the auditors, (b) were authorized in accordance with established policies and (c) have terms similar to those in arm's length transactions. In addition, auditors may ask audit committees, or their chairs, about their understanding of the company relationships with related party transactions and whether the audit committee has any concerns about those transactions.

Executive Compensation and the Compensation Committee. While the standard explicitly provides that the auditors' work does not include an assessment of the appropriateness or reasonableness of executive compensation arrangements, the changes are designed to heighten the auditors' attention to incentives or pressures for the company to achieve a particular financial position or operating results, recognizing the key role that a company's executive officers may play in the company's accounting decisions or financial reporting.

The auditors may ask the chair of the compensation committee and compensation consultants about the structure of executive compensation, including incentive compensation and perks. Audit procedures may include reading employment contracts with executives and proxy statements. In addition, auditors will need to obtain an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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