AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO **FLASH** REPORT ASSURANCE

SUBJECT

SEC APPROVES PCAOB AUDITING STANDARDS ON RELATED PARTIES, SIGNIFICANT UNUSUAL TRANSACTIONS, AND OTHER TOPICS

On October 21, 2014, the SEC approved the PCAOB's Proposed Rules on Auditing Standard No. 18, *Related Parties, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Amendments to PCAOB Auditing Standards* (AS 18), as previously adopted by the PCAOB in June 2014.

The new auditing standard and amendments are meant to strengthen auditor performance with respect to three critical areas that were considered to have been, and continue to be, contributing factors in numerous financial reporting frauds. These areas are:

1. related party transactions;
2. significant unusual transactions outside the ordinary course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature; and
3. a company's financial relationships and transactions with its executive officers.

AS 18 is 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. The following highlights specific requirements under AS 18 as part of an emphasis on and communications about overall audit quality which should be understood by both management and those charged with governance.

The PCAOB Release adopting AS 18 can be accessed here.

The following summarizes the more significant new requirements included within AS 18.

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AS 18, Related Parties

Alignment with the Risk Assessment Standards

AS 18, which supersedes AU sec. 334, *Related Parties*, is designed to align and build upon the PCAOB's risk assessment standards that were adopted in 2010. The new procedures are intended to be performed by auditors in conjunction with the procedures performed during the risk assessment process, which include obtaining an understanding of the company's relationships and transactions with its related parties. The more significant enhancements are explained below.

Management Inquiries

In obtaining an understanding of the client's related party relationships and transactions, in addition to the procedures auditors are currently required to perform, AS 18 now requires specific inquiry of management about the background information concerning the related parties (for example, the physical location, industry, size, and extent of operations); the business purpose for entering into a transaction with a related party versus an unrelated party; any related party transactions that have not been authorized and approved in accordance with the entity's established policies or procedures regarding the authorization and approval of transactions with related parties; and any related party transactions for which exceptions to the entity's established policies or procedures were granted and the reasons for granting such exceptions.

Additionally, auditors are required to identify others within the entity to whom inquiries are to be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding:

a. the entity's related parties or relationships or transactions with related parties;
b. the entity's controls over relationships or transactions with related parties; and
c. the existence of related parties or relationships or transactions with related parties previously undisclosed to us.

Examples of others within the company who may have such knowledge include: personnel in a position to initiate, process, or record transactions with related parties and those who supervise or monitor such personnel; internal auditors; in-house legal counsel; the chief compliance/ethics officer or person in an equivalent position; and the human resources director or person in an equivalent position.

Audit Committee Inquiries

With respect to inquires directed to audit committees, auditors are required to ask about (1) the audit committee's understanding of the entity's relationships and transactions with related parties that are significant to the entity, as well as (2) whether any member of the audit committee has concerns regarding related parties and, if so, the substance of those concerns.

Identifying, Assessing and Responding to Risks of Material Misstatement

As part of identifying and assessing the risks of material misstatement at the financial statement and assertion level, AS 18 requires auditors to assess whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties and determined whether such risks of material misstatement are significant. Moreover, AS 18 requires the auditor to read the underlying contracts or agreements for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk. This differs from current practice, whereby the auditor *inspects* the underlying contract or agreement. Furthermore, AS 18 has expanded the population of transactions on which procedures are required to be performed from 'identified significant related party transactions outside the entity's normal course of business' to 'each related party transaction that is required to be disclosed or represents a significant risk.' However, AS 18 provides some relief in this regard, in that if the applicable financial reporting framework allows for the aggregation of similar related party transactions for disclosure purposes, the auditor may perform the specified procedures for only a selection of transactions from each aggregation of related party transactions, commensurate with the risk of material misstatement.

Communication with Audit Committees

Communications with the audit committee have been enhanced to require communication of certain matters regarding related parties, including the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. Communication of other significant matters arising from the audit is also required, and includes:

- the identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- the identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- the identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;
- the inclusion of a statement in the financial statements that a transaction with a related party was conducted in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and
- the identification of significant related party transactions that appear to the auditor to lack a business purpose.

Consistent with the objective of AS 16, *Communications with Audit Committees*, these communications are required to be made in a timely manner.

Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions

The amendments regarding significant unusual transactions, which revise AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, strengthen the requirements for the identification and evaluation of significant unusual transactions. These amendments require the auditor to (1) perform procedures to identify significant unusual transactions, (2) perform procedures to obtain an understanding of, and evaluate, the business purpose (or lack thereof) of identified significant unusual transactions, and (3) consider certain factors in evaluating whether significant unusual transactions may have been entered into to engage in fraudulent reporting or conceal misappropriation of assets.

Financial Relationships and Transactions with Executive Officers

The amendments to existing standards regarding financial relationships and transactions with executive officers require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. Such amendments are intended to increase the auditor's attention on incentives or pressures for the company to achieve a particular financial position or operating result. These enhancements address the potential influence a company's executive officers may exert over the company's accounting and financial statement presentation. While this new focus represents an important risk assessment consideration, it is not intended to be an assessment of the appropriateness or reasonableness of executive compensation arrangements.