Securities Law ALERT

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SEC Approves PCAOB's New Related Party Auditing Standard and Other Related Amendments

On October 21, 2014, the Securities and Exchange Commission (SEC) approved the rules proposed earlier this year by the Public Company Accounting Oversight Board (the PCAOB).

In June 2014, the PCAOB adopted a new auditing standard, Auditing Standard No. 18, and amendments to other auditing standards to strengthen auditor performance requirements in three areas: related party transactions, 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 a company's financial relationships and transactions with its executive officers. The PCAOB believed that an auditor's efforts in these areas are often complementary given the nature and potential concerns in each of these focus areas.

Related Party Transactions

Auditing Standard No. 18 is designed to strengthen auditor performance requirements by establishing specific procedures to identify, assess and respond to the risks associated with a material misstatement related to a company's relationships and transactions with related parties. As such, Auditing Standard No. 18 requires the auditor to:

- Undertake specific procedures to obtain an understanding of the company's relationships and transactions with related parties;
- Analyze whether the company has properly identified related parties and relationships and transactions with them by testing the accuracy and completeness of management's identification of information during the audit;
- Execute specific procedures if the auditor determines the existence of a related party or relationship or transaction with a related party that was previously undisclosed to the auditor;

- Perform 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; and
- Inform the audit committee about the auditor's evaluation of the company's identification, accounting and disclosure of its relationships and transactions with related parties along with other significant matters arising from the audit concerning the company's relationships and transactions with related parties.

Auditing Standard No. 18 supersedes AU Section 334, *Related Parties*.

Significant Unusual Transactions

The SEC approved amendments to existing significant unusual transactions auditing requirements principally contained in AU Section 316, *Consideration of Fraud in a Financial Statement Audit*. The amendments concerning significant unusual transactions include specific procedures that are designed to:

- Require the auditor to perform procedures to identify significant unusual transactions;
- Require the auditor to perform procedures to evaluate and obtain an understanding of the business purpose or lack thereof of identified significant unusual transactions; and
- Add factors for the auditor to consider in evaluating whether significant unusual transactions may have been entered into to commit or conceal fraud.

The SEC also approved amendments to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*. The purpose of these amendments is to enhance the complementary linkages between the auditor's work concerning significant unusual transactions and related party transactions. The amendments also provide conforming changes to other PCAOB auditing standards to provide consistent use of the term "significant unusual transactions."

Financial Relationships and Transactions with Executive Officers

The SEC also approved amendments to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. By virtue of their unique position within a company, executive officers have the ability to influence a company's accounting and disclosures. As such, a company's financial relationships and transactions with its executive officers can create incentives and pressures for executive officers to meet financial targets, which can result in risks of material misstatement to a company's financial statements.

The amendments provide for improved audit procedures that address a company's financial relationships and transactions with its executive officers. These are intended to heighten the auditor's attention to incentives or pressures for the company to achieve a particular financial result in accounting decisions and financial reporting. In this regard, the auditor will not include an assessment of the appropriateness or reasonableness of executive compensation arrangements as such assessments would have shifted the focus of the current objectives of the audit.

Looking Forward

Auditing Standard No. 18 and the amendments to the existing auditing standards will apply to the audits of all issuers, including those of emerging growth companies and SEC-registered brokers and dealers. Auditing Standard No. 18 and other amendments will be effective 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.

Issuers should prepare for the additional standards by evaluating their internal procedures and recordkeeping regarding related party transactions.

If you have any questions or would like additional information on how to best prepare for these new standards, please contact your Alston & Bird attorney.

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