

PCAOB Adopts New Auditing Standard for Related Party and Other Transactions

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On June 10, the PCAOB adopted [Auditing Standard No. 18](#), which covers three key areas of increased risks for material misstatements: related party transactions, significant unusual transactions and financial relationships and transactions with executive officers. The PCAOB indicated that its inspection and enforcement activities found continuing weakness in auditors' scrutiny of these areas, and the new auditing standard requires additional risk-based procedures that are designed to assist the auditor in identifying red flags. The changes also affect auditor's communications with audit committees. Subject to SEC approval, the standards will become effective for audits of financial statements for fiscal years beginning on or after December 15, 2014.

Relationships and transactions with related parties. Related party transactions pose increased risks of material misstatement, as they may involve difficult measurement and recognition issues, provide an opportunity for management to act in its own interest, have been used in some instances to engage in fraud and, particularly important from an accounting perspective, their substance (such as the financial reality) may differ materially from their legal form. As to the definition of the term "related parties," auditors are expected to look to the requirements of the SEC relevant to the company under audit with respect to the accounting principles applicable to that company. In response to comments, the PCAOB clarified that the company is responsible for identifying its related parties and the auditor begins with the information obtained from the company, with the responsibilities to perform procedures to test the accuracy and completeness of the company's assessment. Management will need to provide written representation to the auditor that it has made available the names of all related parties and transactions with those.

What's new. The requirement to adopt basic procedures that are more in-depth, rather than suggested procedures, makes the standard different from existing AU sec. 334, including a focus on obtaining an understanding of the terms and business purposes (or the lack thereof) of related party transactions. Auditors must evaluate not only the adequacy of disclosure but also the accounting for the transactions. In addition, auditors will be required to communicate with the audit committee its evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.

Significant unusual transactions. Significant unusual transactions are generally transactions that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment, due to their size, timing and nature. Not surprisingly, they sometimes overlap with related party transactions.

What's new. Specific procedures have been developed to improve the auditor's identification of significant unusual transactions, for example, requiring auditors to make inquiries of management and others. Auditors must read the underlying documentation to determine whether the terms and other information are consistent with other audit evidence about the business purpose of the transaction, evaluate whether the transaction has been authorized and approved in accordance with company policies and procedures and assess the financial capability of the other parties to the transaction. There is an additional emphasis on focusing on the business purpose of the transaction due to concerns that the transactions may conceal fraud.

Financial relationships and transactions with executive officers. New procedures in this area are designed to heighten the auditor's attention to incentives or pressures for the company to achieve a particular financial position or operating result. In response to comments, clarifications were made to explicitly provide that this does not include an assessment of the appropriateness or reasonableness of executive compensation arrangements.

What's new. Auditors are already required to consider obtaining an understanding of compensation arrangements with senior management, and will now be required to perform additional procedures to understand the company's financial relationships and transactions with its executive officers as a risk analysis.

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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