

CLIENT UPDATE

PCAOB ADOPTS NEW RULES FOR SCRUTINY OF RELATED PARTY AND SIMILAR TRANSACTIONS

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The Public Company Accounting Oversight Board (“PCAOB”) last week adopted new Auditing Standard No. 18, *Related Parties*, together with related amendments to other auditing standards, which are intended to strengthen auditor procedures for identifying, assessing and responding to the risks of misstatement arising out of a company’s related party transactions, significant unusual transactions and financial relationships and transactions with executive officers.

The PCAOB emphasized the auditor role as gatekeeper and noted that related party transactions and significant unusual transactions have historically been associated with risks of fraudulent financial reporting and increased risk of error. The PCAOB determined that existing standards did not contain sufficient required procedures and risk assessment and identified continuing weakness in auditor’s scrutiny of these areas. Under the new standards, companies can expect a more rigorous examination of their identification of and accounting for related party and similar transactions by their auditors and increased communications with audit committees.

The new auditing standards and related amendments were adopted substantially as re-proposed by the PCAOB for public comment in May 2013. The standard and amendments will be effective, subject to SEC approval, for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of the relevant interim financial information.

RELATIONSHIPS AND TRANSACTIONS WITH RELATED PARTIES

New Auditing Standard No. 18, which supersedes PCAOB interim standard AU 334, *Related Parties*, is designed to enhance auditor review 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 related parties. The standard will require auditors, among other things, to:

- perform procedures to understand the terms and business purposes (or lack thereof) of any related party transactions;
- evaluate whether the company has completely and accurately identified its related parties and related party transactions; and
- communicate to the audit committee the auditor's evaluation of the company's overall treatment of its relationships and transactions with related parties.

For purposes of the standard, auditors will look to the definition of "related party" under SEC requirements applicable to the company. Many of the procedures mandated by the new standard were optional under AU 334 and, therefore, may already have been implemented by auditors in whole or in part with respect to certain companies, particularly larger companies with more robust audit procedures.

SIGNIFICANT UNUSUAL TRANSACTIONS

Revisions to PCAOB AU 316, *Consideration of Fraud in a Financial Statement Audit*, describe "significant unusual transactions" as 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. The related rules require auditors, among other things, to:

- perform specific procedures to identify significant unusual transactions, and to understand and evaluate their business purposes (or lack thereof); and
- consider factors that could indicate that a significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

Companies can expect auditors to focus on documentation underlying any significant unusual transaction, appropriate corporate approvals of the transaction and evaluation of financial aspects of the transaction.

FINANCIAL RELATIONSHIPS AND TRANSACTIONS WITH EXECUTIVE OFFICERS

The amendments to Auditing Standards No. 12, *Identifying and Assessing Risks of Material Misstatement*, are designed to heighten the auditor's attention to incentives or pressures for executive officers to have the company achieve a particular financial position or operating result. The PCAOB reiterated in adopting the amendments that the auditor's review of such relationships and transactions does not include an assessment of the appropriateness or reasonableness of the company's compensation arrangements.

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Please do not hesitate to contact us with any questions.

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