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Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules Relating to Auditing Standard No. 18, Related Parties, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Amendments to PCAOB Auditing Standards; Notice

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-72643; File No. PCAOB-2014-01]

### Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules Relating to Auditing Standard No. 18, Related Parties, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Amendments to PCAOB Auditing Standards

July 18, 2014.

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on July 10, 2014, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "SEC" or the "Commission") the proposed rules described in items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

#### I. Board's Statement of the Terms of Substance of the Proposed Rules

On June 10, 2014, the Board adopted Auditing Standard No. 18, *Related Parties* ("Auditing Standard No. 18" or the "standard"), amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other amendments to PCAOB auditing standards (collectively referred to as, the "standard and amendments" or the "proposed rules"). The amendments to certain PCAOB auditing standards regarding significant unusual transactions (the "amendments regarding significant unusual transactions") and other amendments to PCAOB auditing standards (the "other amendments") are collectively referred to herein as the "amendments." The text of the proposed rules is set out below.

#### Auditing Standard No. 18

##### *Related Parties*

##### Introduction

1. This standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.<sup>1</sup>

<sup>1</sup> The auditor should look to the requirements of the U.S. Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties" and the financial statement disclosure requirements with respect to related parties.

##### Objective

2. The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.<sup>2</sup>

Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions With Its Related Parties

3. The auditor should perform procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. The procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company's process (paragraph 4);
- b. Performing inquiries (paragraphs 5-7); and
- c. Communicating with the audit engagement team and other auditors (paragraphs 8-9).

**Note:** Obtaining an understanding of the company's relationships and transactions with its related parties includes obtaining an understanding of the nature of the relationships between the company and its related parties and of the terms and business purposes (or the lack thereof) of the transactions involving related parties.

**Note:** Performing the risk assessment procedures described in paragraphs 4-9 of this standard in conjunction with the risk assessment procedures required by Auditing Standard No. 12 is intended to provide the auditor with a reasonable basis for identifying and assessing risks of material misstatement associated with related parties and relationships and transactions with related parties.

##### Obtaining an Understanding of the Company's Process

4. In conjunction with obtaining an understanding of internal control over financial reporting, the auditor should obtain an understanding of the company's process for:<sup>3</sup>

<sup>2</sup> See, e.g., paragraphs 30-31 of Auditing Standard No. 14, *Evaluating Audit Results*. See also paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

<sup>3</sup> See, e.g., paragraph 18 of Auditing Standard No. 12, which requires the auditor to obtain a sufficient

a. Identifying related parties and relationships and transactions with related parties;

b. Authorizing and approving transactions with related parties; and

c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

##### *Performing Inquiries*

5. The auditor should inquire of management regarding:<sup>4</sup>

- a. The names of the company's related parties during the period under audit, including changes from the prior period;
- b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);
- c. The nature of any relationships, including ownership structure, between the company and its related parties;
- d. The transactions entered into, modified, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;
- e. The business purpose for entering into a transaction with a related party versus an unrelated party;
- f. Any related party transactions that have not been authorized and approved in accordance with the company's established policies or procedures regarding the authorization and approval of transactions with related parties; and
- g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

6. The auditor should inquire of others within the company regarding their knowledge of the matters in paragraph 5 of this standard. The auditor should identify others within the company<sup>5</sup> to whom inquiries

understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures. See also paragraph 20 of Auditing Standard No. 12, which states that obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

<sup>4</sup> See also AU sec. 333, *Management Representations*. Obtaining such representations from management complements the performance of procedures in paragraph 5 and is not a substitution for those inquiries.

<sup>5</sup> 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 equivalent position; and the human resources director or person in equivalent position.

should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding:

a. The company's related parties or relationships or transactions with related parties;

b. The company'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 the auditor.<sup>6</sup>

7. The auditor should inquire of the audit committee,<sup>7</sup> or its chair, regarding:

a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and

b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

#### *Communicating With the Audit Engagement Team and Other Auditors*

8. The auditor should communicate to engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.<sup>8</sup>

9. If the auditor is using the work of another auditor, the auditor should communicate to the other auditor relevant information about related parties, including the names of the company's related parties and the nature of the company's relationships and transactions with those related parties.<sup>9</sup> The auditor also should inquire

<sup>6</sup> For purposes of this standard, the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes, to the extent not disclosed to the auditor by management: (1) related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties.

<sup>7</sup> The term "audit committee" has the same meaning as the term used in Auditing Standard No. 16, *Communications with Audit Committees*.

<sup>8</sup> This communication, which can be more effective when it occurs at an early stage of the audit, complements the discussion among engagement team members regarding risks of material misstatement in accordance with paragraph 49 of Auditing Standard No. 12. See also paragraph 5 of Auditing Standard No. 10, *Supervision of the Audit Engagement*, which establishes requirements regarding supervision of the engagement team members, including directing engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities.

<sup>9</sup> See AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which describes the

of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.

#### *Identifying and Assessing Risks of Material Misstatement*

10. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level.<sup>10</sup> This includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties.

**Note:** In identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4–9 of this standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

#### *Responding to the Risks of Material Misstatement*

11. The auditor must design and implement audit responses that address the identified and assessed risks of material misstatement.<sup>11</sup> This includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.<sup>12</sup>

**Note:** The auditor also should look to the requirements in paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). For such related party transactions, AU sec. 316.67 requires that the auditor evaluate whether the business purpose (or the lack thereof) of the

auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements.

<sup>10</sup> See paragraph 59 of Auditing Standard No. 12.

<sup>11</sup> See paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

<sup>12</sup> See generally, Auditing Standard No. 13 and paragraph 17 of Auditing Standard No. 15, *Audit Evidence*, which provides that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

transactions indicates that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

#### *Transactions With Related Parties Required To Be Disclosed in the Financial Statements or Determined To Be a Significant Risk*

12. For each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should:

a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

b. Determine whether the transaction has been authorized and approved in accordance with the company's established policies and procedures regarding the authorization and approval of transactions with related parties;

c. Determine whether any exceptions to the company's established policies or procedures were granted;<sup>13</sup>

d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any;<sup>14</sup> and

e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

**Note:** The applicable financial reporting framework may allow the aggregation of similar related party transactions for disclosure purposes. If the company has aggregated related party transactions for disclosure purposes in accordance with the applicable financial reporting framework, the auditor may perform the procedures in paragraph 12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

#### *Intercompany Accounts*

13. The auditor should perform procedures on intercompany account balances as of concurrent dates, even if

<sup>13</sup> Information gathered while obtaining an understanding of the company also might assist the auditor in identifying agreements prohibiting or restricting related party transactions (for example, loans or advances to related parties).

<sup>14</sup> Examples of information that might be relevant to the auditor's evaluation of a related party's financial capability include, among other things, the audited financial statements of the related party, reports issued by regulatory agencies, financial publications, and income tax returns of the related party, to the extent available.

fiscal years of the respective companies differ.

**Note:** The procedures performed should address the risks of material misstatement associated with the company's intercompany accounts.

*Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions With Related Parties*

14. The auditor should evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, taking into account the information gathered during the audit.<sup>15</sup> As part of this evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

**Note:** Appendix A contains examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

15. If the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist.<sup>16</sup> These procedures should extend beyond inquiry of management.

<sup>15</sup> Information obtained from identifying and evaluating a company's significant unusual transactions and obtaining an understanding of a company's financial relationships and transactions with its executive officers could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

<sup>16</sup> See paragraph 29 of Auditing Standard No. 15, which states that if audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

16. If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;

b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;<sup>17</sup>

c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;

d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;

e. Perform the procedures required by paragraph 12 of this standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk; and

f. Perform the following procedures, taking into account the information gathered from performing the procedures in a. through e. above:

i. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;

ii. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk;<sup>18</sup> and

iii. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the

<sup>17</sup> See AU sec. 333.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.

<sup>18</sup> See paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.

auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. 78j-1.

*Evaluating Financial Statement Accounting and Disclosures*

17. The auditor must evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. This includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.<sup>19</sup>

*Assertions That Transactions With Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions*

18. If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.<sup>20</sup>

**Note:** Transactions with related parties might not be conducted on terms equivalent to those prevailing in arm's-length transactions (e.g., a company may receive services from a related party without cost). Except for routine transactions, it may not be possible for management to determine whether a particular transaction would have taken place, or what the terms and manner of settlement would have been, if the parties had not been related. Accordingly, it may be difficult for the auditor to obtain sufficient appropriate audit evidence to substantiate management's assertion that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. A preface to a statement such as "management believes that" or "it is the

<sup>19</sup> See paragraphs 30-31 of Auditing Standard No. 14.

<sup>20</sup> See paragraph .06.1. of AU sec. 333, which requires the auditor to obtain written representations from management if the financial statements include such an assertion. Representations from management alone are not sufficient appropriate audit evidence. See also paragraphs .35-.36 of AU sec. 508, *Reports on Audited Financial Statements*.

company's belief that" does not change the auditor's responsibilities.

#### *Communications With the Audit Committee*

19. The auditor should communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.<sup>21</sup> The auditor also should communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

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

#### **APPENDIX A—Examples of Information and Sources of Information That May Be Gathered During the Audit That Could Indicate That Related Parties or Relationships or Transactions With Related Parties Previously Undisclosed to the Auditor Might Exist**

A1. This Appendix contains examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Specifically, paragraph A2. of this Appendix contains examples of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Similarly, paragraph A3. contains examples of sources that could contain such information. The examples contained in this Appendix are not intended to represent a comprehensive listing.

A2. The following are examples of information that may be gathered during the audit that could indicate that related parties

or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Buying or selling goods or services at prices that differ significantly from prevailing market prices;
  - Sales transactions with unusual terms, including unusual rights of return or extended payment terms generally not offered;
  - "Bill and hold" type transactions;
  - Borrowing or lending on an interest-free basis or with no fixed repayment terms;
  - Occupying premises or receiving other assets or rendering or receiving management services when no consideration is exchanged;
  - Engaging in a nonmonetary transaction that lacks commercial substance;
  - Sales without economic substance (e.g., funding the other party to the transaction to facilitate collection of the sales price, or entering into a transaction shortly prior to period end and unwinding that transaction shortly after period end);
  - Loans to parties that, at the time of the loan transaction, do not have the ability to repay and possess insufficient or no collateral;
  - Loans made without prior consideration of the ability of the party to repay;
  - A subsequent repurchase of goods that indicates that at the time of sale an implicit obligation to repurchase may have existed that would have precluded revenue recognition or sales treatment;
  - Advancing company funds that are used directly or indirectly to pay what would otherwise be an uncollectible loan or receivable;
  - Sales at below market rates to an intermediary whose involvement serves no apparent business purpose and who, in turn, sells to the ultimate customer at a higher price, with the intermediary (and ultimately its principals) retaining the difference;
  - Guarantees and guarantor relationships outside the normal course of business; or
  - Transactions between two or more entities in which each party provides and receives the same or similar amounts of consideration (e.g., round-trip transactions).
- A3. The following are examples of sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:
- Periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies;
  - Disclosures contained on the company's Web site;
  - Confirmation responses and responses to inquiries of the company's lawyers;
  - Tax filings and related correspondence;
  - Invoices and correspondence received from the company's professional advisors, for example, attorneys and consulting firms;
  - Relevant internal auditors' reports;
  - Conflicts-of-interest statements from management and others;
  - Shareholder registers that identify the company's principal shareholders;
  - Life insurance policies purchased by the company;

- Records of the company's investments, pension plans, and other trusts established for the benefit of employees, including the names of the officers and trustees of such investments, pension plans, and other trusts;
- Contracts or other agreements (including, for example, partnership agreements and side agreements or other arrangements) with management;
- Contracts and other agreements representing significant unusual transactions;
- Significant contracts renegotiated by the company during the period under audit;
- Records from a management, audit committee, or board of directors' whistleblower program;
- Expense reimbursement documentation for executive officers; or
- The company's organizational charts.

#### *Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions*

##### *A. Identifying Significant Unusual Transactions*

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements*

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements*, as amended, is amended as follows:

In paragraph 14:

- The first bullet point is replaced with:

Controls over 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"), particularly those that result in late or unusual journal entries;<sup>10A/</sup> and

- Footnote 10A is added at the end of the first bullet:

<sup>10A/</sup> See paragraphs .66-.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

Auditing Standard No. 9, *Audit Planning*

Auditing Standard No. 9, *Audit Planning*, as amended, is amended as follows:

In paragraph 12, subparagraph a. is replaced with:

The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, e.g., 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") executed at the location or business unit.<sup>14/</sup>

##### *Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement*

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is Amended as follows:

a. In paragraph 13:

- The fifth bullet point is replaced with:

The methods the company uses to account for significant transactions that are outside the normal course of business for the company or that otherwise appear to be

<sup>21</sup> See Auditing Standard No. 16 regarding the timing of the communications to the audit committee.

unusual due to their timing, size, or nature (“significant unusual transactions”);<sup>7A</sup> and

- Footnote 7A is added at the end of the fifth bullet:

<sup>7A</sup> See AU secs. 316.66–.67A.

b. In paragraph 56.a.:

- In item (6), delete the word “and” at the end of the item.

- In item (7), change the period (.) at the end of the phrase to a semicolon (;) and add the word “and” after the semicolon.

- Add Item (8):

(8) Whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties.<sup>31A</sup>

- Add footnote 31A at the end of item (8):

<sup>31A</sup> See AU secs. 316.66–.67A.

c. In paragraph 56.b.:

- In item (3), delete the word “and” at the end of the item.

- In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word “and” after the semicolon.

- Add item (5):

(5) Whether the company has entered into any significant unusual transactions.

d. In paragraph 56.c.:

- In item (3), delete the word “and” at the end of the item.

- In item (4), change the period (.) at the end of the phrase to a semicolon (;) and add the word “and” after the semicolon.

- Add item (5):

(5) Whether the company has entered into any significant unusual transactions.

e. In paragraph 57, the third bullet point is replaced with:

Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements, a significant unusual transaction, or a significant related party transaction; and

f. Paragraph 71.g., is replaced with:

Whether the risk involves significant unusual transactions.

g. Paragraph 73A is added after paragraph 73:

73A. The auditor should obtain an understanding of the controls that management has established to identify, authorize and approve, and account for and disclose significant unusual transactions in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18–40 and 72–73 of this standard.

#### *Auditing Standard No. 13, The Auditor’s Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor’s Responses to the Risks of Material Misstatement*, as amended, is amended as follows:

a. The second sentence of footnote 3 to paragraph 5.d. is replaced with:

See also paragraphs .66–.67A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and paragraphs .04 and .06 of AU sec. 411, *The Meaning of Present*

#### *Fairly in Conformity With Generally Accepted Accounting Principles.*

b. Paragraph 15.c. is replaced with:

Evaluating whether the business purpose for 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”) indicates that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets (AU secs. 316.66–.67A).

AU sec. 316, “Consideration of Fraud in a Financial Statement Audit”

SAS No. 99, “Consideration of Fraud in a Financial Statement Audit” (AU sec. 316, “Consideration of Fraud in a Financial Statement Audit”), as amended, is amended as follows:

a. The first item in paragraph .85A.2, section a., under “Opportunities” is replaced with the following two items:

- Related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business)

- Significant transactions with related parties whose financial statements are not audited or are audited by another firm

b. The fourth item in paragraph .85A.2, section a., under “Opportunities” is replaced with:

- Significant or highly complex transactions or significant unusual transactions, especially those close to period end, that pose difficult “substance-over-form” questions

c. The following item is added as the last item to paragraph .85A.2, section a., under “Opportunities”:

- Contractual arrangements lacking a business purpose

AU sec. 722, “Interim Financial Information”

SAS No. 100, “Interim Financial Information” (AU sec. 722, “Interim Financial Information”), as amended, is amended as follows:

a. In paragraph .55, Appendix B, paragraph B1., the tenth bullet is replaced with the following two bullets:

- The occurrence of infrequent transactions
- The occurrence of significant unusual transactions

#### *B. Evaluating Significant Unusual Transactions*

Auditing Standard No. 13, *The Auditor’s Responses to the Risks of Material Misstatement*

Auditing Standard No. 13, *The Auditor’s Responses to the Risks of Material Misstatement*, as amended, is amended as follows:

a. Paragraph 11A is added after paragraph 11:

11A. *Responding to Risks Associated with Significant Unusual Transactions.* Paragraph 71.g. of Auditing Standard No. 12 indicates that one of the factors to be evaluated in determining significant risks is whether the risk involves significant unusual transactions. Also, AU secs. 316.66–.67A

establish requirements for performing procedures to respond to fraud risks regarding significant unusual transactions. Because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66–.67A.

Auditing Standard No. 16, *Communications with Audit Committees*

Auditing Standard No. 16, *Communications with Audit Committees*, is amended as follows:

a. In paragraph 13.d., the phrase “rationale for” is replaced with the phrase “purpose (or the lack thereof) of.”

AU sec. 316, “Consideration of Fraud in a Financial Statement Audit”

SAS No. 99, “Consideration of Fraud in a Financial Statement Audit” (AU sec. 316, “Consideration of Fraud in a Financial Statement Audit”), as amended, is amended as follows:

a. Paragraph .66 is replaced with:  
.66 Evaluating whether the business purpose for significant unusual transactions indicates that the transactions may have been entered into to engage in fraud. 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”) may be used to engage in fraudulent financial reporting or conceal misappropriation of assets.

**Note:** The auditor’s identification of significant unusual transactions should take into account information obtained from: (a) The risk assessment procedures required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial reporting) and (b) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

**Note:** The auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions. See paragraphs 14–16 of Auditing Standard No. 18, *Related Parties*. Appendix A of Auditing Standard No. 18, *Related Parties*, includes examples of such information and examples of sources of such information.

b. Paragraph .66A is added after paragraph .66:

.66A The auditor should design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. The procedures should include:

a. Reading the underlying documentation and evaluating whether the terms and other

information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

b. Determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;

c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; <sup>fn 24A</sup> and

d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

**Note:** Paragraph 11A of Auditing Standard No. 13 requires the auditor to take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures.

c. Footnote 24A is added after subparagraph c. of paragraph .66A

<sup>fn 24A</sup> Examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

d. Paragraph .67 is replaced with:

.67 The auditor should evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. In making that evaluation, the auditor should evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);

- The transaction involves unconsolidated related parties, including variable interest entities;

- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor; <sup>fn 25A</sup>

- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party of the company;

- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);

- The transaction occurs with a party that falls outside the definition of a related party (as defined by the accounting principles applicable to that company), with either party able to negotiate terms that may not be available for other, more clearly independent, parties on an arm's-length basis;

- The transaction enables the company to achieve certain financial targets;

- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction (e.g., accounting-motivated structured transaction); and

- Management has discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

**Note:** Paragraphs 20–23 of Auditing Standard No. 14, *Evaluating Audit Results*, provide requirements regarding the auditor's evaluation of whether identified misstatements might be indicative of fraud.

e. Footnote 25 is deleted and footnote 25A is added at the end of the third bullet in paragraph .67:

<sup>fn 25A</sup> Related parties or relationships or transactions with related parties previously undisclosed to the auditor includes, to the extent not disclosed to the auditor by management: (1) Related parties; (2) relationships or transactions with known related parties; and (3) relationships or transactions with previously unknown related parties. Auditing Standard No. 18, *Related Parties*, requires the auditor to perform certain procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

f. Paragraph .67A is added after paragraph 67:

.67A The auditor must evaluate whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements. This includes evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework. <sup>fn 25B</sup>

**Note:** The auditor considers management's disclosure regarding significant unusual transactions in other parts of the company's Securities and Exchange Commission filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

g. Footnote 25B is added at the end of paragraph .67A:

<sup>fn 25B</sup> See paragraphs 30–31 of Auditing Standard No. 14.

#### *Other Amendments to PCAOB Auditing Standards*

##### *Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement*

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is amended as follows:

a. The following sentence is added to the end of footnote 3 of paragraph 4:

Also, Auditing Standard No. 18, *Related Parties*, requires the auditor to perform procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements.

b. In paragraph 10, the note following the final bullet is deleted.

c. Paragraph 10A is added after paragraph 10:

10A. To assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the Securities and Exchange Commission and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.

d. In paragraph 11:

- The third bullet is replaced with:

Obtaining an understanding of compensation arrangements with senior management other than executive officers referred to in paragraph 10A, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses;

- In the fourth bullet, delete the period (.) and add a semicolon (;) at the end of the bullet.

- Add a fifth bullet:

Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and

- Add a sixth bullet:

Obtaining an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

e. In Appendix A, paragraph A3A is added after paragraph A3:

A3A. Executive officer—For issuers, the president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policy-making functions for the company. (See Rule 3b–7 under the Exchange Act.) For brokers and dealers, the term “executive officer” includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions. (See Schedule A of Form BD.)

Auditing Standard No. 16, *Communications with Audit Committees*

Auditing Standard No. 16, *Communications with Audit Committees*, is amended as follows:

a. The phrase “AU sec. 334, *Related Parties*” in footnote 25 is replaced with the phrase “Auditing Standard No. 18, *Related Parties*.”

b. The following bullet is inserted after the third bullet in Appendix B:

- Auditing Standard No. 18, *Related Parties*, paragraphs 7 and 19.

AU sec. 315, “Communications Between Predecessor and Successor Auditors”

SAS No. 84, “Communications Between Predecessor and Successor Auditors” (AU sec. 315, “Communications Between Predecessor and Successor Auditors”), as amended, is amended as follows:

a. The following bullet is added to the end of paragraph .09:

- The predecessor auditor’s understanding of the nature of the company’s relationships and transactions with related parties and significant unusual transactions.<sup>fn 5A</sup>

b. Add the following footnote to the end of paragraph .09:

<sup>fn 5A</sup> Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, describes significant unusual transactions.

c. In paragraph .11, replace the fifth sentence with:

The predecessor auditor should ordinarily permit the successor auditor to review working papers, including documentation of planning, internal control, audit results, and other matters of continuing accounting and auditing significance, such as the working papers containing an analysis of balance sheet accounts, those relating to contingencies, related parties, and significant unusual transactions.

AU sec. 316, “Consideration of Fraud in a Financial Statement Audit”

SAS No. 99, “Consideration of Fraud in a Financial Statement Audit” (AU sec. 316, “Consideration of Fraud in a Financial Statement Audit”), as amended, is amended as follows:

a. The heading before paragraph .79 is replaced with:

Communication about Possible Fraud to Management, the Audit Committee, the Securities and Exchange Commission, and Others<sup>fn 37</sup>

b. Paragraph .81A is added after paragraph .81:

.81A The auditor has a responsibility, under certain conditions, to disclose possible fraud to the Securities and Exchange Commission to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change and the fraud or related risk factors constitute a reportable event or are the source of a disagreement, as these terms are defined in Item 304 of Regulation S-K and Item 16F of Form 20-F. These requirements also include reports that may be required pursuant to Section 10A(b) of the Securities Exchange

Act of 1934 relating to an illegal act that the auditor concludes has a material effect on the financial statements.

c. For paragraph .82:

- Footnotes 39 and 41 are deleted.
- The paragraph is replaced with:

.82 The auditor also may have a duty to disclose the existence of possible fraud to parties outside the entity in the following circumstances:

a. To a successor auditor when the successor makes inquiries in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors*.<sup>fn 40</sup>

b. In response to a subpoena.

c. To a funding agency or other specified agency in accordance with requirements for the audits of companies that receive governmental financial assistance.

d. The following item is added to paragraph .85A.2, section b., under “Opportunities”:

- The exertion of dominant influence by or over a related party

AU sec. 330, “The Confirmation Process”

SAS No. 67, “The Confirmation Process” (AU sec. 330, “The Confirmation Process”), as amended, is amended as follows:

a. Footnote 2 to paragraph .27 is replaced with:

Auditing Standard No. 18, *Related Parties*, establishes requirements regarding the auditor’s evaluation of relationships and transactions between the company and its related parties.

AU sec. 333, “Management Representations”

SAS No. 85, “Management Representations” (AU sec. 333, “Management Representations”), as amended, is amended as follows:

a. The third sentence of paragraph .03 is replaced with:

For example, after the auditor performs the procedures described in Auditing Standard No. 18, *Related Parties*, the auditor should obtain a written representation that management has no knowledge of any relationships or transactions with related parties that have not been properly accounted for and adequately disclosed. The auditor should obtain this written representation even if the results of those procedures indicate that relationships and transactions with related parties have been properly accounted for and adequately disclosed.

b. In paragraph .06:

- Subparagraph c. is replaced with:

Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Subparagraph f. is replaced with:

Absence of (1) unrecorded transactions and (2) side agreements or other arrangements (either written or oral) undisclosed to the auditor.

- Subparagraph l. is replaced with:

Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm’s-length transaction.<sup>fn 9</sup>

c. Footnote 9 to paragraph .06 is replaced with:

See paragraph 18 of Auditing Standard No. 18, *Related Parties*.

d. The second sentence in paragraph 4 of Appendix A is replaced with:

Examples are fraud, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in Auditing Standard No. 18, *Related Parties*.

e. In paragraph 6 of Appendix A:

- Item 2.a. is replaced with: Financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Item 11.d. is added:

Side agreements or other arrangements (either written or oral) that have not been disclosed to you.

AU sec. 334, “Related Parties”

SAS No. 45, Omnibus Statement on Auditing Standards—1983 (AU sec. 334, “Related Parties”), as amended, is superseded.

AU sec. 9334, “Related Parties: Auditing Interpretations of Section 334”

AU sec. 9334, “Related Parties: Auditing Interpretations of Section 334,” as amended, is superseded.

AU sec. 336, “Using the Work of a Specialist”

SAS No. 73, “Using the Work of a Specialist” (AU sec. 336, “Using the Work of a Specialist”), as amended, is amended as follows:

a. Footnote 6 of paragraph .10 is replaced with:

The term *relationship* includes, but is not limited to, those situations meeting the definition of “related parties” contained in the financial reporting framework applicable to the company under audit.

AU sec. 560, “Subsequent Events”

SAS No. 1, “Codification of Auditing Standards and Procedures,” section 560, “Subsequent Events” (AU sec. 560, “Subsequent Events”), as amended, is amended as follows:

a. In paragraph .12b.:

- Item (v) is added:

Whether there have been any changes in the company’s related parties.

- Item (vi) is added:

Whether there have been any significant new related party transactions.

- Item (vii) is added:

Whether the company has entered into any significant unusual transactions.

AU sec. 722, “Interim Financial Information”

SAS No. 100, “Interim Financial Information” (AU sec. 722, “Interim Financial Information”), as amended, is amended as follows:

a. In paragraph .24:

- Subparagraph g. is replaced with:

Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Subparagraph j. is replaced with:

Absence of (1) unrecorded transactions and (2) side agreements or other arrangements



(either written or oral) undisclosed to the auditor.

- Subparagraph m. is replaced with: Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

b. The second sentence of paragraph C5 of paragraph .56 is replaced with:

Examples are *fraud*, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and related parties, in Auditing Standard No. 18, *Related Parties*.

c. Within paragraph C6 of paragraph .56, within the first illustrative representation letter (1.) for a review of interim financial information (statements):

- Item 2.a. is replaced with: All financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

d. Within paragraph C6 of paragraph .56, within the second illustrative representation letter (2.) for a review of interim financial information (statements):

- Item 2.a. is replaced with: All financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

- Item 12.d. is added: Side agreements or other arrangements (either written or oral) that have not been disclosed to you.

## II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements. In addition, the Board is requesting that the Commission approve the proposed rules, pursuant to Section 103(a)(3)(C) of the Sarbanes-Oxley Act, for application to audits of emerging growth companies ("EGCs"), as that term is defined in Section 3(a)(80) of the Securities Exchange Act of 1934 (the "Exchange Act"). The Board's request is set forth in Section D below.

### A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

#### (a) Purpose

##### Introduction

The Board is adopting a new auditing standard and amendments to its auditing standards to strengthen auditor

performance requirements in three critical areas that historically have represented increased risks of material misstatement in company financial statements. 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,<sup>22</sup> have been contributing factors in numerous financial reporting frauds over the last several decades.<sup>23</sup> Prominent corporate scandals involving these critical areas served to undermine investor confidence and resulted in significant losses for investors, as well as the loss of many jobs.<sup>24</sup> These critical areas have continued to be contributing factors in more recent cases.<sup>25</sup> As discussed below, the Board's oversight activities indicate that there are continuing weaknesses in auditors' scrutiny of these areas.

The Board developed the standard and amendments because, as described more fully below, the Board believes its

<sup>22</sup> A company's related party transactions, significant unusual transactions, and financial relationships and transactions with its executive officers, are collectively referred to herein as "the critical areas" or "these critical areas."

<sup>23</sup> Such prominent corporate scandals include Enron Corporation, Tyco International, Ltd., Refco, Inc., and WorldCom, Inc. For a more detailed discussion of such financial reporting frauds, see: (i) *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (the "proposing release" or the "proposal"), PCAOB Release No. 2012-001 (February 28, 2012) at 9-11, [http://pcaobus.org/Rules/Rulemaking/Docket038/Release\\_2012-001\\_Related\\_Parties.pdf](http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2012-001_Related_Parties.pdf) and (ii) *Proposed Auditing Standard—Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (the "reproposing release" or the "reproposal"), PCAOB Release No. 2013-004 (May 7, 2013) at 2, [http://pcaobus.org/Rules/Rulemaking/Docket038/Release%202013-004\\_Related%20Parties.pdf](http://pcaobus.org/Rules/Rulemaking/Docket038/Release%202013-004_Related%20Parties.pdf).

<sup>24</sup> In one such example, Enron Corporation was the nation's largest natural gas and electric marketer, with reported annual revenue of more than \$150 billion. When it filed for bankruptcy on December 2, 2001, its stock price had dropped, in less than a year, from more than \$80 per share to less than \$1. See *SEC Settles Civil Fraud Charges Filed Against Richard A. Causey, Former Enron Chief Accounting Officer; Causey Barred From Acting as an Officer or Director of a Public Company* (U.S. Securities and Exchange Commission ("SEC" or "Commission") Litigation Release No. 19996, February 9, 2007).

<sup>25</sup> See, e.g., SEC Accounting and Auditing Enforcement Release ("AAER") No. 3447, *SEC v. Keyuan Petrochemicals, Inc. and Aichun Li* (February 28, 2013), and SEC AAER No. 3385, *SEC v. China Natural Gas, Inc. and Qinan Ji* (May 14, 2012).

existing requirements need to be strengthened to heighten the auditor's attention to areas that have been associated with risks of fraudulent financial reporting and that also may pose increased risks of error. The Board has concluded that its existing requirements in these critical areas do not contain sufficient required procedures and are not sufficiently risk-based, which can lead to inadequate auditor effort in the critical areas. The auditor, serving in the role as a gatekeeper<sup>26</sup> in the financial reporting system, should be alert to the possibility that transactions in these critical areas pose increased risks and, thus, require heightened scrutiny during the audit.<sup>27</sup> Increased auditor attention to these critical areas should, in the Board's view, increase the likelihood of the auditor identifying material misstatements.

The standard and amendments being adopted by the Board include: the standard; amendments regarding significant unusual transactions; and other amendments. As described below, the standard and amendments address:

- Relationships and Transactions with Related Parties;
- Significant Unusual Transactions; and
- Financial Relationships and Transactions with Executive Officers.

*Relationships and Transactions with Related Parties:* The standard addresses the auditing of relationships and transactions between a company and its

<sup>26</sup> According to the SEC, "The federal securities laws, to a significant extent, make independent auditors "gatekeepers" to the public securities markets. These laws require, or permit us to require, financial information filed with us to be certified (or audited) by independent public accountants. Without an opinion from an independent auditor, the company cannot satisfy the statutory and regulatory requirements for audited financial statements and cannot sell its securities to the public. The auditor is the only professional that a company must engage before making a public offering of securities and the only professional charged with the duty to act and report independently from management." See SEC Securities Act Release No. 33-7870, *Proposed Rule: Revision of the Commission's Auditor Independence Requirements* (June 30, 2000) at Section II.A. See also, SEC Securities Act Release No. 33-7919, *Final Rule: Revision of the Commission's Auditor Independence Requirements* (November 21, 2000) at Section III.A.

<sup>27</sup> See, e.g., SEC AAER No. 3427, *In the Matter of the Application of Wendy McNeely, CPA*, at 10-12 (December 13, 2012), <http://www.sec.gov/litigation/opinions/2012/34-68431.pdf>. That opinion states, in part, that the SEC and courts have repeatedly held that related party transactions require heightened scrutiny by auditors. See also *McCurdy v. SEC*, 396 F3d 1258, 1261 (D.C. Cir. 2005) (citing *Howard v. SEC*, 376 F3d 1136, 1149 (D.C. Cir. 2004) noting that related-party transactions "are viewed with extreme skepticism in all areas of finance," aff'g James Thomas McCurdy, CPA, 57 SE.C. 277 (2004)).

related parties. A company's related party transactions could pose increased risks of material misstatement, as their substance might differ materially from their form.<sup>28</sup> Related party transactions also may involve difficult measurement and recognition issues that can lead to errors in financial statements. Such transactions potentially provide more of an opportunity for management to act in its own interests, rather than in the interests of the company and its investors. Moreover, in some instances, related party transactions have been used to engage in fraudulent financial reporting and to conceal misappropriation of assets—types of misstatements that are relevant to the auditor's consideration of fraud.<sup>29</sup> The importance to investors of auditing related party transactions is reflected in Section 10A of the Securities Exchange Act of 1934 (the "Exchange Act"), which requires each audit of financial statements of an issuer to include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."<sup>30</sup> The standard is designed to strengthen auditor performance requirements by setting forth specific procedures for the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. The standard supersedes the Board's existing standard, AU sec. 334, *Related Parties*, (the "existing standard"), which has not been substantively updated since it was issued in 1983.<sup>31</sup>

**Significant Unusual Transactions:** The amendments regarding significant unusual transactions recognize that a company's significant unusual transactions can create complex accounting and financial statement disclosure issues that could pose increased risks of material misstatement. In some instances, significant unusual transactions have been used to engage in fraudulent

financial reporting. For example, significant unusual transactions, especially those close to period end that pose difficult "substance-over-form" questions, may be entered into to obscure a company's financial position or operating results.<sup>32</sup> In such cases, management may place more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction. Existing audit requirements regarding significant unusual transactions are principally contained in AU sec. 316. The amendments regarding significant unusual transactions include specific procedures that are designed to improve the auditor's identification and evaluation of a company's significant unusual transactions and, in particular, to enhance the auditor's understanding of the business purpose (or the lack thereof) of such transactions.

**Financial Relationships and Transactions with Executive Officers:** The other amendments include, among other things, improved audit procedures addressing a company's financial relationships and transactions with its executive officers. A company's executive officers are in a unique position to influence a company's accounting and disclosures. A company's financial relationships and transactions with its executive officers (as one example, executive officer compensation) 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 other amendments modify Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, to require the auditor to perform specific procedures, as part of the auditor's risk assessment process,<sup>33</sup> to obtain an understanding of the company's financial relationships and transactions with its executive officers. However, these amendments do not require the auditor to make any determination regarding the reasonableness of compensation

arrangements or recommendations regarding compensation arrangements.

The auditor's efforts regarding these critical areas are, in many ways, complementary. For example, the auditor's efforts to identify and evaluate a company's significant unusual transactions could identify information that indicates that a related party or relationship or transaction with a related party previously undisclosed to the auditor might exist. Likewise, obtaining an understanding of a company's financial relationships and transactions with its executive officers also could identify such information. The standard and amendments direct the auditor to consider the linkage between a company's relationships and transactions with its related parties, its significant unusual transactions, and its financial relationships and transactions with its executive officers. This complementary audit approach should help the auditor "connect the dots" between different aspects of the audit. Both the auditor and the investor benefit from a comprehensive and consistent examination of the critical areas, not only because of the risk of material misstatement due to fraud, but also because these transactions, due to their nature, could pose a risk of material misstatement due to error.

In addition, the standard imposes new requirements relating to the auditor's communications with the company's audit committee. These changes recognize that the new auditor performance requirements contained in the standard relate to areas of the audit that warrant discussion with the audit committee. The new communication requirements in the standard work in concert with the communication requirements in Auditing Standard No. 16, *Communications with Audit Committees*,<sup>34</sup> and require the auditor to include, as one of the auditor's required communications with the audit committee, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships with related parties. Additionally, the amendments regarding significant unusual transactions are intended to enhance the discussion between the auditor and the audit committee regarding the business purpose (or the lack thereof) of a company's significant unusual transactions required by Auditing Standard No. 16.<sup>35</sup> Similarly, requiring

<sup>28</sup> See also Section D for additional discussion of such risks.

<sup>29</sup> See paragraph .06 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

<sup>30</sup> See Section 10A(a)(2) of the Exchange Act, 15 U.S.C. 78j-1(a)(2), which was added to the Exchange Act by the Private Securities Litigation Reform Act, enacted by Congress in 1995.

<sup>31</sup> AU sec. 334 is one of the Board's interim auditing standards. Shortly after the Board's inception, the Board adopted the existing standards of the American Institute of Certified Public Accountants ("AICPA"), as in existence on April 16, 2003, on an initial, transitional basis. See *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (April 18, 2003).

<sup>32</sup> See, e.g., SEC AAER No. 1631, *In the Matter of Dynegy Inc., Respondent* (September 24, 2002), <http://www.sec.gov/litigation/admin/33-8134.htm>; and SEC AAER No. 2775, *In the Matter of Michael Lowther, CPA, Respondent* (January 28, 2008), <http://www.sec.gov/litigation/admin/2008/34-57210.pdf>.

<sup>33</sup> In 2010, the Board adopted eight standards on assessing and responding to risk in an audit (the "risk assessment standards"), which cover the entire audit process, from initial planning activities to evaluating audit evidence to forming the opinion to be expressed in the auditor's report. See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release 2010-004 (August 5, 2010).

<sup>34</sup> See *Communications with Audit Committees: Related Amendments to PCAOB Standards; and Transitional Amendments to AU Sec. 380*, PCAOB Release No. 2012-004 (August 15, 2012).

<sup>35</sup> See paragraph 13.d. of Auditing Standard No. 16, as revised by certain amendments regarding

the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers is intended to improve the auditor's identification of fraud risks or other significant risks, which are also already required to be discussed with the audit committee pursuant to Auditing Standard No. 16.<sup>36</sup>

As discussed below, recommendations to improve the requirements in the critical areas have been longstanding. The standard and amendments reflect public input, including discussions with the Board's Standing Advisory Group ("SAG")<sup>37</sup> and comments received on a proposal in 2012<sup>38</sup> and a reproposal in 2013.<sup>39</sup> A wide range of commenters, including audit firms serving companies of all sizes, were supportive overall of the need to improve existing standards in these critical areas. During the standard-setting process, the Board considered various alternatives, including some proposed by commenters, in order to develop new requirements that would promote investor protection, but that also would provide opportunities for efficient implementation. After considering the comments received on the reproposal, the Board is adopting the standard and amendments substantially as repropoed.

In general, the Board's new performance requirements for auditors are designed to promote heightened scrutiny in the critical areas, with the goal of promoting the auditor's ability to identify, evaluate, and respond to risks

significant unusual transactions. As revised, the auditor is required to communicate to the audit committee the auditor's understanding of the business purpose (or the lack thereof) of significant unusual transactions.

<sup>36</sup> See paragraph 9 of Auditing Standard No. 16, which requires the auditor to discuss with the audit committee the significant risks identified during the auditor's risk assessment procedures.

<sup>37</sup> The SAG discussed the topic of related parties at a number of its meetings prior to the issuance of the Board's proposal, including at meetings occurring on: September 8–9, 2004; June 21, 2007; and October 14–15, 2009. The SAG also discussed the proposal and reproposal on May 17, 2012 and May 15, 2013, respectively. See the SAG Meeting Archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>.

<sup>38</sup> See the proposing release, which included: (i) an auditing standard, *Related Parties* ("proposed standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions; and (iii) other amendments to PCAOB auditing standards (collectively, these are referred to as the "proposed standard and amendments").

<sup>39</sup> See the repropoed release, which included: (i) an auditing standard, *Related Parties* ("repropoed standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions; and (iii) other proposed amendments to PCAOB auditing standards (collectively, these are referred to as the "repropoed standard and amendments").

of material misstatement. The new requirements represent a targeted approach, focusing on areas that have historically reflected increased risks of fraudulent financial reporting and that also may pose increased risks of error. The Board believes that the standard and amendments, which are aligned with the risk assessment standards, represent a cohesive audit approach that will contribute to audit effectiveness and provide opportunities for an efficient implementation. In the Board's view, the new requirements further the Board's overall mission of improving audit quality, protecting the interests of investors, and furthering the public interest in the preparation of informative, accurate, and independent audit reports.<sup>40</sup>

#### Background and Need for Improvement

As described more fully in the Board's proposing and repropoed releases, the Board developed the standard and amendments against the backdrop of several decades of financial reporting frauds involving companies' relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers.<sup>41</sup>

In considering the need for improvement, the Board noted that some of its existing requirements in these critical areas had not been updated to address significant developments since their issuance. For example, the existing standard addressing the auditing of related parties, AU sec. 334, had remained largely unchanged for many years, despite prominent corporate scandals.<sup>42</sup>

<sup>40</sup> See Section 101 of the Sarbanes–Oxley Act of 2002 ("Sarbanes–Oxley" or the "Act"), Public Law 107–204, 116 Stat. 745. Under Section 101 of the Act, the mission of the PCAOB is "to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports . . . ."

<sup>41</sup> See also Section D, which further elaborates on the Board's consideration of the need, the alternatives considered, and the Board's existing requirements and current audit practices, in connection with the Board's consideration of the economic impacts of the standard and amendments.

<sup>42</sup> Audit procedures regarding a company's related parties have remained largely unchanged since the issuance of AU sec. 335, *Related Party Transactions*, in July 1975. In 1983, AU sec. 335 was replaced with AU sec. 334, but the nature and extent of the auditor's responsibilities and procedures pertaining to related parties in AU sec. 335 were carried over into AU sec. 334. AU sec. 334 removed guidance relating to accounting considerations and disclosure standards for related parties (in response to the issuance of Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, which is now contained in FASB

The Board observed that the existing standard provided guidance and examples of procedures the auditor could perform, in lieu of specific required procedures. This could result in inadequate audit effort in an area that could pose increased risks of material misstatement. Additionally, the nature and extent of audit procedures addressing a company's related party transactions could vary widely. AU sec. 334 also does not reflect the risk-based approach taken in the Board's risk assessment standards, adopted in 2010, which provide an overall framework for the audit, based on the auditor's assessment of, and response to, risks of material misstatement.<sup>43</sup>

The Board's view was also informed by a number of prominent reports and studies that supported the need to improve its existing requirements in the critical areas to better address issues pertinent to fraudulent financial reporting. These included studies by the audit profession that predated the establishment of the Board, and that suggested improvements to certain auditing standards adopted by the Board on an interim basis in 2003. For example, the Report of the Quality Control Inquiry Committee (the "QCIC Report") of the AICPA's SEC Practice Section recommended, after studying more than 200 cases involving audit failures, that "required audit procedures be broadened to help ensure the auditor gains a more complete understanding of related-party transactions, including the business aspects of the transactions."<sup>44</sup>

The Board also considered the results of its oversight activities. For example, the Board has observed that the facts underlying a significant percentage of the Board's settled disciplinary actions to date have involved auditors' failures to perform sufficient procedures regarding related party transactions.<sup>45</sup>

Accounting Standards Codification Topic 850, *Related Party Disclosures*), along with other related technical changes.

<sup>43</sup> See PCAOB Release 2010–004 (August 5, 2010).

<sup>44</sup> See AICPA SEC Practice Section, Memo To Managing Partners of SECPS Member Firms, "Recommendations for the Profession Based on Lessons Learned from Litigation" (October 2002), which includes the QCIC Report as an attachment.

<sup>45</sup> See, e.g., *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of P. Parikh & Associates, Ashok B. Rajagiri, CA, Sandeep P. Parikh, CA, and Sandeep P S G Nair, CA, Respondents*, PCAOB Release No. 105–2013–002 (April 24, 2013); *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Jaspers + Hall, PC, Thomas M. Jaspers, CPA, and Patrick A. Hall, CPA, Respondents*, PCAOB Release No. 105–2008–002 (October 21, 2008); *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Williams & Webster, P.S., Kevin J. Williams, CPA,*

Continued

Many of these cases involve smaller audit firms. Likewise, the Board's inspection program has identified a range of deficiencies in auditing related party transactions, particularly with respect to audits of smaller public companies that were conducted by smaller domestic audit firms.<sup>46</sup> The audit deficiencies cited included failures to test for undisclosed related parties and failures to address risks posed by known related party transactions, including failures to obtain an understanding of the business purpose of such transactions. The types of audit deficiencies observed by the Board indicate that audit practice is inconsistent under the existing framework, which suggests that this is a challenging area warranting additional auditor effort and focus.

Significantly, the need for heightened scrutiny of related party transactions has been highlighted by SEC enforcement actions. For example, in a 2012 opinion issued by the SEC involving a company's transactions with its executive officers, the SEC stated "although in an ordinary arms-length transaction, one may assume that parties will act in their own economic interest, this assumption breaks down when the parties are related."<sup>47</sup> Additionally, a study performed by the SEC of five years of enforcement actions that was

and John G. Webster, CPA, Respondents, PCAOB Release No. 105-2007-1 (June 12, 2007); and Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA, Respondents, PCAOB Release No. 105-2005-022 (November 22, 2005).

<sup>46</sup> See Report on 2007-2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies, PCAOB Release No. 2013-001 (February 25, 2013) at 29, [http://pcaobus.org/Inspections/Documents/02252013\\_Release\\_2013\\_001.pdf](http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf), which states, in part, "Inspections staff have observed deficiencies related to firms' failures to test for undisclosed related parties or transactions with undisclosed related parties. Some of those firms failed to identify and address the lack of disclosure of related party transactions in the financial statements. Inspections staff have also identified deficiencies relating to the firms' failure to obtain an understanding of the nature and business purpose of transactions with related parties and to evaluate whether the accounting for those transactions reflects their economic substance." See also Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms, PCAOB Release No. 2007-010, at 7 (October 22, 2007), [http://pcaobus.org/Inspections/Documents/2007\\_10-22\\_4010\\_Report.pdf](http://pcaobus.org/Inspections/Documents/2007_10-22_4010_Report.pdf).

<sup>47</sup> See SEC, In the Matter of the Application of Wendy McNeely, CPA, AAER No. 3427, at 15 (December 13, 2012), <http://www.sec.gov/litigation/opinions/2012/34-68431.pdf>. As previously noted, that opinion states, in part, that the SEC and courts have repeatedly held that related party transactions require heightened scrutiny by auditors and notes the importance of the auditor understanding the business purpose of material related party transactions.

required by Section 704 of the Act examined 227 enforcement matters and found that 23 of those cases included the failure to disclose related party transactions.<sup>48</sup>

SEC enforcement cases also have highlighted the role played by executive officers in fraudulent financial reporting by public companies. For example, a study examining SEC AAERs from 1998 to 2007 noted that the most commonly cited motivations for fraud included the need to: (i) Meet external earnings expectations of analysts and others; (ii) meet internally set financial targets or make the company look better; (iii) conceal the company's deteriorating financial condition; (iv) increase the stock price; (v) bolster financial position for pending equity or debt financing; (vi) increase management compensation through achievement of bonus targets and through enhanced stock appreciation; and (vii) cover up assets misappropriated for personal gain.<sup>49</sup> That study indicated that the chief executive officer and/or chief financial officer were named in 89 percent of the cases involving fraudulent financial reporting brought by the SEC during that period.

The Board further considered that other standard-setters already have taken action to update their standards in related areas. For example, in July 2008, the International Auditing and Assurance Standards Board ("IAASB") took action to update and revise its auditing standard on related parties with the issuance of International Standard on Auditing No. 550, *Related Parties*. The IAASB emphasized that its new standard was warranted given the public focus on the accounting and auditing of related party relationships and transactions after recent major corporate scandals.<sup>50</sup> The Auditing Standards Board ("ASB") of the AICPA also revised its auditing standard on

<sup>48</sup> Section 704 of the Act directed the SEC to study enforcement actions over the five years preceding its enactment "to identify areas of issuer financial reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management." See Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (January 24, 2003) at 6.

<sup>49</sup> See Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson, and Terry L. Neal, *Fraudulent Financial Reporting 1998-2007: An Analysis of U.S. Public Companies*, Committee of Sponsoring Organizations of the Treadway Commission (May 2010) at 3, [http://www.coso.org/documents/COSOFRAUDSTUDY2010\\_001.pdf](http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf).

<sup>50</sup> See IAASB Exposure Draft, *Related Parties* (December 2005). In addition, the IAASB staff issued guidance in August 2010 addressing the auditing of significant unusual or highly complex transactions. See IAASB Staff Questions and Answers, *Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions* (August 2010).

related parties with the issuance of AU-C Section 550, *Related Parties*, contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification*, in October 2011.

These considerations, particularly the magnitude and number of financial fraud cases over the last several decades involving companies' relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers, strongly indicate the need to strengthen existing auditing standards addressing these critical areas to promote audit quality and investor protection.

The Board's Proposals and Development of the Board's Approach

The following discussion highlights a number of key decisions made by the Board as it developed the standard and amendments, beginning with its proposal in 2012.<sup>51</sup>

*The Board's Proposals:* The Board issued its proposal on February 28, 2012.<sup>52</sup> The Board received 37 comment letters on the proposed standard and amendments and discussed the proposed standard and amendments with the SAG on May 17, 2012.<sup>53</sup>

In general, commenters were supportive of the Board's standard-setting efforts to enhance the auditor's efforts in the critical areas addressed by the proposal. However, commenters suggested several areas in which the proposed standard and amendments could be clarified or improved, including with respect to the other proposed amendments regarding a company's financial relationships and transactions with its executive officers.

In response to comments received, the Board made a number of revisions to its proposal and issued a reproposal for comment on May 7, 2013.<sup>54</sup> The Board's reproposing release discussed the Board's consideration of comments received and the reasons for making the changes in the reproposed standard and amendments. Additionally, the Board

<sup>51</sup> Prior to proposing the standard and amendments, the Board considered a number of alternatives. Section D contains a more detailed discussion of alternatives considered by the Board, including alternatives considered before the Board determined to issue the proposed standard and amendments in 2012.

<sup>52</sup> See the proposing release.

<sup>53</sup> The comment period was extended from May 15, 2012 until May 31, 2012 to accommodate the discussion and comments received in connection with the SAG meeting. The transcript of the SAG's discussion of the proposed standard and amendments is available at [http://pcaobus.org/Rules/Rulemaking/Docket038/2012-05-17\\_Transcript-Related\\_Parties.pdf](http://pcaobus.org/Rules/Rulemaking/Docket038/2012-05-17_Transcript-Related_Parties.pdf).

<sup>54</sup> See the reproposing release.

sought comment, and empirical data, on the potential economic implications of the repropoed standard and amendments, as well as on issues pertinent to the application of the repropoed standard and amendments to audits of brokers and dealers. Further, as a result of the enactment of the Jumpstart Our Business Startups Act (the "JOBS Act"), the Board also sought comment in its repropoal on issues pertinent to the applicability of the repropoed standard and amendments to audits of emerging growth companies ("EGCs").<sup>55</sup>

The Board received 24 comment letters on the repropoed standard and amendments and discussed the repropoed standard and amendments with the SAG on May 15, 2013.<sup>56</sup> In general, commenters were supportive overall of the Board's efforts to improve existing standards in these critical areas. Notably, virtually all of those who commented on the repropoed amendments regarding a company's financial relationships and transactions with its executive officers indicated that the repropoed amendments sufficiently clarified an issue raised during the initial proposal, i.e., that the requirement for the auditor to obtain an understanding of the company's financial relationships and transactions with its executive officers does not require the auditor to assess the appropriateness of the compensation of the company's executive officers. Those who commented on the applicability of the standard were generally supportive of applying the standard and amendments to companies of all sizes, as well as to audits of brokers and dealers and audits of EGCs.

In response to the Board's request for input and empirical data regarding economic considerations, commenters provided their views regarding whether the standard and amendments would improve audit quality, as well as their views regarding potential costs and implementation issues. However, commenters did not provide empirical data.<sup>57</sup>

As noted above, after consideration of the comments received, the Board is adopting the standard and amendments substantially as repropoed, with some

clarifications and revisions in response to certain comments received. Section C contains a detailed discussion of comments received by the Board during the repropoal process, including the Board's response to significant comments received on the repropoed standard and amendments. Additionally, to assist the auditor in implementing the standard and amendments, Section C includes discussion and examples from the Board's proposing and repropoing releases modified to address the standard and amendments being adopted by the Board.

*The Board's Overall Approach:* The following discussion describes the Board's overall approach to developing the standard and amendments, and highlights some of the alternatives and policy choices made as the Board moved from its proposal to its repropoal and then to the adoption of the standard and amendments. In general, in developing the standard and amendments, the Board determined to develop an approach that would promote the auditor's heightened scrutiny of the critical areas but that would, at the same time, also provide opportunity for efficient implementation. Key considerations included:

- *Aligning with the Risk Assessment Standards:* The Board initially proposed to align the auditor's efforts with the risk assessment standards, which require the auditor to consider the risks of material misstatement, whether due to error or fraud, throughout the audit. In the Board's view, this overall risk assessment approach promotes a cohesive audit, with opportunities to integrate audit effort where appropriate, and, at the same time, positions the auditor to identify areas in which there may be increased risks of material misstatement in company financial statements. In response to comments on its proposal, the Board took steps in its repropoal to more closely align the repropoed standard and amendments with its risk assessment standards. Commenters who addressed this aspect of the repropoal generally agreed that the revisions improved the alignment with the risk assessment standards. This approach is retained in the standard and amendments being adopted by the Board.

- *Addressing Complementary Audit Areas:* The proposed standard and amendments were intended to highlight: (i) linkages between the standard and amendments and (ii) the opportunity for complementary audit work, which could improve audit effectiveness and offer opportunities for efficient

implementation. For example, the auditor's work in identifying and evaluating significant unusual transactions could assist the auditor in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor by management. In its repropoal, the Board made revisions to improve the linkage between the repropoed standard and amendments. This approach is retained in the standard and amendments being adopted by the Board.

- *Using Existing Concepts and Procedures:* The Board included some existing auditing concepts and procedures in its proposed standard and amendments. This was intended to permit audit firms to build on existing methodologies and training. This approach could minimize the costs of implementing the standard and amendments. In its repropoal, the Board sought comment on such issues. Several auditing firms who commented indicated that they would be able to update their methodologies and train staff to apply the standard and amendments in a short period, suggesting that the implementation of the standard would not be unduly burdensome. This approach is retained in the standard and amendments being adopted by the Board.

- *Providing Opportunity for a Scaled Approach:* The proposed standard was intended to provide for a scaled approach, establishing basic required procedures intended to assist the auditor in identifying red flags that indicate potential risks of material misstatement. The basic procedures were supplemented by more in-depth procedures that are commensurate with the facts and circumstances of the company under audit. Such facts and circumstances may include the size or complexity of the transaction, the nature of the company's relationships or transactions with its related parties, and the related risk of material misstatements in the financial statements. In response to a request for comments arising out of the Board's repropoal, many commenters agreed that the repropoed standard and amendments provide for a scaled approach. This approach is retained in the standard and amendments being adopted by the Board.

Additionally, commenters raised a variety of issues for consideration by the Board during the standard-setting process. A number of such comments resulted in revisions and clarifications

<sup>55</sup> Public Law 112-106 (April 5, 2012). See Section 103(a)(3)(C) of the Act (15 U.S.C. 7213(a)(3)(C)), as added by Section 104 of the JOBS Act.

<sup>56</sup> The transcript of the SAG's discussion of the repropoed standard and amendments is available at [http://pcaobus.org/Rules/Rulemaking/Docket038/2013-05-15\\_SAG%20Transcript-Related\\_Parties.pdf](http://pcaobus.org/Rules/Rulemaking/Docket038/2013-05-15_SAG%20Transcript-Related_Parties.pdf).

<sup>57</sup> Section D discusses the Board's consideration of the economic impacts regarding the standard and amendments in greater detail.

to the standard and amendments.<sup>58</sup> Some of the more significant of these include:

- *Expanding Auditor Judgment:* In response to comments, the Board made changes to the proposed standard to allow for more auditor judgment, in appropriate circumstances. For example, in its proposal, all related party relationships or transactions that were not previously disclosed to the auditor, as well as those that would require disclosure in the company's financial statements, would have been considered to be a significant risk, requiring additional audit attention in all cases. In response to comments, the Board removed from the reproposal the requirement that the auditor always treat each related party relationship or transaction previously undisclosed by management as a significant risk. In making this change, the Board observed that not all undisclosed related party relationships or transactions might represent a significant risk. Instead, the additional procedures would only be required in circumstances where previously undisclosed transactions were determined by the auditor to require disclosure in the financial statements or consideration as a significant risk. This change, which is retained in the standard being adopted by the Board, could eliminate potentially unnecessary audit work.

- *Clarifying the Auditor's Responsibilities To Identify a Company's Related Parties:* In response to comments received, the Board made clarifications to the proposed standard to emphasize that the auditor's efforts to identify a company's related parties and relationships and transactions with its related parties begins with management's work. The approach taken in the Board's reproposal in this area recognizes that the company is responsible for the preparation of its financial statements, including the identification of the company's related parties, and that the auditor begins the audit with information obtained from the company. This approach is retained in the standard being adopted by the Board. Additionally, in response to comments received on the repropose standard, several clarifying changes have been made. Those changes emphasize more prominently the auditor's responsibility to perform procedures to test the accuracy and completeness of the company's identification of its related parties,

<sup>58</sup> Section C contains a more detailed discussion of comments received by the Board during the reproposal process, including the Board's response to significant comments received on the repropose standard and amendments.

taking into account the information gathered during the audit. Those changes also clarify that Appendix A of the standard contains examples of information and sources of information that may be gathered by the auditor during the audit.

- *Clarifying the Focus Regarding Executive Officers:* As proposed, the other amendments provided direction to the auditor to consider the potential risks of material misstatement relating to a company's executive compensation arrangements as part of the auditor's risk assessment procedures. While some commenters were fully supportive of this approach, other commenters on the proposal raised concerns regarding whether the Board intended that the auditor make an assessment of the reasonableness of executive compensation arrangements. As repropose, the other amendments relating to this area were clarified to explicitly provide that the procedures required for the auditor to obtain an understanding of a company's financial relationships and transactions with its executive officers do not require the auditor to make any determinations regarding the appropriateness or reasonableness of the company's compensation arrangements with its executive officers. This approach is retained in the amendments being adopted by the Board.

#### Overview of the Standard and Amendments and Key Improvements From Existing Standards

The following discussion provides a summary of the standard and amendments being adopted by the Board, key improvements from existing standards, and changes being made to the repropose standard and amendments.

#### Auditing Standard No. 18, Related Parties

*Overview of the Standard:* The standard is intended to strengthen auditor performance requirements for identifying, assessing, and responding to the risks of material misstatement associated with a company's relationships and transactions with its related parties. Among other things, the standard requires the auditor to:

- Perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties, including obtaining an understanding of the nature of the relationships between the company and its related parties and of the terms and business purposes (or the lack thereof) of transactions involving related parties. The new

procedures are performed in conjunction with the auditor's risk assessment procedures pursuant to Auditing Standard No. 12.

- Evaluate whether the company has properly identified its related parties and relationships and transactions with its related parties.<sup>59</sup> In making that evaluation, the auditor performs procedures to test the accuracy and completeness of management's identification, taking into account information gathered during the audit. If the auditor identifies information that indicates that undisclosed relationships and transactions with a related party might exist, the auditor performs procedures necessary to determine whether undisclosed relationships or transactions with related parties in fact exist.

- Perform specific procedures if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists.

- 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.

- Communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, and other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

*The Existing Standard:* The existing requirements for auditing relationships and transactions with related parties are contained primarily in AU sec. 334. AU sec. 334 recognizes that the auditor performs procedures to identify and evaluate a company's relationships and transactions with its related parties as part of performing an audit of financial statements. In doing so, AU sec. 334 provides guidance and examples of procedures for the auditor's consideration in identifying and evaluating related party transactions. Examples of procedures in AU sec. 334 include procedures to obtain information from management (such as obtaining the names of all related parties and inquiring whether there were any transactions with these parties

<sup>59</sup>To further assist the auditor's efforts in this area, the other amendments include a complementary provision that expands existing management representations contained in AU sec. 333, *Management Representations*. However, the auditor may not rely solely on management's representations since they are not a substitute for the application of those audit procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.

during the period) as well as procedures intended to assist the auditor in identifying related parties that have not been disclosed to the auditor by management (such as reviewing filings with the SEC, reviewing company accounting records and certain invoices, and making inquiries of other auditors). Notably, AU sec. 334 states that not all of the procedures may be required in every audit. It further states that, in the absence of evidence to the contrary, related party transactions should not be assumed to be outside the ordinary course of business.<sup>60</sup> Finally, AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions.

**Key Improvements from the Existing Standard:** The standard includes some auditing concepts and procedures from AU sec. 334 that relate to identifying and evaluating related parties and related party transactions. However, the standard differs from AU sec. 334 in a number of key respects. These include:

- **Adding Basic Requirements:** AU sec. 334 suggests procedures for the auditor's consideration, noting that not all of them may be required in every audit. The standard requires basic procedures for the auditor's response to the risks of material misstatement associated with a company's relationships and transactions with its related parties that focus on those related party transactions that require disclosure in the financial statements or that are determined to be a significant risk. These procedures are designed to assist the auditor in identifying red flags that indicate potential risks of material misstatement. Additionally, the standard requires more in-depth procedures that are designed to be scalable and commensurate with the company's facts and circumstances.

- **Enhancing Procedures To Obtain an Understanding of the Company's Relationships and Transactions With Its Related Parties:** Unlike AU sec. 334, which includes limited direction for obtaining an understanding of the company's relationships and transactions with its related parties, the standard requires the performance of specific procedures in this area, including obtaining an understanding of the terms and business purposes (or the lack thereof) of related party transactions.

- **Aligning With the Risk Assessment Standards:** Since the adoption of AU sec. 334, the Board adopted and

amended a number of auditing standards, including its risk assessment standards. The standard is designed to align with and build upon the risk assessment standards that were adopted in 2010. The new procedures are intended to be performed in conjunction with the procedures performed during the auditor's risk assessment.

- **Improving the Auditor's Focus on Accounting:** As noted above, AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions. The standard requires that the auditor evaluate both the accounting for, and disclosure of, related party transactions.

- **Adding Audit Committee Communications:** AU sec. 334 does not mention communications with audit committees regarding related party transactions. The standard requires the auditor to communicate with the audit committee (or its chair) to obtain information during the auditor's risk assessment, as well as to communicate to the audit committee regarding the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.

- **Emphasizing a Complementary Audit Approach:** The standard requires the auditor to take into account information gathered during the audit when evaluating a company's identification of its related parties, for example, information with respect to significant unusual transactions.

**Changes From the Reproposed Standard:** The Board is adopting the standard substantially as repropose, except for certain clarifications and changes that are being made largely in response to comments. One change more prominently emphasizes that the auditor's evaluation of whether a company has properly identified its related parties and relationships and transactions with related parties requires the auditor to perform procedures to test the accuracy and completeness of the company's identification of its related parties and relationships and transactions with its related parties. That change also provides that the auditor's evaluation takes into account the information gathered during the audit. Another change clarifies that Appendix A of the standard contains examples of information and sources of information that may be gathered by the auditor during the audit. More detail regarding the changes made to the standard is included in Section C.

#### Amendments Regarding Significant Unusual Transactions

The amendments regarding significant unusual transactions revise AU sec. 316 and other PCAOB auditing standards with the intent of strengthening the auditor's performance requirements for the identification and evaluation of significant unusual transactions. Among other things, the amendments regarding significant unusual transactions:

- Require the auditor to perform procedures to identify significant unusual transactions;
- Require the auditor to perform procedures to obtain an understanding of, and evaluate, the business purpose (or the 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 engage in fraudulent financial reporting or conceal misappropriation of assets.

The amendments regarding significant unusual transactions include targeted enhancements to AU sec. 316, as well as amendments to Auditing Standard No. 12 and Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*. The amendments regarding significant unusual transactions also include conforming changes to other PCAOB auditing standards to provide for consistency in the use of the term "significant unusual transactions" throughout the Board's standards. During the reproposal process, the Board added a number of clarifying changes, including some intended to enhance the complementary linkages between the auditor's work relating to significant unusual transactions and related party transactions. This approach is maintained in the amendments being adopted by the Board.

**Existing Standards Regarding Significant Unusual Transactions:** Existing auditing requirements regarding significant unusual transactions are principally contained in AU sec. 316.<sup>61</sup> Specifically, AU sec. 316.66 recognizes that during a financial statement audit, the auditor may become aware of significant 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. AU sec. 316.66 requires that, if the auditor becomes aware of significant unusual transactions during the course of an

<sup>60</sup> Thus, AU sec. 334 could be misunderstood to create a "presumption of validity" for the business purpose of related party transactions in situations where experience suggests a need for heightened scrutiny.

<sup>61</sup> See AU secs. 316.66–67.



audit, the auditor should gain an understanding of the business rationale of such transactions and whether that rationale (or the lack thereof) suggests that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. In addition, the existing risk assessment standards anticipate that the auditor will consider risks of material misstatement that are posed by significant transactions that are outside the normal course of business for the company or otherwise appear unusual due to their timing, size, or nature.<sup>62</sup>

*Key Improvements From the Existing Standards:* The amendments regarding significant unusual transactions are designed to improve existing Board standards in the following key respects:

- *Conforming Descriptions of Significant Unusual Transactions:* The amendments regarding significant unusual transactions amend AU sec. 316.66 to 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 amendments regarding significant unusual transactions also include conforming changes to introduce a uniform description of “significant unusual transactions” throughout the Board’s standards.

- *Improving Requirements for Identifying Significant Unusual Transactions:* The amendments regarding significant unusual transactions require the performance of specific procedures intended to improve the auditor’s identification of significant unusual transactions, for example, by amending Auditing Standard No. 12 to require the auditor to make inquiries of management and others.

- *Improving the Auditor’s Evaluation of Significant Unusual Transactions:* The amendments regarding significant unusual transactions to AU secs. 316.66–.67A include basic procedures for obtaining information for evaluating significant unusual transactions. The basic procedures include: (i) Reading the underlying documentation relating to significant unusual transactions and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction; (ii) determining whether the transaction has been authorized and approved in

accordance with the company’s established policies and procedures; and (iii) evaluating the financial capability of the other parties to the transaction with respect to significant uncollected balances, guarantees, and other obligations. The basic procedures are designed to assist the auditor in identifying red flags that indicate potential risks of material misstatement. Additionally, the standard requires more in-depth procedures that are designed to be scalable and commensurate with the facts and circumstances of the audit.

- *Enhancing Attention to the Business Purpose (or the Lack Thereof) of Significant Unusual Transactions:* The amendments regarding significant unusual transactions to AU secs. 316.66–.67 are intended to enhance the auditor’s evaluation of the business purpose of significant unusual transactions by, among other things, expanding the factors considered by the auditor in evaluating whether the business purpose (or the lack thereof) indicates that such transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

- *Emphasizing a Complementary Audit Approach:* The amendments to AU secs. 316.66–.67A emphasize a complementary audit approach by requiring the auditor to take into account other work performed during the audit, for example, information gathered with respect to related party transactions, when identifying a company’s significant unusual transactions.

- *Emphasizing Accounting and Disclosure:* The amendments regarding significant unusual transactions to AU sec. 316.67A are intended to heighten the auditor’s attention to accounting matters relative to significant unusual transactions. The new requirements emphasize that the auditor must evaluate whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework.<sup>63</sup>

*Changes From the Reproposed Amendments:* The Board is adopting the amendments substantially as reproposed, with some clarifying changes. More detail regarding those changes is included in Section C.

#### Financial Relationships and Transactions With Executive Officers

The other amendments are intended to provide for improved audit procedures in complementary areas, including requiring that the auditor perform procedures, as part of the auditor’s risk assessment, to obtain an understanding of the company’s financial relationships and transactions with its executive officers.<sup>64</sup> These new procedures are intended to heighten the auditor’s attention to incentives or pressures for the company to achieve a particular financial position or operating result, recognizing the key role that a company’s executive officers may play in the company’s accounting decisions or in a company’s financial reporting.

As discussed previously, clarifications were made to the other amendments to explicitly provide that the auditor’s work relating to a company’s financial relationships and transactions with its executive officers does not include an assessment of the appropriateness or reasonableness of executive compensation arrangements.

*The Existing Standards and Key Improvements:* The existing risk assessment standards require the auditor to consider obtaining an understanding of compensation arrangements with senior management (including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses) as part of obtaining an understanding of the company. The other amendments strengthen existing requirements by requiring the auditor, as part of the audit risk assessment process, to perform procedures to obtain an understanding of the company’s financial relationships and transactions with its executive officers. This reflects that a company’s executive officers are a group that, because of their position in the company, can exert influence over the company’s accounting and financial statement presentation.

*No Changes From Reproposed Amendments:* The Board is adopting the amendments regarding financial relationships and transactions with executive officers as reproposed. A discussion of the comments received is included in Section C.

#### Other Amendments to PCAOB Auditing Standards

In addition to the other amendments relating to financial relationships and

<sup>62</sup> See paragraph 71.g. of Auditing Standard No. 12.

<sup>63</sup> See paragraphs 30–31 of Auditing Standard No. 14, *Evaluating Audit Results*, which address the auditor’s evaluation of the presentation of the financial statements, including the disclosures.

<sup>64</sup> See Section C—Other Amendments to PCAOB Auditing Standards, for a discussion of the applicable definition of the term “executive officer.”



transactions with executive officers, the other amendments being adopted by the Board revise other auditing standards to conform them to the standard and amendments and, where appropriate, include new requirements that complement the standard and amendments regarding significant unusual transactions.

For example, the other amendments include changes to AU sec. 333, relating to management's written representations to the auditor, to include a representation that management has made available to the auditor the names of all related parties and relationships and transactions with related parties. Additionally, the other amendments to AU sec. 333 require the auditor to obtain relevant written representations from management: (i) That there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor, and (ii) if the company's financial statements include an assertion that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction.

Other new requirements in the other amendments complement the requirements in the standard and amendments through improvements to the auditor's: (i) communications with a predecessor auditor; (ii) procedures during the period subsequent to the balance sheet date through the date of the auditor's report; and (iii) procedures during reviews of interim financial information. These and the other amendments being adopted by the Board are discussed in greater detail in Section C.

The Board is adopting the other amendments substantially as proposed, with only minor clarifying changes. More detail regarding those changes is included in Section C.

#### (b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

#### *B. Board's Statement on Burden on Competition*

Not applicable. The Board's consideration of the economic impacts of the standard and amendments are discussed in Section D.

#### *C. Board's Statement on Comments on the Proposed Rules Received From Members, Participants or Others*

The Board released the proposal for public comment on February 28, 2012. The Board received 37 written comment letters relating to the proposal. The Board discussed the proposal with the SAG on May 17, 2012.

The Board released the reproposal for public comment on May 7, 2013. The Board received 24 written comment letters relating to the reproposal. The Board discussed the reproposal with the SAG on May 15, 2013.

The Board has carefully considered all comments received. The Board's response to the comments it received on the reproposal and the changes made to the rules in response to the comments received are discussed below.

Additionally, below is a comparison of the objective and key requirements of the proposed rules with the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the AICPA.

#### 1. Discussion of the Proposed Rules and Comments Received

##### Introduction

After considering the comments received, the Board is adopting the standard and amendments substantially as proposed, except for certain clarifications and changes that are being made largely in response to comments.

A recurring theme from comments received on both the proposal and reproposal dealt with including additional discussion and examples in the standard and amendments. Several commenters requested that the Board include additional discussion and examples contained in the proposing and reproposing releases in the text of the standard and amendments. Some commenters suggested that not including additional discussion and examples could affect the consistency of implementation and the initial and recurring implementation costs.

The Board considered these comments and determined, as it has done in other projects, to include performance requirements in the standard and amendments and to provide additional discussion and examples primarily in an appendix to its adopting release. As noted in the reproposal, this approach promotes a clear separation between the required procedures and the Board's additional discussion regarding the application of the standard and amendments. To assist auditors in implementing the standard and amendments, the discussion below includes additional discussion and examples previously included in the proposing and reproposing releases, modified to address the standard and amendments being adopted by the Board.

The discussion below relates to: Auditing Standard No. 18, *Related Parties*; Amendments to Certain PCAOB

Auditing Standards Regarding Significant Unusual Transactions; Other Amendments to PCAOB Auditing Standards; Audits of Brokers and Dealers; and Effective Date.

#### Auditing Standard No. 18, *Related Parties*

Commenters generally supported the Board's standard-setting efforts to strengthen the existing auditing standard, with many commenters noting that the reproposed standard could have a positive impact on audit quality. Many commenters also suggested changes for further improving the reproposed standard, including some clarifications and editorial suggestions.

The Board is adopting the standard, substantially as proposed, but is making certain revisions to clarify and refine various aspects of the standard. The most significant changes include:

- *Clarifying the Scope of the Auditor's Inquiries Regarding Related Party Transactions (Paragraph 5)*: Paragraph 5 of the standard includes a revision to clarify the scope of the auditor's inquiries of management to include transactions with its related parties that were modified during the period under audit.
  - *Including Examples of Others Within the Company of Whom the Auditor Might Inquire (Paragraph 6)*: A footnote has been added to paragraph 6 of the standard to provide examples of others within the company that the auditor might inquire of regarding the company's relationships and transactions with related parties.
    - *Providing Direction Regarding Timing of Communications (Paragraph 8)*: Paragraph 8 of the standard includes a revision that notes that the communication to engagement team members pursuant to paragraph 8 can be more effective when it occurs at an early stage of the audit.
      - *Providing Direction Regarding Intercompany Accounts (Paragraph 13)*: A note has been added to paragraph 13 of the standard to clarify that the procedures performed by the auditor should address the risks of material misstatement associated with the company's intercompany accounts.
        - *Clarifying the Auditor's Responsibility for Evaluating the Company's Identification of its Related Parties (Paragraph 14)*: Paragraph 14 includes revisions to highlight that the auditor's evaluation of a company's identification of its related parties includes performing procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, and that

such evaluation takes into account the information gathered during the audit.

- *Clarifying the Auditor's*

*Responsibility Regarding Appendix A (Paragraph 14):* Language has been added to paragraph 14 and Appendix A (referred to in paragraph 14) to clarify that Appendix A contains examples of information and sources of information that may be gathered during the audit.

- *Expanding the Examples Contained in Appendix A (Appendix A):* The examples of sources of information contained in Appendix A of the standard have been expanded to include the company's "disclosures contained on the company's Web site" (in addition to the company's disclosures in SEC filings, which is already included as an example in Appendix A).

- *Clarifying the Procedures*

*Performed If the Auditor Identifies a Related Party or Relationship or Transaction with a Related Party Previously Undisclosed to the Auditor (Paragraph 16):* Paragraph 16 includes a number of clarifications, the most significant of which include revisions clarifying that paragraph 16 requires the auditor to perform initial procedures intended to help the auditor understand and evaluate the nature of the undisclosed related party or relationship or transaction with a related party identified by the auditor. Taking into account the information gathered from performing those procedures, the auditor then performs additional procedures to evaluate any broader implications for the audit.

The following sections discuss the standard being adopted by the Board, the existing standard, significant comments received, and the Board's responses, including a description of the changes from the repropoed standard. The following sections also include additional discussion and examples that could be useful to auditors in implementing the standard. The sections are organized by the following topical areas:

- Introduction (Paragraph 1)
- Objective (Paragraph 2)
- Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties (Paragraphs 3–9)
- Identifying and Assessing Risks of Material Misstatement (Paragraph 10)
- Responding to the Risks of Material Misstatement (Paragraphs 11–13)
- Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14–16)

- Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17–18)
- Communications with the Audit Committee (Paragraph 19)

Introduction (Paragraph 1 of the Standard)

*Discussion of Paragraph 1 of Auditing Standard No. 18*

Paragraph 1 of the standard states that the standard establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.

A footnote to paragraph 1 of the standard provides that the auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term "related parties" and the financial statement disclosure requirements with respect to related parties (which is referred to as a "framework neutral" approach).<sup>65</sup>

In contrast to the specific required procedures contained in the standard, AU sec. 334 provides guidance on procedures that the auditor should consider to identify related party relationships and transactions, and to satisfy himself concerning the required financial statement accounting and disclosures.<sup>66</sup> The standard also improves upon the existing standard by using a framework neutral approach. The existing standard, on the other hand, refers the auditor to the definition of a related party contained in GAAP.

After considering all comments received, the Board is adopting paragraph 1 of the standard as repropoed.

Objective (Paragraph 2 of the Standard)

*Discussion of Paragraph 2 of Auditing Standard No. 18*

Paragraph 2 of the standard states that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with

<sup>65</sup> For SEC filings that include financial statements prepared in accordance with or reconciled to U.S. Generally Accepted Accounting Principles ("GAAP"), see, e.g., Financial Accounting Standards Board's ("FASB") Accounting Standards Codification Topic 850, *Related Party Disclosures*. For SEC filings that include financial statements prepared in accordance with International Financial Reporting Standards, as issued by the International Accounting Standards Board ("IFRS"), see, e.g., International Accounting Standard No. 24, *Related Party Disclosures*.

<sup>66</sup> See AU secs. 334.01–02.

related parties have been properly identified, accounted for, and disclosed in the financial statements. A footnote refers the auditor to other relevant standards, including paragraphs 30–31 of Auditing Standard No. 14, *Evaluating Audit Results*, and paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*.

The intent of the objective is to focus the auditor on the end result—obtaining sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

In contrast, the existing standard does not specifically describe an objective for the auditor's work regarding a company's relationships and transactions with its related parties.

*Discussion of Comments Received on Paragraph 2 of the Repropoed Standard*

The Board considered all comments received, including the following significant comments:

*Including the Consideration of "Fraud" as an Explicit Objective:* A few commenters recommended that the objective of the standard refer to the risk of fraud as an explicit objective of the standard. The Board considered similar comments received on the proposal in developing its repropoal. As noted in the repropoal, related party transactions warrant special attention by the auditor, in part, because of their historic association with material misstatements that are associated with fraudulent financial reporting. The standard requires the auditor to perform specific procedures intended to provide for heightened scrutiny of the company's identification of, accounting for, and disclosure of its related parties and relationships and transactions with related parties. Since some related party transactions may be routine and occur in the ordinary course of business, the Board determined to take a risk-based approach that aligns with and builds upon its risk assessment standards.<sup>67</sup> The risk assessment standards emphasize that the auditor's responsibilities for assessing and responding to fraud are an integral part of the audit process rather than a separate, parallel process. In the Board's view, this represents an effective and efficient audit approach. This is in

<sup>67</sup> See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to Other PCAOB Standards*, PCAOB Release 2010–004 (August 5, 2010).

contrast to the approach taken in the existing standard, which states that in the absence of evidence to the contrary, related party transactions should not be assumed to be outside the ordinary course of business.<sup>68</sup>

*Incorporating Materiality into the Objective:* A few commenters recommended including a reference to materiality in the objective of the standard. The Board considered these comments but noted that auditing standards require the auditor to design and perform audits to identify material misstatements. Also, direction regarding the auditor's considerations of materiality already is contained in Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*.

The Board is adopting paragraph 2 of the standard as repropoed, except for an additional reference to paragraph 30 of Auditing Standard No. 14 that has been added to footnote 2.

Performing Risk Assessment Procedures To Obtain an Understanding of the Company's Relationships and Transactions With Its Related Parties (Paragraphs 3 Through 9 of the Standard)

*Discussion of Paragraphs 3 Through 9 of Auditing Standard No. 18*

Paragraph 3 of the standard builds upon the foundational risk assessment requirements contained in Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Chiefly, paragraph 3 of the standard requires the auditor to perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements, in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12.<sup>69</sup>

Understanding the nature and business purpose (or the lack thereof) of a company's relationships and transactions with its related parties is important for the auditor's evaluation of the company's accounting for and disclosure of related party transactions because a company's relationships and transactions with its related parties could pose increased risks of material misstatement. For example, to improve the appearance of its financial condition, a company and a related

party could attempt to "dress up" the appearance of the company's balance sheet at period end by agreeing to have the company temporarily pay down its related party debt prior to the balance sheet date while having an undisclosed side agreement to subsequently borrow the same or a comparable amount shortly after period end.

Paragraph 3 further provides that the procedures to be performed to obtain an understanding of the company's relationships and transactions include: (i) procedures to obtain an understanding of the company's process; (ii) performing inquiries; and (iii) communicating with the audit engagement team and other auditors.

The existing standard suggests some similar procedures for the auditor's consideration. For example, the existing standard states in AU sec. 334.05 that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component of the entity to the total entity. AU sec. 334.05 further states that the auditor should consider controls over management activities and the business purpose served by the various components of the entity. AU sec. 334.09 states that, after identifying related party transactions, the auditor should apply the procedures that the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. Additionally, paragraph 71 of Auditing Standard No. 12 states that one factor to be considered in determining whether a risk represents a significant risk is whether the risk involves significant transactions with related parties.

*Obtaining an Understanding of the Company's Process (Paragraph 4 of the Standard)*

Paragraph 4 of the standard also aligns with and builds upon the requirements in Auditing Standard No. 12. Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to: (i) identify the types of potential misstatement; (ii) assess the factors that affect the risks of material misstatement; and (iii) design further audit procedures.<sup>70</sup> Paragraph 4 of the standard requires that, in conjunction with obtaining an understanding of internal control over financial reporting, the auditor obtain an understanding of

the controls that management has established to: (i) identify related parties and relationships and transactions with related parties; (ii) authorize and approve transactions with related parties; and (iii) account for and disclose relationships and transactions with related parties in the financial statements.

Obtaining an understanding of the company's controls, including its policies and procedures, is important to an auditor's consideration of the risks that a company's relationships and transactions with related parties may pose for material misstatement of the company's financial statements. The standard recognizes that material features of companies' policies and procedures for the review, approval, or ratification of related party transactions will vary depending on both the size and complexity of the company and the types of transactions covered by such policies and procedures. The standard should not be read to imply that such policies and procedures should be in writing or adhere to any particular framework.

AU sec. 334, issued before the adoption of the risk assessment standards, is similar, but not as specific. Among other things, AU sec. 334.05 states that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities. AU sec. 334.05 further states that the auditor should consider controls over management activities.

*Performing Inquiries (Paragraphs 5 Through 7 of the Standard)*

Briefly, paragraphs 5 through 7 of the standard require the auditor to make specific inquiries of: (i) company management; (ii) others within the company likely to have additional knowledge regarding the company's related parties or relationships or transactions with the company's related parties; and (iii) the company's audit committee.

Appropriately focused inquiries can inform the auditor's understanding of the nature of the relationships between the company and its related parties, and the terms and business purposes (or the lack thereof) of transactions involving related parties. In addition, inquiries can assist the auditor in determining the extent of audit procedures that should be performed to determine whether the company has identified its related parties and relationships and transactions with its related parties.

The inclusion of the phrase "(or the lack thereof)" throughout the standard

<sup>68</sup> AU sec. 334.06.

<sup>69</sup> In addition, the other amendments make a conforming amendment to Auditing Standard No. 12.

<sup>70</sup> See paragraph 18 of Auditing Standard No. 12.

and amendments is intended to promote a questioning and skeptical approach by the auditor when obtaining an understanding of the business purpose of related party transactions. Sharpening the auditor's focus on evaluating the business purpose of related party transactions is particularly appropriate in view of the risk of material misstatement involving related party transactions.<sup>71</sup> The importance of identifying transactions that appear to lack a business purpose also is reinforced in other parts of the standard. For example, the standard requires the auditor to communicate to the audit committee the identification of significant related party transactions that appear to the auditor to lack a business purpose.

Paragraph 5 contains a list of inquiries of management that consist of basic information that the auditor should obtain as part of obtaining an understanding of the company's financial relationships and transactions with its related parties, such as the names of the company's related parties and the nature of the company's relationships and transactions with those related parties. A footnote to paragraph 5 refers the auditor to AU sec. 333, *Management Representations*, and notes that obtaining such representations from management complements the performance of procedures in paragraph 5 and is not a substitution for those inquiries.

Paragraph 6 provides that the auditor also inquire of others within the company regarding their knowledge of the same matters that are the subject of the auditor's inquiries of management pursuant to paragraph 5 of the standard.

A footnote to paragraph 6 states that 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 equivalent position; and the human resource director or person in equivalent

position. These examples of "others" included in the standard are not intended to imply that these individuals could not also be members of "management" for a particular company.

The inquiries required in paragraph 6 provide an opportunity for the auditor to corroborate the information obtained from management. Paragraph 6 does not, however, require the auditor to inquire of others within the company regarding matters that the auditor does not believe are reasonably within their knowledge.

Paragraph 7 of the standard provides that the auditor also should make inquiries of the company's audit committee, or its chair, regarding the audit committee's understanding of the company's relationships and transactions with related parties, focusing on those that are significant to the company.<sup>72</sup> Additionally, the standard provides that the auditor should inquire as to whether any member of the audit committee has concerns regarding the company's relationships or transactions with related parties. The inquiries of the audit committee, or its chair, pursuant to paragraph 7 of the standard work in concert with the auditor's communications with the audit committee pursuant to paragraph 19 of the standard to provide an opportunity for the auditor to corroborate management's responses. The audit committee communication requirements in the standard are intended to provide the auditor with a forum to discuss sensitive areas that potentially may involve the financial interests of members of the company's management.

The inquiries in paragraphs 5 through 7 of the standard could be performed at the same time as the inquiries about the risks of material misstatement, including fraud risks, that are performed as part of the auditor's risk assessment, as required by paragraphs 54 through 58 of Auditing Standard No. 12. These inquiries also would provide an opportunity for the auditor to discuss, as appropriate, the company's financial relationships and transactions with its executive officers with the audit committee, or its chair, as part of the auditor's procedures to obtain an understanding of the company's relationships and transactions with its related parties.

In contrast to the new requirements contained in the standard, the existing

standard describes a variety of specific audit procedures for the auditor's consideration in determining the existence of related parties.<sup>73</sup> These specific procedures include requesting from appropriate management personnel the names of all related parties and inquiring whether there were any transactions with these parties during the period. The existing standard has no audit committee communication requirement. The procedures in paragraph 5 through 7 of the standard provide more specific procedures for the auditor regarding the use of inquiries of management and others.

#### *Communicating With the Audit Engagement Team and Other Auditors (Paragraphs 8 and 9 of the Standard)*

Paragraphs 8 and 9 of the standard require the auditor to communicate to engagement team members and, if applicable, other auditors, relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties. A footnote to paragraph 8 states that this communication, which can be more effective when it occurs at an early stage of the audit, complements the discussion among engagement team members regarding risks of material misstatement in accordance with paragraph 49 of Auditing Standard No. 12. That footnote also refers the auditor to paragraph 5 of Auditing Standard No. 10, *Supervision of the Audit Engagement*. If the auditor is using the work of another auditor, paragraph 9 of the standard further requires the auditor to make certain inquiries of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.<sup>74</sup>

Communicating information to engagement team members regarding a company's related parties and relationships and transactions with related parties might increase the likelihood that the engagement team will identify related parties or relationships or transactions with related parties previously undisclosed to the auditor by management. Effective communication to engagement team members might also highlight evidence

<sup>73</sup> See AU sec. 334.07.

<sup>74</sup> The standard does not include a specific requirement for the auditor to make similar inquiries of engagement team members because existing standards already require engagement team members to bring relevant matters to the attention of the audit engagement partner. See, e.g., paragraph 5 of Auditing Standard No. 10.

<sup>71</sup> See, e.g., paragraph 15 of FASB Statement No. 57, *Related Parties*, which states "[w]ithout disclosure to the contrary, there is a general presumption that transactions reflected in financial statements have been consummated on an arm's-length basis between independent parties. However, that presumption is not justified when related party transactions exist because the requisite conditions of competitive, free-market dealings may not exist. Because it is possible for related party transactions to be arranged to obtain certain results desired by the related parties, the resulting accounting measures may not represent what they usually would be expected to represent."

<sup>72</sup> Paragraph 8 of Auditing Standard No. 16, *Communications with Audit Committees*, also requires the auditor to make certain inquiries of the audit committee.

that corroborates or contradicts information provided by management about relationships and transactions with related parties. Additionally, effective communication to engagement team members could enhance the auditor's understanding of the company's relationships and transactions with its related parties.

Examples of matters regarding related parties that the engagement team might discuss include: (i) Information that could indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor; (ii) sources of information that could indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor; (iii) how entities controlled by management (e.g., variable interest entities) might be used to facilitate earnings management; and (iv) how transactions between the company and a known business partner of a member of management could be arranged to facilitate fraudulent financial reporting or asset misappropriation.

In addition, under PCAOB standards, a principal auditor may use the work and reports of other auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the company's financial statements.<sup>75</sup> Exchanging relevant information about related parties with the other auditor can assist the principal auditor in understanding the overall nature of the company's relationships and transactions with related parties and in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor.

AU sec. 334.08 contains audit procedures intended to provide guidance for identifying material transactions that may be indicative of the existence of previously unidentified related party relationships. One such procedure is to provide audit personnel performing segments of the audit, or auditing and reporting separately on the accounts of related components of the reporting entity, with the names of known related parties so that they may become aware of transactions with such parties during their audits. Further, AU sec. 334.07.g., suggests a number of audit procedures for determining the existence of related party relationships, including making inquiries of other auditors of related entities concerning

their knowledge of existing relationships and the extent of management involvement in material transactions. Finally, paragraph .13 of AU sec. 9334, *Related Parties: Auditing Interpretations of Section 334*, states that the principal auditor and the other auditor should obtain from each other the names of known related parties and that, ordinarily, the exchange should be made at an early stage of the audit. In contrast to the suggested procedures provided in the existing standard, the standard provides specific procedures for the auditor regarding this topic.

#### *Discussion of Comments Received on Paragraphs 3 Through 9 of the Reproposed Standard*

The Board considered all comments received, including the following significant comments:

*Inquiring Regarding "Modifications" to Related Party Transactions:* One commenter stated that modifications to transactions with related parties during the period may give rise to a risk of material misstatement. This commenter suggested clarifying the scope of paragraph 5.d. of the reproposed standard by adding the word "modified" after the phrase "the transactions entered into." This change would clarify that the auditor's inquiries regarding the company's related party transactions entered into during the audit period would include inquiries regarding any such transactions that were modified during that period. The Board considered this comment and agreed that this would be a useful change. The Board has made a change to paragraph 5.d. to reflect the commenter's suggestion.

*Providing Additional Direction Regarding the Auditor's Inquiries:* Two commenters recommended including additional direction regarding the auditor's inquiries. One commenter suggested providing further direction on the nature and extent of the auditor's inquiries. Another commenter suggested that the Board provide examples of others within the company of whom the auditor might inquire to clarify the intent of the requirement in paragraph 6. The Board considered these comments and has added a new footnote to paragraph 6. That new footnote states that 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 equivalent position; and the human resources

director or person in equivalent position.<sup>76</sup> The Board declined to add more specific requirements because determining the nature and extent of the auditor's inquiries is an area that would benefit from the auditor's consideration of the facts and circumstances of the audit.

*Timing of the Auditor's Communications:* At the SAG discussion, a suggestion was made to include direction regarding the timing of the auditor's communication to the engagement team. The Board considered this comment, noting that, similar to the approach under the existing standard, this communication would generally occur at an early stage of the audit as it would be performed in conjunction with the risk assessment procedures.<sup>77</sup> Further, the proposing release had noted that communicating information about related parties at an early stage of the audit would benefit such discussions and should continue throughout the audit. The Board has revised the footnote to paragraph 8 of the standard to indicate that this communication can be more effective when it occurs at an early stage of the audit.

The Board is adopting paragraphs 3 through 9 of the standard substantially as reproposed, except for, as described above: (i) Revising item d. of paragraph 5 to clarify that auditors' inquiries include inquiries regarding any transactions that were modified during the period; (ii) adding a footnote to paragraph 6 that includes examples of others within the company to whom the auditor may address inquiries; and (iii) revising the footnote to paragraph 8 to indicate that the communication can be more effective when it occurs at an early stage of the audit. Identifying and Assessing Risks of Material Misstatement (Paragraph 10 of the Standard)

#### *Discussion of Paragraph 10 of Auditing Standard No. 18*

Paragraph 10 of the standard aligns with the risk assessment requirements contained in Auditing Standard No. 12, which require the auditor to identify

<sup>76</sup> These examples of "others" had been included in the proposed standard but were removed from the reproposal because the Board did not wish to suggest that the auditor should make inquiries of each of these individuals in all instances. Additionally, one commenter on the proposal observed that some of the "others" might also be members of management in some companies. However, in view of comments indicating that additional examples in the standard would be helpful, the Board believes that these examples could be useful to auditors, and including them in a footnote to the standard should avoid the notion that these examples in and of themselves impose requirements.

<sup>77</sup> See AU sec. 9334.13.

<sup>75</sup> See paragraph .01 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 10 of the standard states that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties. A footnote to paragraph 10 refers the auditor to paragraph 59 of Auditing Standard No. 12.

The clause “including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties” in paragraph 10 is intended to highlight, among other things, that the auditor’s assessment of risk includes a focus on risks related to the company’s less than complete identification of its related parties or relationships or transactions with related parties. Such a focus helps support the auditor’s evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties.

Due to their nature, transactions with related parties might involve difficult measurement and recognition issues that can lead to errors in financial statements, for example, when terms are not properly considered in accounting determinations. Related parties might also buy or sell goods or services at prices that differ significantly from prevailing market prices or offer unusual rights of return or extended payment terms.

Additionally, as previously discussed, under the risk assessment standards, the auditor is required to determine whether any of the identified and assessed risks of material misstatement are fraud risks or other significant risks.<sup>78</sup> The standard does not mandate that all related party transactions be presumed to be or deemed to be significant risks or designated as a fraud risk. Under the risk assessment approach, the auditor’s assessment is based on the facts and circumstances of the audit, including the facts and circumstances of a company’s relationships and transactions with related parties. However, depending on the facts and circumstances, assessed risks of material misstatement associated with related parties and relationships and transactions with

related parties might also represent fraud risks or other significant risks. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, provides examples of fraud risk factors, including some concerning related parties.<sup>79</sup>

The complexity of a transaction is a factor considered by auditors when assessing risks of material misstatement associated with related party transactions. Further, when the substance of a related party transaction differs materially from its form, or when a company’s related parties operate through an extensive and complex range of relationships and structures, heightened scrutiny is warranted. For example, depending upon the facts and circumstances, the creation of a variable interest entity in which the company’s economic interest (its obligation to absorb losses or its right to receive benefits) is disproportionately greater than the company’s stated power might represent a fraud risk or other significant risk, especially in the presence of other fraud risk factors.<sup>80</sup> Examples of fraud risk factors regarding related parties that individually, or in combination with other fraud risk factors, might indicate the existence of a fraud risk, include significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.<sup>81</sup>

The existence of dominant influence is another factor considered by auditors when assessing the risks of material misstatement. Related parties, due to their ability to control or significantly influence, may be in a position to prevent a company from pursuing its own separate interests. Identifying the risks of material misstatement associated with dominant influence can assist the auditor’s assessment of the risks of material misstatement. AU sec. 316.85 already describes the principle of dominant influence in the example of a fraud risk factor by stating that the ineffective monitoring of management as a result of domination of management by a single person or small group, without compensating controls,

provides an opportunity for management to engage in fraudulent financial reporting.

Examples of factors that may signal dominant influence exerted by a related party include:

- Significant transactions are referred to the related party for approval;
- There is little or no debate among management and the board of directors regarding business proposals initiated by the related party; or
- The related party played a leading role in starting the company and continues to play a leading role in managing the company, even if the related party is no longer formally part of management or the board of directors.

The existence of dominant influence by itself, or in the presence of other fraud risk factors (e.g., use of an intermediary whose involvement serves no apparent business purpose), might indicate the existence of a fraud risk.

The other amendments to PCAOB auditing standards complement the requirements of paragraph 10 by amending AU sec. 316.85.A.2 to include the exertion of dominant influence by or over a related party as an example of a fraud risk factor. The other amendment to AU sec. 316.85.A.2 expands that concept to encompass all related parties outside of management of the company. The amendments do not define dominant influence, as doing so might result in some auditors being overly focused on the definition itself, instead of focusing on the red flags associated with dominant influence that might create risks of material misstatement at the financial statement level.

AU sec. 334 does not provide specific guidance for the auditor regarding the identification and assessment of risks of material misstatement associated with related party transactions. In fact, AU sec. 334.06 provides that, in the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business.<sup>82</sup>

#### *Discussion of Comments Received on Paragraph 10 of the Reproposed Standard*

The Board considered all comments received, including the following significant comments:

*Referencing Information Obtained From Past Audits:* One commenter recommended requiring the auditor to determine that there were no changed circumstances for material related party

<sup>82</sup> Thus, AU sec. 334.06 could be misunderstood to create a “presumption of validity” for the business purpose of related party transactions in situations where experience suggests a need for heightened scrutiny.

<sup>78</sup> See paragraphs 59.f., 70, and 71 of Auditing Standard No. 12.

<sup>79</sup> See AU sec. 316.85.A.2, Section a., under “Opportunities.”

<sup>80</sup> Paragraph 10 of Auditing Standard No. 12 states that obtaining an understanding of the nature of the company includes understanding the company’s significant investments, including equity method investments, joint ventures and variable interest entities.

<sup>81</sup> The amendments regarding significant unusual transactions separate this example into two examples—(i) related party transactions that are also significant unusual transactions and (ii) significant transactions with related parties whose financial statements are not audited or are audited by another firm.

transactions previously authorized and approved. Another commenter suggested including a reference to the requirements pertaining to information obtained from past audits contained in the risk assessment standards both to improve the effectiveness of the audit process and to remind auditors of their responsibility regarding the information previously obtained regarding ongoing matters.

The Board considered these comments, noting that paragraph 10 requires that, in identifying and assessing the risks associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4 through 9 and the risk assessment procedures required by Auditing Standard No. 12, which address information obtained from past audits.<sup>83</sup> Thus, the auditor is already required to take such information obtained from past audits into account in identifying and assessing risks of material misstatement. Further, the revisions made to item d. of paragraph 5, which require the auditor to inquire of management regarding transactions with related parties modified during the period under audit, should assist the auditor in identifying transactions for which the auditor would not be able to rely on information obtained from past audits.

The Board is adopting paragraph 10 of the standard as repropounded. Responding to the Risks of Material Misstatement (Paragraphs 11 through 13 of the Standard).

#### *Discussion of Paragraphs 11 Through 13 of Auditing Standard No. 18*

Paragraph 11 of the standard aligns with the requirement in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, for the auditor to design and implement audit responses that address the identified and assessed risks of material misstatement. Paragraph 11 states that this includes designing and performing audit procedures that address the risks of material misstatement associated with related parties and relationships and transactions with related parties. Footnotes to paragraph 11 refer the auditor to relevant paragraphs of the risk assessment standards. A note to paragraph 11 refers the auditor to the

<sup>83</sup> Paragraphs 41 through 45 of Auditing Standard No. 12 note that the auditor's risk assessment procedures require the auditor to consider information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements.

new requirements in paragraphs .66-.67A of AU sec. 316 for related party transactions that are also significant unusual transactions.

AU sec. 334 also provides guidance to the auditor regarding audit procedures to evaluate identified related party transactions. For example, AU sec. 334.09 provides that, after identifying related party transactions, the auditor should apply the procedures the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient appropriate evidential matter and should extend beyond inquiry of management. AU sec. 334.09 includes procedures that should be considered and footnote 6 of AU sec. 334.09 provides that, until the auditor understands the business sense of material transactions, he cannot complete his audit.<sup>84</sup> AU sec. 334.10 includes other procedures that the auditor should consider when the auditor believes it necessary to fully understand a particular transaction, and notes that those procedures might not otherwise be deemed necessary to comply with generally accepted auditing standards.

#### *Transactions With Related Parties Required To Be Disclosed in the Financial Statements or Determined To Be a Significant Risk (Paragraph 12 of the Standard)*

Briefly, paragraph 12 of the standard requires the auditor to perform certain basic procedures (supplemented by more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances) regarding related party transactions that are either required to be disclosed in the financial statements or determined to be a significant risk.<sup>85</sup>

Focusing the auditor's attention on related party transactions that are

<sup>84</sup> AU sec. 411.06 requires the auditor to consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. Understanding the "business sense" of material transactions is encompassed by this consideration.

<sup>85</sup> The SEC expects that auditors will provide "heightened scrutiny" of a company's related party transactions. See SEC Accounting and Auditing Enforcement Release ("AAER") No. 3427, *In the Matter of the Application of Wendy McNeeley, CPA*, at 10–12 (December 13, 2012), which states in part that the SEC and courts have repeatedly held that related party transactions require heightened scrutiny by auditors and notes the importance of the auditor understanding the business purpose of material related party transactions.

required to be disclosed in the financial statements or determined to be a significant risk is intended to make the auditor's evaluation of whether the company's related party transactions are properly accounted for and disclosed most effective.

One important focus of the procedures required by paragraph 12 is the auditor's evaluation of the business purpose (or the lack thereof) of the related party transactions that are required to be disclosed or determined to be a significant risk. The procedures in paragraph 12 are designed to work with the procedures in paragraphs 3 through 9 to provide the auditor with additional information to understand and assess the business purpose (or the lack thereof) of the targeted related party transactions that are subject to paragraph 12. Understanding the business purpose of related party transactions is an important consideration in assessing and responding to risks of material misstatement and requires the auditor to understand other factors underlying the transaction. For example, although a company may assert that it has utilized a related party transaction to achieve a particular goal, the company may, in fact, have used the transaction for some other purpose.<sup>86</sup> Obtaining an understanding of the terms and business purpose of a related party transaction includes understanding why the company entered into the transaction with a related party versus an unrelated party. A business purpose that appears inconsistent with the nature of the company's business might represent a fraud risk factor.

#### *Performing Basic Procedures:*

Paragraphs 12.a.–d. contains the basic procedures to be applied to related party transactions that are either required to be disclosed in the financial statements or determined to be a significant risk. Paragraph 12.a. requires the auditor to read the underlying documentation relating to the company's related party transaction(s) and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction. This requirement, together with the other requirements in paragraphs 12.b.–d., require the auditor to evaluate appropriate information regarding the transaction, including, for example, the executed contract, and to

<sup>86</sup> For example, a broker or dealer might use related party transactions to make the size of their operations appear smaller to avoid regulatory requirements.



consider whether the contract and other underlying documentation is appropriately authorized and approved, and is consistent with explanations from inquiries of management and others. The auditor also considers how that information compares to other available audit evidence. For example, when evaluating the responses to inquiries of management and others, the auditor takes into account information obtained from other sources. Such sources could include, for example, SEC filings that include a description of the registrant's policies and procedures for the review, approval, or ratification of "related person" transactions or that identify any "related person" transaction where such policies and procedures did not require review, approval or ratification or where such policies and procedures were not followed.<sup>87</sup>

In particular, paragraph 12.d. of the standard requires the auditor to evaluate the financial capability of the related party with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations. This requirement applies only to items that are individually or collectively significant. Obtaining evidence to evaluate the financial capability of a related party can inform the auditor's evaluation of the business purpose (or the lack thereof), including whether the substance of that transaction differs materially from its form.<sup>88</sup>

*Performing Other Procedures:* Paragraph 12.e. requires the auditor to supplement the basic required procedures contained in paragraphs 12.a.–d. with more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. This approach provides the auditor with the opportunity to scale the audit based on the auditor's

judgment regarding other procedures that are necessary to address the identified and assessed risks of material misstatement. This requires the auditor to make a determination about what procedures are needed to evaluate the accounting and disclosure of the related party transactions. For example, related party transactions might pose valuation and measurement issues that are not present in arm's-length transactions. Consequently, the auditor's tests regarding valuation of a receivable from an entity under common control might be more extensive than for a trade receivable of the same amount from an unrelated party because the common controlling parties may be motivated to obscure the substance of the transaction.

The procedures contained in paragraph 12.e. are designed to work with other procedures that the auditor performs during the audit to address the relevant assertions associated with each related party transaction that requires disclosure.<sup>89</sup> For example, if a company makes a material purchase of property, plant and equipment from an unconsolidated related party, the auditor could inspect the asset to obtain audit evidence that supports management's assertion regarding the existence of the asset. Further, the auditor might examine underlying documents supporting the transfer of title and ownership to obtain audit evidence that supports management's assertion regarding its rights and obligations.

The economic substance of a related party transaction may differ materially from its form. AU sec. 411.06 requires that the auditor consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. Thus, the procedures performed pursuant to paragraph 12.e. are intended to address the auditor's concerns about whether

the substance of a related party transaction differs materially from its form. For example, evaluating the collectability of receivables due from companies owned or controlled by officers of the company under audit might include questions beyond evaluating the financial capability of the related party to pay.

Examples of other procedures that might be appropriate for the auditor to perform pursuant to paragraph 12.e., depending on the nature of the transaction and the risks of material misstatement of the financial statements, include:

- Inquiring directly of the related party regarding the business purpose of the transaction;
- Inspecting information in the possession of the related party or other parties to the transaction, if available;
- Reading public information regarding the related party and the transaction, if any;
- Reading the financial statements or other relevant financial information obtained from the related party, if available, to understand how the related party accounted for the transaction;
- Confirming the terms of the transaction with other parties with knowledge of the transaction (e.g., banks, guarantors, agents, or attorneys), if any;
- Determining whether there are any side agreements or other arrangements (either written or oral) with the related party, including confirming that none exist, if appropriate;
- Evaluating the transferability and value of collateral provided by the related party, if any; and
- Performing procedures at the related party, if possible.

In certain circumstances, an auditor may decide to perform audit procedures at the related party in order to obtain sufficient appropriate audit evidence to support the auditor's opinion. The auditor, however, may not be able to perform procedures at the related party's premises because the related party may not allow the auditor to perform such procedures. However, in all cases the auditing standards require the auditor to obtain sufficient appropriate audit evidence to support his or her audit opinion.<sup>90</sup>

<sup>90</sup> Paragraph 2 of the standard states that the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements. As provided by paragraph 14 of the standard, the auditor's evaluation should be supported by auditing procedures and evidence obtained from procedures performed during the audit, including procedures designed to test the

<sup>87</sup> See Instruction 1 to Item 404(a) of SEC Regulation S–K for the definition of "related person." Disclosure requirements regarding "related persons" in Regulation S–K may differ from "related party" disclosures. See also, Securities Act Release No. 33–8732A, *Executive Compensation and Related Person Disclosure* (August 29, 2006), <http://www.sec.gov/rules/final/2006/33-8732afr.pdf>.

<sup>88</sup> See, e.g., *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005), noting that "among transactions calling for close inspection are related-party transactions, including transactions between a company and its officers or directors. Such dealings are viewed with extreme skepticism in all areas of finance . . . . The reason for this is apparent: Although in an ordinary arms-length transaction, one may assume that parties will act in their own economic self-interest, this assumption breaks down when the parties are related. A company that would perform a thorough credit-risk assessment before extending a loan might not do so if the loan were to one of its officers or directors."

<sup>89</sup> See paragraph 8 of Auditing Standard No. 13, which requires the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure. This includes designing and performing audit procedures in a manner that addresses the assessed risks of material misstatement associated with related parties and relationships and transactions with related parties. See also, paragraph 17 of Auditing Standard No. 13, which states that tests of controls must be performed in the audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when necessary to support the auditor's reliance on the accuracy and completeness of financial information used in performing other audit procedures.



*Aggregating Transactions for Disclosure:* Accounting principles applicable to the company may allow the aggregation of related party transactions that require disclosure (e.g., by type of related party transaction). A note to paragraph 12 of the standard addresses the auditor's responsibility for aggregated related party disclosures. That note states that, if the company has aggregated related party transactions for disclosure purposes in accordance with the applicable financial reporting framework, the auditor may perform the procedures in paragraph 12 of the standard for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement. The Board notes that a "selection of transactions" could be the selection of one transaction from the aggregation in the appropriate circumstances.

Existing standards require the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.<sup>91</sup> AU sec. 334.08–.09 contains procedures that the auditor should consider performing when responding to risks arising from related party relationships and transactions and directs the auditor to apply the procedures the auditor considers necessary to obtain satisfaction concerning the purpose, nature, and extent of identified related party transactions and their effect on the financial statements, noting that those procedures should extend beyond inquiry of management.

#### *Intercompany Accounts (Paragraph 13 of the Standard)*

Paragraph 13 of the standard requires the auditor to perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ. This requirement is based on the procedure in the existing standard, AU sec. 334.09.e., which requires the auditor to consider arranging for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information. Other existing

standards also reference the importance of the auditor's review of consolidating accounts.<sup>92</sup>

A new note to paragraph 13 states that the procedures performed should address the risks of material misstatement associated with the company's intercompany accounts. *Discussion of the Comments Received on Paragraphs 11 through 13 of Auditing Standard No. 18.* The Board considered all comments received, including the following significant comments:

*Evaluating the Financial Capability of the Related Party:* One commenter recommended that the standard should require the auditor to consider evaluating the financial capability of a related party and that the standard should include appropriate alternative procedures if information regarding the related party's financial capability is not readily available. Another commenter stated that the evaluation of the financial capability of the related party should not result in significant additional time by management or the auditor. The Board considered these comments noting that auditors are currently performing procedures to evaluate the financial capability of counterparties in a variety of audit areas today, regardless of whether the counterparty is a related party. For example, auditors might examine the company's support regarding the financial capability of another party as part of evaluating the company's decision to recognize revenue on a particular transaction.

*Performing Procedures on Intercompany Balances:* Some commenters recommended providing additional direction, including specific procedures that the auditor should perform pursuant to paragraph 13. One commenter recommended requiring the auditor to determine the business purpose for intercompany transactions, and whether the transactions have "economic substance."

The Board considered these comments, noting that the preparation of consolidated financial statements could involve complex matters regarding intercompany transactions. For example, a company could consolidate a subsidiary that has a different year-end. The risks of material misstatement with intercompany transactions could include not only the risks associated with intercompany account balances, but also the resulting

effect on the consolidated financial statements, after elimination of such balances. The procedures performed pursuant to paragraph 13 should address the risks of material misstatement. Those procedures could include examining account reconciliations and material transactions, regardless of their timing. The procedures performed pursuant to paragraphs 3 through 9 apply to intercompany transactions and include inquiring of management regarding the business purpose of the transaction and the business purpose for entering into the transaction. Some intercompany transactions might give rise to significant risks of material misstatement that are subject to the procedures in paragraph 12.

The Board considered including additional direction regarding intercompany transactions, but noted that such direction could be viewed as making the requirement unnecessarily prescriptive, which could result in unnecessary costs. However, to remind auditors of the need to address the potential risks of material misstatement, the Board added a note to paragraph 13, which states that the procedures performed should address the risks of material misstatement associated with the company's intercompany accounts. Further, based on comments received, the header preceding paragraph 13 has been revised to refer to "Intercompany Accounts."

The Board is adopting paragraphs 11 through 13 of the standard, substantially as repropoed, except for changing the header to paragraph 13 and adding a new note to paragraph 13, discussed above.

*Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties (Paragraphs 14 through 16 and Appendix A of the Standard)*

#### *Discussion of Paragraphs 14 Through 16 and Appendix A of Auditing Standard No. 18*

Briefly, paragraphs 14 through 16 of the standard address the auditor's evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties. Appendix A includes examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Paragraph 14 of the standard requires the auditor to evaluate whether the company has properly identified its

accuracy and completeness of the related parties and relationships and transactions with related parties disclosed by the company to the auditor.

<sup>91</sup> See paragraph 8 of Auditing Standard No. 13.

<sup>92</sup> See, e.g., paragraph .10 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, and paragraphs .28–.34 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

related parties and relationships and transactions with related parties. Paragraph 14 states that evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. Paragraph 14 also states that this evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, taking into account the information gathered during the audit. Paragraph 14 further requires that, as part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

Paragraph 14 of the standard focuses the auditor on a key aspect of the objective by requiring the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Paragraph 14 recognizes that the company is responsible for the preparation of its financial statements, including, in the first instance, the identification of the company's related parties and relationships and transactions with related parties, and that the auditor begins the audit with information obtained from the company. While paragraph 14 of the standard anticipates that the auditor would start his or her work regarding related parties with the names of related parties and relationships and transactions with related parties identified by the company, the auditor may not merely rely on management's representations<sup>93</sup> as to the accuracy and completeness of the information provided to the auditor. While management has the primary responsibility for preparing the company's financial statements, the auditor should be sensitive throughout the audit to the possibility that management may not have informed the auditor of all related parties or relationships or transactions with related parties.

Paragraph 14 also recognizes that the auditor's procedures to evaluate whether the company has properly

identified its related parties should extend beyond the inquiries pursuant to paragraphs 5 through 7 of the standard. Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company.

A note to paragraph 14 of the standard refers the auditor to Appendix A, which describes examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Many of the examples contained in Appendix A of the standard are contained in AU secs. 334.07–.08. The standard does not require an auditor to perform procedures with respect to each source of information referenced in Appendix A. The information and sources relevant to a particular audit would depend on the facts and circumstances of the audit and, thus, not all of the information or sources of information in Appendix A would need to be considered in every audit. However, other auditing standards, or the performance of auditing procedures in other areas, may impose requirements on the auditor to perform auditing procedures with respect to certain of those sources (for example, reading confirmation responses and responses to inquiries of the company's lawyers).<sup>94</sup> Appendix A also states that the examples contained in that Appendix are not intended to represent a comprehensive listing.

Paragraph 14 precludes the auditor's reliance on the company's identification of its related parties without the auditor taking additional steps, including following up on possible contradictory information gathered during the audit. Thus, while the standard does not require the auditor to search public information indiscriminately to identify a company's related parties, the standard does anticipate that the auditor will take additional steps, including following up on inconsistencies or red flags that arise during the audit. For example, the auditor might review public documents for information regarding a company's related parties and transactions with related parties, particularly when such information is

readily available.<sup>95</sup> Additionally, a review of relevant available public information might be appropriate in situations in which information comes to the auditor's attention that suggests that related parties previously undisclosed to the auditor might exist.

In general, the steps performed by the auditor to evaluate whether the company has properly identified its related parties and relationships and transactions with related parties include: (i) Performing risk assessment procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements; (ii) identifying and assessing risks associated with a company's relationships and transactions with its related parties, including whether the company has properly identified its related parties and relationships and transactions with related parties; (iii) designing and performing audit procedures that address and respond to the risks of material misstatement associated with the company's related parties and transactions, including procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company; and (iv) performing specific procedures that address related party relationships or transactions identified by the auditor that were previously undisclosed by company management. Performing these procedures should position the auditor to obtain sufficient evidence to provide reasonable assurance to support the auditor's opinion.

The approach in paragraph 14 also considers that the auditor's efforts to identify and evaluate a company's significant unusual transactions and obtain an understanding of a company's financial relationships and transactions with its executive officers might assist the auditor in identifying information that might indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Also, the amendments to AU sec. 560, *Subsequent Events*, require that during the "subsequent period" the auditor inquire regarding whether there have been any changes in the company's related parties and whether the company has entered into any

<sup>93</sup> To further assist the auditor's efforts in identifying related parties, the other amendments include a complementary provision that expands existing management representations contained in AU sec. 333 to state that the company has provided the names of all related parties and all relationships and transactions with its related parties to the auditor. However, the auditor may not solely rely on management's representations.

<sup>94</sup> See, e.g., AU sec. 330, *The Confirmation Process*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

<sup>95</sup> Paragraph 11 of Auditing Standard No. 12 requires that as part of obtaining an understanding of the company the auditor should consider reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements.

significant new related party transactions. This could inform the auditor's evaluation of the company's identification of its related parties and relationships and transactions with related parties.

Pursuant to paragraph 15 of the standard, if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor then performs the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. The standard requires that these procedures extend beyond inquiry of management.

Pursuant to paragraph 16 of the standard, if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should perform certain procedures targeted at enhancing the auditor's understanding of the previously undisclosed related party or relationship or transaction. The procedures contained in paragraph 16 are intended to focus the auditor on (i) obtaining additional information and evaluating the related party or relationship or transaction with a related party that the auditor has identified, and (ii) assessing the impact of the new information on all aspects of the audit.

Specifically, the procedures contained in paragraph 16 require that if the auditor determines that an undisclosed related party or relationship or transaction exists, the auditor should:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;
- c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 12 of the standard for each related party transaction previously

undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;

f. Perform the following procedures, taking into account the information gathered from performing the procedures in a. through e. above:

- i. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
- ii. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and

iii. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79–82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. 78j–1.

A footnote to paragraph 16 refers the auditor to AU sec. 333.04, which states that, if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified. Another footnote refers the auditor to paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessment.

As described above, the procedures required by paragraphs 16.a.–e. are performed to obtain the information necessary to evaluate the related party or relationship or transaction with a related party previously undisclosed to the auditor that the auditor has determined exists. Significantly, because of the potential for fraud, paragraph 16.b. of the standard requires the auditor to evaluate why the related party or relationship or transaction with a related party was previously

undisclosed to the auditor. If the related party transaction is either required to be disclosed or is determined to be a significant risk, the auditor is required to perform the procedures in paragraph 12 of the standard.

Paragraph 16.f. requires the auditor to take into account the information gathered from the procedures in paragraph 16.a.–e. regarding the relationship or transaction identified by the auditor to assess the impact on the audit. For example, paragraph 16.f.iii. requires the auditor to reassess the implications for the audit if the company's nondisclosure indicates that fraud or an illegal act may have occurred.

Determining that a related party transaction that was previously undisclosed to the auditor exists could have significant implications for the audit. This information contradicts representations made by management to the auditor and may contradict the auditor's preliminary assessment of whether the company has properly identified its related parties and relationships and transactions with related parties. Identifying such contradictory information requires the auditor to reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk.

The auditor takes the information gathered from performing the procedures set forth in paragraph 16 into account when evaluating whether the company has properly identified its related parties and relationships and transactions with related parties pursuant to paragraph 14 of the standard.

In contrast to the approach set forth in paragraphs 14 through 16, the existing standard contains a variety of procedures that are less specific and focused. For example, AU sec. 334.05 alerts the auditor to the fact that business structure and operating style are occasionally deliberately designed to obscure related party transactions. AU sec. 334.05 states that, in determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component to the total entity and should consider controls over management activities, and the business purpose served by the various components of the entity. AU sec. 334.07 states that determining the existence of transactions with related parties beyond those that are clearly evident requires the application of specific audit procedures and provides

examples of such procedures. AU sec. 334.07 further states that the auditor should place emphasis on testing material transactions with parties the auditor knows are related to the reporting entity. AU sec. 334.08 includes procedures that are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships.

*Discussion of the Comments Received on Paragraphs 14 Through 16 and Appendix A of the Reproposed Standard*

The Board considered all comments received, including the following significant comments:

*Clarifying the Auditor's Responsibility Regarding Appendix A:* Many commenters recommended clarifying the auditor's responsibilities for the examples of information and sources of information contained in Appendix A. Some of the commenters recommended including clarifying language regarding the scope of the auditor's responsibilities with respect to Appendix A; others suggested qualifying language stating that the auditor is not required to perform procedures with respect to each type or source of information referenced in Appendix A.

The Board considered these comments, noting that Appendix A is intended to provide examples of information and sources of information and does not provide a comprehensive or mandatory listing. Further, other auditing standards may impose requirements on the auditor to perform procedures regarding the examples contained in Appendix A. Accordingly, the suggested qualifying language would not be appropriate. The Board, however, made certain revisions intended to clarify the applicability of Appendix A by revising the note in paragraph 14 and similar language in Appendix A to state that Appendix A contains examples of information and sources of information that the auditor may gather during the audit.

*Clarifying the Auditor's Responsibility for Evaluating the Company's Identification of Its Related Parties:* Many commenters recommended a number of clarifications to paragraph 14 of the reproposed standard. Several commenters recommended incorporating footnote 14 into paragraph 14 of the reproposed standard to clarify that the auditor's evaluation of the company's identification of its related parties and relationships and

transactions with related parties requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company. Other commenters recommended clarification regarding the extent of the auditor's evaluation in paragraph 14 and whether it is based on the information gathered during the audit.

In response to these comments, the Board made a number of clarifications. Specifically, the Board incorporated footnote 14 of the reproposed standard into paragraph 14 to clarify that the auditor's evaluation requires the auditor to perform procedures to test the accuracy and completeness of the company's identification. Additionally, the revisions give more prominence to the requirement and clarify that, in performing the evaluation required by paragraph 14, the auditor takes into account the information gathered during the audit. This revision, in conjunction with the clarifications to the note regarding the examples and sources of information contained in Appendix A (discussed below), is intended to further describe the auditor's responsibilities for evaluating the company's identification of its related parties and relationships and transactions with its related parties.

*Examples Included in Appendix A:* A few commenters suggested revisions to the examples of information or sources of information contained in Appendix A to the standard. The Board considered these comments, noting that Appendix A contains examples of information and sources of information that the auditor may gather during the audit and does not represent a comprehensive listing. The Board revised Appendix A to include "disclosures contained on the company's Web site" (in addition to the company's disclosures in SEC filings, which is already included as an example in Appendix A) as another example of a source of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

*Verifying the Ownership Structure Between the Company and Its Related Parties:* One commenter stated that verifying the ownership structure between the company and its related parties may be one of the most difficult aspects of an audit. That commenter recommended that the Board outline procedures for verifying the ownership structure between the company and the related parties disclosed to the auditor

by management, including the levels of direct and indirect control, and changes in those levels during the period under audit. The Board considered this comment, noting that determining the procedures for verifying these matters (for example, determining whether the company or its management is able to exercise significant influence over another entity) requires an evaluation of the facts and circumstances. Additionally, in making such a determination, the auditor's response should address the risks of material misstatement.<sup>96</sup> Including additional direction in a context that is so heavily facts and circumstances driven could make the standard unnecessarily complex and prescriptive, making it potentially more difficult to apply.<sup>97</sup>

*Setting Appropriate Expectations Regarding the Auditor's Responsibilities:* Some commenters stated that the extent of the auditor's procedures necessary for evaluating management's identification of its related parties and relationships did not take into account the responsibility of management. One commenter recommended including additional context, similar to that contained in International Standard on Auditing No. 550, *Related Parties*, to recognize that the nature of related party transactions could compromise the auditor's ability to detect material misstatements associated with related parties, even though the audit is properly planned and performed. Another commenter stated that the objective appears to require performance of procedures equivalent to a forensic engagement to uncover all related parties and transactions.

The Board considered these comments and did not agree that additional changes were necessary to address the appropriate expectations for the auditor's responsibilities with respect to identifying related parties and relationships and transactions with

<sup>96</sup> The auditor may also be required to perform procedures on these matters by other auditing standards, such as AU sec. 332.

<sup>97</sup> See, e.g., Canadian Public Accountability Board, *Auditing in Foreign Jurisdictions CPAB Special Report* (2012) <http://www.cpab-ccrc.ca/en/topics/PublicSpecialReports/Pages/default.aspx>, which noted that the existence of related parties and transactions are more likely to represent an audit risk for operations in foreign jurisdictions when the legal or regulatory environment requires reliance on complex business structures or when dominant shareholders are involved in the operations of the business. That report also noted that because the identification of related parties may also be more difficult in foreign jurisdictions, it is important that auditors have a heightened sensitivity to possible related-party transactions by performing procedures to determine the ownership and management structure of significant customers and suppliers.

related parties.<sup>98</sup> Additionally, the Board had already taken note of commenters' requests to clarify its proposal to focus the auditor's attention first on information provided by management and is also adopting revisions to AU sec. 333 to provide for additional written representations by management pertaining to its related parties. Moreover, the Board declined to pursue an alternative that would have designated related party transactions as fraud risks, which would have resulted in more forensic-type procedures. Instead, the Board's approach overall to the auditor's responsibility to identify a company's related parties has been targeted and risk-based, requiring heightened scrutiny in areas that have historically represented high risk of material misstatement. The Board believes this approach appropriately recognizes the auditor's existing responsibilities for the identification of related parties and relationships and transactions with related parties in a cost-sensitive way.

*Applicability of Paragraph 16 to Related Party Transactions Identified by the Auditor That Are "Clearly Trivial":* Several commenters recommended that the procedures required by paragraph 16 should not be required if the related party transaction identified by the auditor is "clearly trivial," as that term is described in Auditing Standard No. 14.<sup>99</sup> Those commenters generally noted that such an approach would avoid unnecessary work.

The Board considered these comments, noting that the auditor might not be able to determine if the previously undisclosed transaction identified by the auditor is "clearly trivial" without the information that would be obtained from the procedures in paragraph 16.a.–d. of the repropoed standard.<sup>100</sup> For example, inquiring of management regarding why the transaction was not disclosed to the auditor and evaluating that explanation would be important to determining whether the transaction is "clearly trivial." Further, taking into account

information regarding a related party transaction identified by the auditor that is "clearly trivial" generally would not significantly impact the auditor's evaluation of the matters in paragraphs 16.f.–h. of the repropoed standard.<sup>100</sup>

The use of the phrase "clearly trivial" could also result in other consequences. For example, providing such an exception could inappropriately focus the auditor's evaluation on quantitative considerations to the detriment of qualitative considerations and might allow management an opportunity to influence the auditor's evaluation. In addition, providing such an exception could create confusion regarding paragraph 16.h. of the repropoed standard (paragraph 16.f.iii of the standard), which refers to Section 10A of the Exchange Act. Section 10A of the Exchange Act applies to information indicating that fraud or another illegal act has or might have occurred, whether or not perceived to have a material effect on the financial statements of the company.

However, after considering these comments, the Board did make revisions to paragraph 16 to clarify that the procedures performed pursuant to paragraph 16 focus the auditor on obtaining additional information both by (i) performing the initial procedures in paragraph 16.a.–e. so that the auditor can evaluate the nature and potential impact of the previously undisclosed related party or relationship or transaction that the auditor has identified, and (ii) performing additional procedures to evaluate the implications for the audit, including the auditor's risk assessment, taking into account the information gathered from performing the procedures in paragraph 16.a.–e. These revisions should clarify the auditor's approach.

The Board also made technical changes to paragraph 16.h. of the repropoed standard to more closely align with the corresponding requirement contained in paragraph 23 of Auditing Standard No. 14. Paragraph 23 of Auditing Standard No. 14 states that if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79–82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Exchange Act, 15 U.S.C. 78j–1.

As revised, if the auditor determines that a related party or relationship or transaction with a related party

previously undisclosed to the auditor exists, the auditor is required to perform certain initial procedures. Those procedures required by paragraphs 16.a.–e. focus the auditor on obtaining additional information and evaluating the related party or relationship or transaction with a related party that the auditor has identified. A footnote to paragraph 16.b. refers the auditor to AU sec. 333.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. After performing the procedures in paragraph 16.a.–e., the auditor performs the procedures in paragraphs 16.f.i–iii. of the standard taking into account the information previously gathered by the auditor, to assess the broader impact of the auditor's findings on the audit.

*"Other" Related Parties Previously Undisclosed to the Auditor:* One commenter recommended that paragraph 16 be clarified to include that the auditor also inquire of management about the possible existence of transactions with *other* undisclosed related parties. The Board considered this comment, noting that while this inquiry was not explicitly stated, assessing whether there are *other* undisclosed related parties is a component of the auditor's response once a related party or a relationship or transaction with a related party previously undisclosed to the auditor by management has been identified by the auditor.

Inquiring of management regarding the identification of the possible existence of transactions with other undisclosed related parties and relationships and transactions with related parties, including whether there are any *other* undisclosed related parties, would generally be encompassed in the auditor's procedures performed in discharging the auditor's responsibilities once the auditor has determined that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Based on the auditor's reassessment of risk, the auditor performs additional procedures that would include such inquiries, but also would extend beyond inquiring of management.

Significantly, paragraph 16.f.ii. of the standard<sup>101</sup> requires the auditor to reassess the risks of material misstatement and perform additional procedures as necessary, if such

<sup>98</sup> For example, the auditor's responsibility to perform procedures to identify related party transactions that are material to the financial statements is reflected in Section 10A(a) of the Exchange Act.

<sup>99</sup> Paragraph 10 of Auditing Standard No. 14 states that "clearly trivial" is not another expression for "not material." Paragraph 10 also states that matters that are clearly trivial will be of a smaller order of magnitude than the materiality level established in accordance with Auditing Standard No. 11, and will be inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature, or circumstances. Paragraph 10 further states that when there is any uncertainty about whether one or more items is clearly trivial, the matter is not considered trivial.

<sup>100</sup> Paragraphs 16.f.–h. of the repropoed standard are now contained in paragraphs 16.f.i–iii. of the standard.

<sup>101</sup> Paragraph 16.g. of the repropoed standard is now contained in paragraph 16.f.ii. of the standard.

reassessment results in a higher risk. This would include procedures designed to address the risk of transactions with *other* undisclosed related parties.

To clarify the auditor's responsibilities regarding *other* undisclosed related parties, the Board added a new footnote to paragraph 16 that refers the auditor to paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.

The Board is adopting paragraphs 14 through 16 and Appendix A as repropose, with the following changes:

a. Revising paragraph 14 to highlight that the auditor performs procedures to test the accuracy and completeness of management's identification, taking into account information gathered during the audit;

b. Clarifying in the note to paragraph 14 that Appendix A contains examples of information and sources of information that the auditor may gather during the audit;

c. Revising Appendix A to include a new example, "disclosures contained on the company's Web site";

d. Revising paragraph 16 to clarify that the auditor performs the procedures in 16.f.i.–iii., taking into account the information gathered from performing the procedures in paragraph 16.a.–e.;

e. Adding a new footnote to paragraph 16.f.ii., referring to paragraph 74 of Auditing Standard No. 12, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments; and

f. Revising paragraph 16.f.iii. to more closely align with paragraph 23 of Auditing Standard No. 14, which states if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79–.82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. 78j–1.

Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17 and 18 of the Standard)

*Discussion of Paragraphs 17 and 18 of Auditing Standard No. 18*

Paragraph 17 of the standard aligns with requirements in Auditing Standard No. 14 to require the auditor to evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. Paragraph 17 states that this includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework. A footnote to paragraph 17 refers the auditor to paragraphs 30 and 31 of Auditing Standard No. 14.

The auditor's evaluation of a company's accounting and disclosure of relationships and transactions with related parties is important to the protection of investor interests because the substance of related party transactions might differ materially from their form. Furthermore, related party transactions not only may involve difficult measurement and recognition issues, but may also be used to engage in financial statement fraud and conceal misappropriation of assets.

Paragraph 17 is intended to align the auditor's evaluation with the objective of the standard and to focus the auditor on both the accounting and disclosure of the company's relationships and transactions with related parties. Footnote 1 to paragraph 1 of the standard states that the auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company. Unlike the existing standard, paragraph 17 of the standard does not include a separate requirement to evaluate whether the substance of a related party transaction differs materially from its form because that evaluation is part of the auditor's evaluation of whether the financial statements have been presented fairly in conformity with the applicable financial reporting framework pursuant to AU sec. 411.06.

Consistent with the existing standard, evaluating substance over form does not require the auditor to challenge the appropriateness of the accounting standards. However, financial statements may not be presented fairly if they do not include information about the matters that affect their use, understanding, and interpretation.<sup>102</sup>

<sup>102</sup> See AU sec. 411.04.

For example, to improve the appearance of its financial condition, a company and a related party could attempt to "dress up" the appearance of the company's balance sheet at period-end. Some period-end "window-dressing" transactions might involve side agreements undisclosed to the auditor, while others might represent transactions that the auditor is aware of, in which management placed more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction.

AU sec. 334 requires the auditor to consider whether sufficient appropriate evidence has been obtained to understand each related party relationship, as well as the effect of each material related party transaction on the financial statements. The existing standard states that the auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure. Further, AU sec. 334.02 states that the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form. Additionally, Auditing Standard No. 14 describes the auditor's responsibility for evaluating the presentation of financial statements, including disclosures, more generally. Auditing Standard No. 14 requires the auditor to evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.<sup>103</sup> Furthermore, AU sec. 411.06 requires the auditor to consider whether the substance of transactions or events differs materially from their form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework.

*Assertions That Transactions With Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (Paragraph 18 of the Standard)*

Paragraph 18 of the standard states that if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence

<sup>103</sup> See paragraph 30 of Auditing Standard No. 14.

obtained supports or contradicts management's assertion.

Financial reporting frameworks permit management to assert that a related party transaction that is required to be disclosed in the financial statements was conducted on terms equivalent to those prevailing on an arm's-length basis only when support for such an assertion exists. Management's refusal to modify such a disclosure when support for that statement does not exist represents a departure from GAAP and IFRS. Such a misstatement would require the auditor to express either a qualified or adverse opinion on the financial statements. A decision by management to remove, at the auditor's request, such an assertion from the financial statements due to management's inability to provide the auditor with sufficient appropriate audit evidence might affect the auditor's assessment of internal control over financial reporting.

The requirements in paragraph 18 of the standard are complemented by the other amendments to AU sec. 333, which require the auditor to obtain written representations from management when management has asserted that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

AU sec. 334 includes requirements regarding the auditor's evaluation of assertions that related party transactions occurred on terms equivalent to those occurring on an arm's-length basis. AU sec. 334.12 notes the difficulty in substantiating such representations and states that, except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. AU sec. 334 also states that if such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, the auditor should express a qualified or adverse opinion because of a departure from GAAP, depending on materiality.

After considering all comments received, the Board is adopting paragraphs 17 and 18 of the standard as repropoed, except for the addition of a reference to paragraph 30 of Auditing Standard No. 14 in footnote 19 to paragraph 17.

Communications With the Audit Committee (Paragraph 19 of the Standard)

*Discussion of Paragraph 19 of Auditing Standard No. 18*

Paragraph 19 of the standard requires the auditor to communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with its related parties, as well as other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

Both the auditor and the audit committee benefit from a meaningful exchange of information regarding significant risks of material misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports, including matters arising from a company's relationships and transactions with related parties.

Paragraph 19 of the standard is intended to work in tandem with paragraph 7 of the standard. The inquiries of the audit committee, or its chair, pursuant to paragraph 7, can be more effective when they occur at an earlier point in the audit, when the auditor is obtaining an understanding of the company's relationships and transactions with its related parties. This can avoid situations where the auditor's communications regarding a company's relationships and transactions with its related parties might first occur at the end of the audit. This is consistent with Auditing Standard No. 16, which anticipates timely and robust communications between the auditor and the audit committee throughout the audit. These communications also provide an opportunity for the auditor to corroborate the information obtained from management regarding the company's relationships and transactions with its related parties.

The communication required by paragraph 19 of the standard provides an opportunity for the auditor to communicate information obtained during the audit relevant to those earlier inquiries pursuant to paragraph 7. For example, the auditor might discuss relationships or transactions with related parties that are significant to the company that were not previously discussed with the audit committee, or its chair. The auditor also would communicate significant matters to the audit committee if the auditor encountered these matters during the

review of interim financial information.<sup>104</sup>

In all cases, the auditor's communications with the audit committee pursuant to paragraph 19 of the standard would cover all the items listed in paragraphs 19.a.-e., to the extent applicable. Such communications involve matters such as the identification of related parties and relationships and transactions with related parties that were previously undisclosed to the auditor, which, as described in the paragraph below, may be of particular interest and concern to the audit committee. Thus, the auditor's communications pursuant to paragraph 19 are not intended to be done only when an exception is identified by the auditor. Doing so would not provide for the proactive communication that should occur with the audit committee regarding what the auditor found as a result of the auditor's evaluation of the company's identification of, accounting for, and disclosure of, its relationships and transactions with its related parties. Further, these communications cannot be made by management as the communication requirements involve communication of the auditor's evaluation of certain matters and management is not in a position to communicate the auditor's evaluation and views.

As noted in paragraph 19, the auditor's communications to the audit committee may not be limited to only those examples of significant matters included in paragraph 19 of the standard. For example, in evaluating the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, the auditor might identify other significant matters that might be of interest to the audit committee, such as concerns over the company's process for identifying related parties and relationships and transactions with related parties.

AU sec. 334 does not include specific requirements regarding the auditor's communication with the audit committee. Other existing auditing standards, however, require that the auditor communicate significant matters to the audit committee, including those encountered during a review of interim financial information.<sup>105</sup>

<sup>104</sup> See paragraph .34 of AU sec. 722, *Interim Financial Information*.

<sup>105</sup> See Auditing Standard No. 16 and AU sec. 722.34.



*Discussion of the Comments Received on Paragraph 19 of the Reproposed Standard*

The Board considered all comments received, including the following significant comments:

*Communicating Significant Matters:* Many commenters recommended revising paragraph 19.a. of the reproposed standard to allow for additional auditor judgment. Some of these commenters suggested that paragraph 19.a. of the reproposed standard be revised to only require the communication of “significant” related parties or relationship or transactions with related parties that were previously undisclosed to the auditor.

The Board considered these comments and believes that communicating all related party relationships and transactions previously undisclosed to the auditor to the audit committee is beneficial. For example, such communications could inform the audit committee of such matters that management had previously concealed from the audit committee as well as from the auditor. While the auditor determines the impact of the identification of a related party relationship or transaction on the audit, these communications can inform the audit committee of matters that might be important to their oversight of management and the financial reporting process. Further, this communication also serves as an opportunity to corroborate management’s explanation regarding why the related party transaction was undisclosed to the auditor.

*Form of the Communications:* At the SAG discussion, the point was raised as to whether the auditor’s communications with the audit committee should be communicated in writing or orally. The Board considered this comment, noting that paragraph 19 of the standard is aligned with the requirements in Auditing Standard No. 16, which includes specific requirements on the nature and timing of auditor communications with the audit committee. Paragraph 25 of Auditing Standard No. 16 states that generally the communications can be made orally or in writing.<sup>106</sup>

The Board is adopting paragraph 19 of the standard as reproposed.

<sup>106</sup> Paragraph 25 of Auditing Standard No. 16 also states that the auditor must document the communications in the work papers, whether such communications took place orally or in writing.

*Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions*

Significant unusual transactions can present increased risks of material misstatement of the financial statements due to fraud or error. The amendments regarding significant unusual transactions being adopted by the Board improve the existing standards regarding the auditor’s identification and evaluation of a company’s significant unusual transactions.

Many commenters generally supported the Board’s efforts to strengthen the existing standards regarding significant unusual transactions. A few commenters noted that the improvements could have a positive impact on audit quality. However, some commenters suggested certain revisions to clarify and refine the reproposed amendments regarding significant unusual transactions.

After considering the comments received, the Board is adopting the amendments regarding significant unusual transactions substantially as reproposed, with certain minor revisions that include:

- *Clarifying the Phrase “Infrequent or Significant Unusual Transactions” in the Amendments to AU sec. 722 (Identifying Significant Unusual Transactions):* The amendments to Appendix B of AU sec. 722 include revisions to clarify that the “occurrence of infrequent transactions” and the “occurrence of significant unusual transactions” are separate examples; and

- *Clarifying the Auditor’s Evaluation of Identified Significant Unusual Transactions in the Amendments to Paragraph .67 of AU sec. 316 (Evaluating Significant Unusual Transactions):* The amendments to AU sec. 316.67 include revisions to clarify that, in considering the business purpose (or the lack thereof) of the significant unusual transaction, the auditor should evaluate whether the transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party of the company.

The following sections describe the amendments regarding significant unusual transactions being adopted by the Board and existing requirements, as well as discuss the significant comments received and Board responses, where applicable. The sections are organized by the following topical areas:

- Identifying Significant Unusual Transactions

- Evaluating Significant Unusual Transactions

Identifying Significant Unusual Transactions

*Discussion of the Amendments Regarding Identifying Significant Unusual Transactions*

The amendments regarding identifying significant unusual transactions: (i) align the description of significant unusual transactions in the Board’s auditing standards; (ii) enhance the requirements for identifying a company’s significant unusual transactions; and (iii) revise and add to the examples of fraud risk factors described in AU sec. 316.

*Aligning the Descriptions of Significant Unusual Transactions*

*Amendments to AU sec. 316.66:* The amendments regarding significant unusual transactions revise AU sec. 316.66 to 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. This description is consistent with the existing description in paragraph 71.g. of Auditing Standard No. 12. The amendments to AU sec. 316.66 also state that significant unusual transactions may be used to engage in fraudulent financial reporting or conceal misappropriation of assets.

*Conforming Amendments:* The amendments regarding significant unusual transactions also make conforming changes to introduce a uniform description of “significant unusual transaction” throughout the Board’s standards. Specifically, the amendments align the terminology in: (i) Paragraph 14 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*; (ii) paragraph 12 of Auditing Standard No. 9, *Audit Planning*; (iii) paragraph 13 of Auditing Standard No. 12; (iv) paragraph 15.c. of Auditing Standard No. 13; (v), paragraph .85.A.2 of AU sec. 316; and (vi) AU sec. 722.55.B1.

In general, the description of a significant unusual transaction included in the amendments permits the auditor flexibility in applying the description to different companies of different sizes and in different industries. The description of a significant unusual transaction is designed so that the auditor determines whether a transaction is a significant unusual transaction based on the specific facts



and circumstances of the company under audit.

A significant unusual transaction does not necessarily need to occur infrequently. Whether a transaction constitutes a significant unusual transaction should be based upon the specific facts and circumstances. The timing or frequency of transactions is only one element to be considered in determining whether a transaction is a significant unusual transaction.

#### *Enhancing Requirements for Identifying Significant Unusual Transactions*

Existing requirements relating to the auditor's consideration of fraud in a financial statement audit recognize that during an audit the auditor may become aware of significant 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.<sup>107</sup> The risk assessment standards also anticipate that the auditor might come across 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. For example, paragraph 71.g. of Auditing Standard No. 12 states that one factor that should be evaluated for the auditor's determination of which risks are significant risks is whether the risk involves significant transactions outside the normal course of business or that otherwise appear to be unusual due to their timing, size, or nature.

The amendments include changes to existing standards that require the performance of procedures as part of the auditor's risk assessment process to identify significant unusual transactions. As discussed below, these procedures include: (i) Inquiring of management and others; (ii) understanding controls relating to significant unusual transactions; and (iii) taking into account other information obtained during the audit.

*Inquiring of Management and Others (Paragraphs 56–57 of Auditing Standard No. 12):* The amendments regarding significant unusual transactions build on existing requirements in Auditing Standard No. 12 that require the auditor to make inquiries of management and others within the company about the risks of material misstatement.<sup>108</sup> Specifically, the amendments regarding significant unusual transactions revise paragraph 56.a. of Auditing Standard No. 12 to require the auditor to inquire

of company management regarding whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties. The amendments regarding significant unusual transactions also revise paragraphs 56.b. and 56.c. of Auditing Standard No. 12 to require the auditor to inquire of the audit committee and internal audit personnel (if applicable), respectively, regarding whether the company has entered into any significant unusual transactions.

The amendments regarding significant unusual transactions also amend paragraph 57 of Auditing Standard No. 12, which currently requires that the auditor inquire of others within the company about their views regarding fraud risks and includes the example of employees involved in initiating, recording, or processing complex or unusual transactions. The amendments add significant unusual transactions as an example of a complex or unusual transaction to paragraph 57 of Auditing Standard No. 12.

Inquiring of management and others within the company regarding the existence of significant unusual transactions as part of the auditor's risk assessment procedures is an important step—but not the only step—in the auditor's identification of significant unusual transactions. The auditor might determine that there are significant unusual transactions despite management's assertion that there are no significant unusual transactions (e.g., through other procedures performed during the audit, such as reading minutes of the board of directors meetings and performing journal entry testing).

*Understanding Controls Relating to Significant Unusual Transactions (Paragraph 73A of Auditing Standard No. 12):* Auditing Standard No. 12 requires that the auditor obtain a sufficient understanding of each component of internal control over financial reporting to: (i) Identify the types of potential misstatements; (ii) assess the factors that affect the risks of material misstatement; and (iii) design further audit procedures.<sup>109</sup>

The amendments regarding significant unusual transactions build on the risk assessment standards by adding paragraph 73A to Auditing Standard No. 12. That paragraph requires the auditor to obtain an understanding of the controls management has established to identify, authorize and approve, and

account for and disclose, significant unusual transactions in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18 through 40, 72, and 73 of Auditing Standard No. 12.

*Taking into Account Other Information Obtained During the Audit (AU sec. 316.66):* The amendments regarding significant unusual transactions add a note to AU sec. 316.66 stating that the auditor's identification of significant unusual transactions should take into account information obtained from: (i) The risk assessment procedures required by Auditing Standard No. 12 (e.g., inquiring of management and others, obtaining an understanding of the methods used to account for significant unusual transactions, and obtaining an understanding of internal control over financial reporting), and (ii) other procedures performed during the audit (e.g., reading minutes of the board of directors meetings and performing journal entry testing).

Examples of those procedures include:

- Reading minutes of meetings of the board of directors and its committees;<sup>110</sup>
- Reading periodic and current reports, and other relevant company filings with the SEC and other regulatory agencies;<sup>111</sup>
- Inspecting confirmation responses and responses to inquiries of the company's lawyers;<sup>112</sup>
- Obtaining an understanding of the company's selection and application of accounting principles, including related disclosures (e.g., reading accounting policy manuals and technical memoranda prepared by or for management);<sup>113</sup>
- Performing analytical procedures during the audit;<sup>114</sup> and
- Performing journal entry testing, including inquiring of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments as required by existing standards.<sup>115</sup>

<sup>110</sup> See AU sec. 560.12.c. and AU sec. 722.18.a.

<sup>111</sup> See paragraph 11 of Auditing Standard No. 12, which requires the auditor to consider reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements as part of obtaining an understanding of the company.

<sup>112</sup> See paragraph .06 of AU sec. 337.

<sup>113</sup> See paragraph 7.c. of Auditing Standard No. 12.

<sup>114</sup> See paragraphs 46 through 48 of Auditing Standard No. 12.

<sup>115</sup> See AU secs. 316.58 through 62.

<sup>107</sup> See AU secs. 316.66–67.

<sup>108</sup> See paragraphs 56 and 57 of Auditing Standard No. 12.

<sup>109</sup> See paragraph 18 of Auditing Standard No. 12.

Also, the auditor might identify significant unusual transactions when examining information gathered during the audit. For example, an auditor might identify a significant unusual transaction by scanning a population of invoices for unusual items when determining a sample of items to be tested. By doing so, the auditor might identify an unusual item in terms of dollar amount, the date on which the item was shipped (e.g., on a Sunday when the shipping department is closed), or an unusually high concentration of transactions during a given time period.

Appendix A to the standard includes examples of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. These examples could also be helpful in identifying significant unusual transactions.

The amendments add a second note to AU sec. 316.66 that states that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions.

Also, the amendments to AU sec. 560 require that during the “subsequent period” the auditor inquire regarding whether the company has entered into any significant unusual transactions. This could inform the auditor’s identification of a company’s significant unusual transactions.

Improving the auditor’s identification of significant unusual transactions also can inform the auditor’s evaluation of whether the company has properly identified its related parties and relationships and transactions with related parties, as a significant unusual transaction might also be a related party transaction previously undisclosed to the auditor.

#### *Revising and Adding to the Examples of Fraud Risk Factors*

The amendments regarding significant unusual transactions also revise certain examples of fraud risk factors contained in AU sec. 316. For example, AU sec. 316.85A.2 notes that significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm can provide opportunities to engage in fraudulent financial reporting. The amendments regarding significant unusual transactions separate that existing example into two

distinct examples, namely: (i) Related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business); and (ii) significant transactions with related parties whose financial statements are not audited or are audited by another firm. The amendments also add contractual arrangements lacking a business purpose as an example of a fraud risk factor.

#### *Discussion of the Comments Received on the Reproposed Amendments Regarding Identifying Significant Unusual Transactions*

The Board considered all comments received, including the following significant comments:

*Identifying Significant Unusual Transactions Is the Auditor’s Responsibility:* One commenter noted that the reproposed procedures for identifying significant unusual transactions (performing inquiries, understanding controls, and taking other information into account) are performed as part of the auditor’s risk assessment process rather than to enable the auditor to perform an initial identification of significant unusual transactions—which, in that commenter’s view, is the role of management. That commenter suggested clarifying that management is responsible for identifying the company’s significant unusual transactions, consistent with the changes regarding a company’s related parties. Another commenter stated that, as the size and complexity of a company increases, the likelihood of an auditor being able to identify significant unusual transactions diminishes proportionately.

The Board considered these comments, noting that the determination of whether a transaction is a significant unusual transaction is the responsibility of the auditor. The auditor takes management’s responses to inquiries and other procedures into account when identifying significant unusual transactions. However, the information provided by management is not the sole consideration. The auditor’s procedures for identifying significant unusual transactions are performed as part of the auditor’s risk assessment, and the auditor’s procedures should be sufficient to identify risks of material misstatement of the financial statements, based on the size and complexity of the company.

*Clarifying the Phrase “Infrequent or Significant Unusual Transactions” in the Amendments to AU sec. 722:* AU

sec. 722.55 contains examples of situations about which the auditor would ordinarily inquire of management when conducting a review of interim financial information. A few commenters suggested revisions to clarify the reproposed amendment to the tenth bullet of AU sec. 722.55, which as reproposed stated “the occurrence of infrequent or significant unusual transactions.” In response to comments, the Board revised the tenth bullet into two separate items: one bullet relating to the occurrence of infrequent transactions and the other relating to the occurrence of significant unusual transactions.

The Board is adopting the amendments regarding the identification of significant unusual transactions substantially as reproposed, except for the revision to AU sec. 722 discussed above.

#### *Evaluating Significant Unusual Transactions*

##### *Discussion of the Amendments Regarding Evaluating Significant Unusual Transactions*

The amendments regarding the evaluation of significant unusual transactions address the following areas: (i) evaluating the business purpose (or the lack thereof) of significant unusual transactions; (ii) evaluating the accounting and disclosure of significant unusual transactions; and (iii) other matters regarding significant unusual transactions.

##### *Evaluating the Business Purpose (or the Lack Thereof) of Significant Unusual Transactions*

The amendments regarding significant unusual transactions strengthen the auditor’s evaluation of whether the business purpose (or the lack thereof) for significant unusual transactions indicates that those transactions were entered into to engage in fraud.

Existing AU sec. 316.66 requires that once an auditor becomes aware of significant unusual transactions, the auditor should gain an understanding of the business rationale for such transactions and whether that rationale (or the lack thereof) suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. Existing AU sec. 316.67 identifies several matters that the auditor should consider in understanding the business rationale for those transactions.

The amendments build on the existing requirements in AU secs. 316.66-.67 and include additional

procedures to more specifically focus the auditor's attention on critically evaluating whether the business purpose (or the lack thereof) for significant unusual transactions indicates that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.

Those improvements are accomplished through: (i) revisions to AU sec. 316.66; (ii) adding AU sec. 316.66A; and (iii) revisions to AU sec. 316.67. Each of those amendments is discussed in further detail below.

*Revisions to AU sec. 316.66:* Because a company might use a significant unusual transaction to engage in fraudulent financial reporting or to obscure the company's financial position or operating results, existing standards require the auditor to perform procedures to evaluate significant unusual transactions identified by the auditor and discuss the auditor's evaluation of such transactions with the audit committee.<sup>116</sup> The amendments to AU sec. 316.66 are intended to improve the auditor's evaluation of significant unusual transactions, including the auditor's evaluation of the business purpose (or the lack thereof), and whether the transactions have been appropriately accounted for and adequately disclosed in the company's financial statements, by requiring the auditor to perform specific procedures to evaluate significant unusual transactions. Improving the auditor's evaluation of significant unusual transactions should also result in a more meaningful exchange of information between the auditor and the audit committee.

*Adding AU sec. 316.66A:* The amendments regarding evaluating significant unusual transactions add a new paragraph to AU sec. 316, paragraph AU sec. 316.66A, which requires that the auditor design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. The procedures include:

a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

b. Determining whether the transaction has been authorized and approved in accordance with the

company's established policies and procedures;

c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and

d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

A footnote to item c. of the amendments to AU sec. 316.66A also states that examples of information that might be relevant to the auditor's evaluation of the other party's financial capability include, among other things, the audited financial statements of the other party, reports issued by regulatory agencies, financial publications, and income tax returns of the other party, to the extent available.

Item d. of the amendments to AU sec. 316.66A provides an opportunity for the auditor to scale the audit by supplementing the basic required procedures with more in-depth procedures commensurate with the auditor's evaluation of the company's facts and circumstances. Those procedures should: (i) Address the assessed risks of material misstatement; (ii) provide an understanding of the business purpose (or the lack thereof) that is sufficient to evaluate whether the transaction was entered into to commit fraudulent financial reporting or misappropriate assets; and (iii) provide the auditor with sufficient audit evidence to evaluate whether the financial statement accounting and disclosure requirements have been met.

Examples of other procedures that might be appropriate, depending on the nature of the significant unusual transaction and the risks of material misstatement of the financial statements, include:

- Inquiring directly of the other party regarding the business purpose of the transaction;
- Reading public information regarding the transaction and the parties to the transaction, if available;
- Reading the financial statements or other relevant financial information obtained from other parties involved in the transaction, if available, to understand how the other party accounted for the transaction;
- Evaluating the transferability and value of collateral provided by the other party, if any;
- Confirming the terms of the transaction with other parties with knowledge of the transaction (e.g., banks, guarantors, agents, or attorneys), if any; and

- Confirming whether there are any side agreements or other arrangements (either written or oral) with the other party.

The amendments regarding significant unusual transactions were designed to establish basic procedures for the auditor to identify and evaluate significant unusual transactions and allow the auditor to assess risks and respond to risks based on the facts and circumstances, including the size and complexity of the company and the assessed significance of the identified risks of material misstatement in the financial statements.

Significant unusual transactions, like all transactions, are subject to the requirements contained in AU sec. 411.06, which requires that the auditor consider whether the substance of a transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. That evaluation encompasses an understanding of the "business sense" of material transactions, which was referred to in footnote 6 of AU sec. 334.

Existing standards require that the auditor design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.<sup>117</sup> This includes designing and performing audit procedures in a manner that addresses the assessed risks of material misstatement associated with significant unusual transactions. The procedures contained in AU sec. 316.66A work in conjunction with the procedures that the auditor performs during the audit to address the relevant assertions associated with each significant unusual transaction.

*Revisions to AU sec. 316.67:* The amendments regarding significant unusual transactions also require the auditor to evaluate certain matters when evaluating whether the business purpose (or the lack thereof) of a significant unusual transaction suggests that the transaction may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. The amendments incorporate the list of matters currently in AU sec. 316.67 and add the following matters:

- The transaction lacks commercial or economic substance, or is part of a larger series of connected, linked, or otherwise interdependent arrangements

<sup>116</sup> See AU secs. 316.66–.67 and paragraph 13.d. of Auditing Standard No. 16.

<sup>117</sup> See also paragraph 8 of Auditing Standard No. 13.

that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);

- The transaction occurs with a party that falls outside the definition of a related party (as defined by the accounting principles applicable to that company), with either party able to negotiate terms that may not be available for other, more clearly independent, parties on an arm's-length basis;<sup>118</sup> and
- The transaction enables the company to achieve certain financial targets.

These additional matters are intended to improve the auditor's evaluation of the business purpose (or the lack thereof) for significant unusual transactions, including whether they may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. For example, considering whether a transaction enables the company to achieve certain financial targets is an important consideration when evaluating whether that transaction has been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. These additional matters also represent areas that may be relevant to the auditor's evaluation of whether the financial statements contain the information regarding the significant unusual transaction essential for a fair presentation in conformity with the applicable financial reporting framework.

Including these additional matters in the auditor's evaluation of a significant unusual transaction can also assist the auditor in the identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor because it focuses the auditor on the substance of the relationship or transaction. For example, relationships such as those with entities managed by former officers, interlocking directors/ownership, significant customers and suppliers, competitors, strategic alliances or partnerships, or collaborative arrangements could represent matters that involve related parties or relationships or transactions with related parties previously undisclosed to the auditor. Further, a related party could be involved in a significant unusual transaction either

directly or indirectly, through the use of an intermediary whose involvement in the transaction appears to serve no apparent business purpose.

A footnote to AU sec. 316.67 references the requirement, contained in paragraph 16 of the standard, that the auditor perform certain procedures in circumstances in which the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist.

#### Evaluating the Accounting and Disclosure of Significant Unusual Transactions

The amendments add a new paragraph to AU sec. 316, paragraph .67A, to require the auditor to evaluate whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements. AU sec. 316.67A further states that this includes evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in conformity with the applicable financial reporting framework. A footnote directs the auditor to paragraphs 30 and 31 of Auditing Standard No. 14, which address the auditor's evaluation of the presentation of the financial statements, including the disclosures.

A note to AU sec. 316.67A states that, in evaluating whether the financial statements contain the information regarding significant unusual transactions essential for a fair presentation in accordance with the financial reporting framework, the auditor considers management's disclosure regarding significant unusual transactions in other parts of the company's SEC filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

#### Other Matters Regarding Significant Unusual Transactions

The amendments regarding significant unusual transactions also make a number of other related amendments, including adding a new paragraph, paragraph 11A, to Auditing Standard No. 13 and making a conforming amendment to Auditing Standard No. 16.

The new paragraph 11A to Auditing Standard No. 13 reminds auditors that significant unusual transactions can affect the risks of material misstatement due to error or fraud, and that the auditor should take into account the

types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to the repropoed amendments to AU secs. 316.66-.67A regarding significant unusual transactions.

The amendments regarding significant unusual transactions also amend the auditor communication requirements in Auditing Standard No. 16. The amendments revise paragraph 13.d. of Auditing Standard No. 16 to refer to the "business purpose (or the lack thereof)" instead of the "business rationale" of a significant unusual transaction. In the Board's view improving the auditor's identification and evaluation of significant unusual transactions should enhance the quality of the auditor's discussions with the audit committee.

#### Discussion of the Comments Received on the Repropoed Amendments Regarding Evaluating Significant Unusual Transactions

The Board considered all comments received, including the following significant comments:

*Clarifying the Auditor's Evaluation of Identified Significant Unusual Transactions:* One commenter suggested several clarifying revisions to the factors in AU sec. 316.67 that are relevant to the auditor's evaluation of whether the business purpose (or the lack thereof) of a significant unusual transaction indicates that the transaction may have been entered into to engage in fraud. For example, that commenter suggested revising the fourth bullet to state "the transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party." The Board considered these suggestions and agrees that emphasizing that a related party might be involved in a significant unusual transaction in place of the company is an important clarification, and has revised AU sec. 316.67, accordingly.

*Understanding Economic Substance Versus Commercial Substance:* One commenter stated that repropoed AU sec. 316.67 did not distinguish "commercial substance" (a term used in connection with accounting for nonmonetary transactions) from "economic substance" (a doctrine governing all transactions). That commenter suggested revising this factor in AU 316.67 so that "commercial substance" is understood to only refer to nonmonetary transactions. The Board considered this comment, noting that the auditor's evaluation does not impose

<sup>118</sup> See Section II.C. of Securities Act Release No. 33-8056, *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations* (January 22, 2002), <http://www.sec.gov/rules/other/33-8056.htm>.

accounting requirements on the auditor as the standard and amendments follow a “framework neutral” approach.

*Understanding “Financial Targets”:* A few commenters suggested improving the auditor’s evaluation of whether a significant unusual transaction enables the company to achieve certain financial targets pursuant to AU sec. 316.67, by including required procedures to obtain an understanding of the company’s financial targets. The Board considered these comments noting that the auditor’s understanding of a company’s financial targets is already informed by information obtained during the auditor’s risk assessment process.<sup>119</sup> The procedures to obtain an understanding of the company’s financial relationships and transactions with its executive officers required by the other amendments to Auditing Standard No. 12 further inform the auditor’s understanding. The information obtained from such procedures informs the auditor’s evaluation of whether a company’s significant unusual transaction enables the company to achieve certain financial targets.

The Board is adopting the amendments regarding the evaluation of significant unusual transactions substantially as repropounded, except for the revisions discussed above to AU sec. 316.67 and the addition of a reference to paragraph 30 of Auditing Standard No. 14 in footnote 25B of AU sec. 316.67A.

Other Amendments to PCAOB Auditing Standards

The Board is also adopting other amendments to PCAOB auditing standards, including: (i) Amendments regarding a company’s financial relationships and transactions with its executive officers; (ii) other new requirements that complement the standard and amendments; and (iii) amendments that conform other auditing standards to the standard and amendments being adopted by the Board, including conforming amendments that revise the references to the Board’s superseded auditing standard, AU sec. 334.

After considering the comments received, the Board is adopting the other amendments substantially as repropounded. The Board is, however, making a number of minor clarifications in response to comments. These include:

- *Clarifying the Auditor’s Inquiries of Management (AU sec. 560):* The

amendments to paragraph 12 of AU sec. 560 include revisions to clarify that the auditor should inquire regarding both whether there have been any changes in the company’s related parties and whether there have been any significant new related party transactions; and

- *Revising the First Illustrative Letter in AU sec. 722 (AU sec. 722):* The amendments to AU sec. 722 include revisions to clarify that the auditor should obtain a representation from management that management has provided “all financial records and related data, including the names of all related parties and all relationship and transactions with related parties” whether the auditor is using the first illustrative letter or the second illustrative letter contained in AU sec. 722.

The following sections describe the other amendments being adopted by the Board and existing requirements, as well as discuss the significant comments received and Board responses, including revisions made, where applicable. The sections are organized by the following areas:

- Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement
  - AU sec. 315, *Communications Between Predecessor and Successor Auditors*
  - AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*
  - AU sec. 333, *Management Representations*
  - AU sec. 560, *Subsequent Events*
  - AU sec. 722, *Interim Financial Information*

Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement

Discussion of the Amendments to Auditing Standard Auditing Standard No. 12

In some circumstances, a company’s financial relationships and transactions with its executive officers can create risks of material misstatement that relate pervasively to the financial statements. The other amendments to Auditing Standard No. 12 require the auditor to perform specific procedures to obtain an understanding of a company’s financial relationships and transactions with its executive officers as part of the auditor’s risk assessment.

As described in the following sections, the other amendments to Auditing Standard No. 12: (i) Add a new paragraph, paragraph 10A, to Auditing Standard No. 12; (ii) revise paragraph 11 of Auditing Standard No. 12; and (iii) make a related conforming amendment to the risk assessment standards.

*Paragraph 10A of Auditing Standard No. 12:* The other amendments add paragraph 10A to Auditing Standard No. 12 to require the auditor to perform procedures to obtain an understanding of the company’s financial relationships and transactions with its executive officers. Paragraph 10A states that those procedures should be designed to identify risks of material misstatement and should include, but not be limited to: (i) Reading the employment and compensation contracts between the company and its executive officers; and (ii) reading the proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company’s financial relationships and transactions with its executive officers. The other amendments are intended to assist the auditor in identifying and assessing risks associated with a company’s financial relationships and transactions with its executive officers. The other amendments anticipate that the additional procedures to be performed would contribute to the auditor’s consideration of fraud in a financial statement audit pursuant to AU sec. 316, which recognizes certain incentives and pressures on management to commit fraud as examples of fraud risk factors.<sup>120</sup>

Performing procedures to obtain an understanding of a company’s financial relationships and transactions with its executive officers assists the auditor in understanding whether those relationships and transactions affect the risks of material misstatement.<sup>121</sup> For

<sup>120</sup> See AU sec. 316.85, which provides examples of fraud risk factors that could result in incentives and pressures to commit fraud, including available information that indicates that management’s or the board of directors’ personal financial situation is threatened by the entity’s financial performance arising from: (i) Significant financial interests in the entity; (ii) significant portions of their compensation (e.g., bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow; or (iii) personal guarantees of debts of the entity.

<sup>121</sup> For example, a May 2010 academic study that examined SEC accounting and auditing enforcement releases from 1998 to 2007 noted that the most commonly cited motivations for fraud included the need to: (i) Meet external earnings expectations of analysts and others; (ii) meet internally set financial targets or make the company look better; (iii) conceal the company’s deteriorating financial condition; (iv) increase the stock price; (v) bolster financial position for pending equity or debt financing; (vi) increase management compensation through achievement of bonus targets and through enhanced stock appreciation; and (vii) cover up assets misappropriated for personal gain. That study indicated that the chief executive officer and/or chief financial officer were named in 89 percent of the cases involving fraudulent financial reporting brought by the SEC during that period. See M. Beasley, J. Carcello, D. Hermanson, and T. Neal,

Continued

<sup>119</sup> See paragraphs 16 and 17 of Auditing Standard No. 12.

example, the auditor could consider whether the company's internal control over financial reporting is designed and operating to address the risk that management might seek accounting results solely to boost certain executive officers' compensation. This understanding could also assist the auditor in determining areas where management bias might occur (for example, certain accounting estimates, including fair value measurements).

Reading proxy statements and other relevant company filings with the SEC that are available to the auditor can provide the auditor with relevant information regarding a company's financial relationships and transactions with its executive officers that informs the auditor's understanding of the company. In addition, the risk assessment standards require that the auditor consider reading public information about the company, for example, SEC filings.<sup>122</sup>

The information obtained regarding a company's financial relationships and transactions with its executive officers, in conjunction with other information obtained during the risk assessment process (e.g., information about company performance measures),<sup>123</sup> could be used to identify account balances that are likely to be affected and that could have a significant effect on the financial statements. That information could be used by the auditor to identify and assess risks of material misstatement due to fraud and to design appropriate audit responses. In addition, obtaining an understanding of a company's financial relationships and transactions with its executive officers could identify information that indicates the existence of related party relationships or transactions previously undisclosed to the auditor.

The amendments to paragraph 10A are not intended to call into question the policies and procedures of the company with respect to its compensation arrangements with executive officers, but rather to assist the auditor in identifying and assessing risks of material misstatement associated with those financial relationships and transactions. Such risks could include unrecognized compensation, self-dealing or other conflicts of interest, or possible illegal acts. If present, these conditions may

*Fraudulent Financial Reporting 1998–2007: An Analysis of U.S. Public Companies*, Committee of Sponsoring Organizations of the Treadway Commission (May 2010) at 3, [http://www.coso.org/documents/COSO\\_FRAUDSTUDY2010\\_001.pdf](http://www.coso.org/documents/COSO_FRAUDSTUDY2010_001.pdf).

<sup>122</sup> See paragraph 11 of Auditing Standard No. 12.

<sup>123</sup> See paragraphs 16 and 17 of Auditing Standard No. 12.

call into question the integrity of management's representations or represent violations of the company's established policies and procedures. In addition, these procedures could identify potential instances of management override of internal controls that could inform the auditor whether others in the company are willing to challenge management or whether management might be dominating others in the company.

The purpose of the procedures in paragraph 10A is to further the auditor's risk assessment rather than to require the auditor to determine the appropriateness of a company's compensation agreements with its executive officers. The amendments would not require the auditor to assess the appropriateness of the compensation of executive officers. The procedures performed are intended to occur in the context of the auditor's process for assessing the risks of material misstatement of the company's financial statements.

The other amendments do not change the existing requirement in paragraph 10 of Auditing Standard No. 12 to consider obtaining an understanding of compensation arrangements with senior management. The population for the procedures required by paragraph 10A of the other amendments is the list of "executive officers," as defined in SEC Rule 3b–7 or included on Schedule A of Form BD,<sup>124</sup> while the existing requirement in paragraph 11 of Auditing Standard No. 12 continues to apply to what may be a larger population of a company's management.

The term "senior management" is not a defined term in Auditing Standard No. 12. For certain companies or brokers or dealers, senior management might be the same population as its executive officers. Further, the individuals the company considers to be its "senior management" may differ among issuers and among broker-dealers. The existing standard anticipates that a company's or broker's or dealer's facts and circumstances may affect the composition of its "senior management." The auditor could: (i) Gain an understanding of the compensation arrangements with a larger group of "senior management" under Auditing Standard No. 12 in order to obtain an understanding of the company and then (ii) perform the procedures under the other repropoed amendments regarding the financial

<sup>124</sup> See Exchange Act Rule 3b–7, 17 CFR 240.3b–7, and Schedule A of Form BD. See generally Item 401(b) of Regulation S–K, 17 CFR 229.401(b).

arrangements with a smaller group of "executive officers."

The other amendments do not require the auditor to evaluate the company's identification of its "executive officers," for SEC filing and other regulatory purposes. In the Board's view, the SEC rules cited in the amendments provide a definition of the term "executive officers" that provides sufficient direction to auditors.<sup>125</sup>

*Amendments to Paragraph 11:* The other amendments also include other changes designed to strengthen the auditor's consideration of the risks of material misstatement associated with financial relationships and transactions with its executive officers.

For example, the amendments to Auditing Standard No. 12 amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider making inquiries regarding the structuring of the company's compensation for executive officers to the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company.

An auditor performing this inquiry could take into account other available audit evidence, such as disclosures in SEC filings that: (i) describe the company's compensation policies and practices that present material risks to the company<sup>126</sup> and (ii) disclose fees paid to compensation consultants, in certain circumstances.<sup>127</sup> An auditor performing this inquiry could inquire of the audit committee, or its chair, regarding its views on executive officer compensation at the same time the auditor makes inquiries regarding how the audit committee exercises oversight of the company's assessment of fraud risks and the establishment of controls to address fraud risks as required by paragraph 56.b.(4) of Auditing Standard No. 12.

In addition, the amendments to paragraph 11 of Auditing Standard No. 12 also require the auditor to consider performing procedures to obtain an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

<sup>125</sup> See Item 401(b) of Regulation S–K, 17 CFR 229.401(b). For a discussion of "executive officer" for foreign private issuers, see the discussion in this section titled "Identifying the Executive Officers of Foreign Private Issuers."

<sup>126</sup> See Securities Act Release No. 33–9089, *Proxy Disclosure Enhancements* (December 16, 2009), <http://www.sec.gov/rules/final/2009/33-9089.pdf>.

<sup>127</sup> See Item 407(e)(3)(iii) of Regulation S–K.

Based on the auditor's assessment of risk, the auditor might determine that additional procedures are necessary. For example, the auditor might read available reports from the internal audit function that contain an evaluation of the expense report process. In other cases, the auditor might determine that it is necessary to inspect executive officer expense reimbursement documentation for unusual items.

*Conforming Amendment to the Risk Assessment Standards:* The other amendments include a conforming amendment to Auditing Standard No. 12. The change aligns Auditing Standard No. 12 with the requirement in paragraph 3 of the standard, which states that the procedures in paragraphs 4 through 9 of the standard are performed in conjunction with the risk assessment procedures required by Auditing Standard No. 12. That amendment removes the note to the final bullet of paragraph 10 of Auditing Standard No. 12.

*Discussion of the Comments Received on the Reproposed Amendments to Auditing Standard No. 12*

The Board considered all comments received, including the following significant comments:

*Revisions Included in Paragraph 10A of the Reproposed Amendments:*

Commenters who commented on the revisions included in paragraph 10A of the repropose amendments to Auditing Standard No. 12 generally were supportive of the revisions to the repropose amendments. Some commenters stated that it is sufficiently clear that the auditor: (i) should obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment; and (ii) is not required to assess the appropriateness of executive officer compensation. One commenter stated that the repropose amendments addressed their concerns regarding the proposed amendments. Another commenter recommended including additional language stating that the amendments are not intended to call into question the policies and procedures of the company. The Board considered these comments and believes that the revisions contained in the repropose amendments sufficiently acknowledge that the auditor is not required to assess the appropriateness or reasonableness of compensation arrangements with executive officers.

*Alternatives to Reading Each Compensation Arrangement:* One commenter expressed their support for the auditor to obtain an understanding of compensation arrangements with the

company's executive officers. That commenter suggested including further clarification to these amendments, including, for example, considering whether such an understanding could be achieved by the auditor assessing the company's internal control over such arrangements as opposed to reading each compensation arrangement. The Board considered this comment, but noted that the purpose of these procedures is to obtain information regarding individuals who perform specific functions at the company, as part of the auditor's risk assessment. Relying on a company's process may not provide the information necessary for the auditor to identify incentives and pressures that may result in risks of material misstatement. Further, reading the documents underlying the financial relationships and transactions with a company's executive officers could identify information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist and also informs the auditor's evaluation of whether a significant unusual transaction enables the company to achieve financial targets as part of the auditors evaluation pursuant to AU sec. 316.67.

*Identifying the "Executive Officers" of Foreign Private Issuers:* One commenter expressed concern that the auditor would need to determine which individuals fall within the definition of "executive officers" if foreign private issuers do not identify "executive officers" in their filings with the SEC. The Board considered this comment and determined not to make revisions.

The auditor's risk assessment procedures with respect to a company's financial relationships and transactions with its executive officers begins with the company's identification of its executive officers. These procedures do not require the auditor to evaluate the company's identification of its executive officers for SEC filing or other regulatory purposes. The company's identification of its executive officers is generally available from its SEC filings or other company information.

For example, foreign private issuers might identify their executive officers in their SEC filings:

- Some foreign private issuers currently disclose their "executive officers" in their filings with the SEC (e.g., some foreign private issuers simply disclose "executive officers" in Form 20-F, and some foreign private issuers voluntarily file their annual report on Form 10-K and disclose their executive officers).

- Some home country filing requirements require a foreign company to determine executive officers using a similar definition to Rule 3b-7. For example, in Canada, National Instrument 51-102, *Continuous Disclosure Obligations* states that "executive officer means, for a reporting issuer, an individual who is (a) a chair, vice-chair or president; (b) a vice-president in charge of a principal business unit, division or function including sales, finance or production; or (c) performing a policy-making function in respect of the issuer." Canadian foreign private issuers are also required to disclose such individuals in annual information filings with the SEC.

Further, the individuals comprising a company's "[d]irectors and senior management" determined pursuant to item F. of the General Instructions to Form 20-F would include, among others, those individuals who, on the basis of title or policy making function, qualify as "executive officers" under Rule 3b-7.

In addition, foreign private issuers might identify their executive officers for a number of other reasons, for example:

- If more than 50% of a foreign company's voting securities are held by U.S. residents, the company must determine its eligibility to be a "foreign private issuer" by considering, among other things, whether the majority of its "executive officers" or directors are U.S. citizens or residents.<sup>128</sup>

- A foreign private issuer listed on the New York Stock Exchange ("NYSE") would need to identify its executive officers for purposes of complying with Section 303A.12(b), *Certification Requirements* of the NYSE Listed Company Manual, which requires that each listed company chief executive officer must promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any non-compliance with any applicable provisions of Section 303A of the NYSE Listed Company Manual.

Although the Board did not revise the amendments to Auditing Standard No. 12 for this comment, the Board's consideration of this comment did prompt a change to the amendments to AU sec. 316.81A to include a reference to Item 16F of Form 20-F to remind auditors of foreign private issuers of their responsibilities.

*Performing Procedures Relating to Individuals Outside of the Company's Executive Officers:* Some commenters

<sup>128</sup> "Foreign private issuer" is defined in Rule 405 of Regulation C under the Securities Act of 1933 and Rule 3b-4(c) under the Exchange Act.



suggested that the auditor's procedures should not be limited to "executive officers," because compensation arrangements with persons outside the definition of "executive officers" (e.g., the most highly compensated individuals, or individuals holding a material block of stock options that are in a position to influence the company) also might create incentives and pressures that could create risks of material misstatement.

The Board considered these comments, noting that the intent of the amendments was to sharpen the auditor's focus on a company's financial relationships and transactions with individuals that could pose increased risks of material misstatement because of the ability of those individuals to have direct involvement in the company's financial reporting. However, the amendments do not change the existing requirement that the auditor consider obtaining an understanding of the compensation arrangements with what may be a larger group of individuals, a company's senior management. The Board agrees that financial relationships with individuals outside of a company's executive officers also may warrant the auditor's attention. However, obtaining an understanding of the compensation arrangements with individuals outside of management should be based upon the company's facts and circumstances.

*Expanding the Examples of Executive Officer Compensation:* One commenter suggested including in the amendments a discussion of the basic components of many of today's executive compensation plans and requiring the auditor to read and understand each of the documents underlying those common components. The Board considered this comment but did not make changes, noting that the requirement to obtain an understanding of the company's financial relationships and transactions with its executive officers is intended to provide an overarching requirement for the auditor that can be applied to all companies as part of the auditor's risk assessment procedures and apply to companies of different size and complexity. Additionally, the Board notes that the auditor might have an overall understanding of the issues pertinent to compensation arrangements with the company's executive officers due to the existing responsibility under Auditing Standard No. 12 to consider obtaining an understanding of the compensation arrangements with the company's senior management.

The Board is adopting the amendments to Auditing Standard No. 12 as proposed.

#### AU sec. 315, *Communications Between Predecessor and Successor Auditors*

##### Discussion of the Amendments to AU sec. 315

The Board is adopting amendments to AU sec. 315, *Communications Between Predecessor and Successor Auditors*. AU sec. 315 provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place, but does not specifically address a company's relationships or transactions with its related parties or its significant unusual transactions. AU sec. 334 notes that determining the existence of relationships with related parties requires the application of audit procedures that may include inquiring of predecessor auditors concerning their knowledge of existing relationships and the extent of management involvement in material transactions.<sup>129</sup>

The amendments to AU sec. 315 require the auditor to make inquiries regarding the predecessor auditor's understanding of the company's relationships and transactions with related parties and significant unusual transactions. The amendments also include within the successor auditor's review of the predecessor auditor's working papers any documentation regarding relationships and transactions with related parties and significant unusual transactions.

Inquiring of a predecessor auditor regarding the company's relationships and transactions with related parties and significant unusual transactions can assist the successor auditor in determining whether to accept the engagement. Such inquiries also can benefit the successor auditor in obtaining an understanding of the company's relationships and transactions with its related parties and in identifying significant unusual transactions.

After considering all comments received, the Board is adopting the amendments to AU sec. 315 as proposed.

#### AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*

##### Discussion of the Amendments to AU sec. 316

The amendments to AU sec. 316 expand the discussion in the standard regarding certain audit requirements contained in Section 10A of the Exchange Act. The amendments emphasize the auditor's responsibility to investigate and disclose possible

fraud to management, the audit committee and, upon the satisfaction of certain conditions, the SEC, consistent with the auditor's responsibility under Section 10A of the Exchange Act.

Improving the auditor's identification and evaluation of significant unusual transactions could lead to more instances of auditors becoming aware of indications that fraud or another illegal act has or may have occurred.

In addition, the other amendments to AU sec. 316 also add a new example of a fraud risk factor, the exertion of dominant influence by or over a related party.

The Board's consideration of the comments received regarding the amendments to paragraph 10A of Auditing Standard No. 12, regarding the audits of foreign private issuers, prompted a change to the amendments to AU sec. 316.81A. Specifically, to assist auditors of foreign private issuers with their responsibility when there is a change in a registrant's certifying accountants, a reference to Item 16F of Form 20-F in the amendments to AU sec. 316.81A has been included.

After considering all comments received, the Board is adopting the amendments to AU sec. 316 as proposed, except for adding a reference to Item 16F of Form 20-F to AU sec. 316.81A.

#### AU sec. 333, *Management Representations*

##### Discussion of the Amendments to AU sec. 333

The amendments to AU sec. 333 require that the auditor obtain certain written representations each interim period regarding a company's relationships and transactions with its related parties. AU sec. 333 currently requires auditors to obtain written representations from management for the periods covered by the auditor's report. That standard addresses representations covering financial statements; completeness of information; recognition, measurement, and disclosure; and subsequent events. Additionally, AU sec. 333 currently requires the auditor to obtain a representation regarding the recognition, measurement, and disclosure of related party transactions.

The amendments to AU sec. 333.06 require that the auditor obtain written representations from management indicating that management has disclosed to the auditor the names of all of the company's related parties and all relationships and transactions with related parties. The standard also amends AU sec. 333.06 to require the

<sup>129</sup> See AU sec. 334.07.g. and AU secs. 9334.12-.13.



auditor to obtain a written representation from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor.

Side agreements or other arrangements (either written or oral) undisclosed to the auditor could represent a risk of material misstatement of the financial statements for both related party and significant unusual transactions. For example, the lack of an arm's-length relationship in related party transactions can raise questions about whether all transaction terms have been disclosed to the auditor. Similarly, significant unusual transactions occurring close to the end of the period that pose difficult substance over form questions also could involve side agreements or other arrangements undisclosed to the auditor. The existence of implicit or informal understandings (either written or oral) could have a significant impact on the financial accounting and disclosure of relationships and transactions with related parties and significant unusual transactions.

In addition, the amendments to AU sec. 333 require that the auditor obtain written representations from management in situations in which the financial statements include an assertion by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction. This requirement complements the auditor's evaluation, required by paragraph 18 of the standard, when management has asserted that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction.

After considering all comments received, the Board is adopting the amendments to AU sec. 333 as repropoed.

#### AU sec. 560, *Subsequent Events*

##### *Discussion of the Amendments to AU sec. 560*

AU sec. 560 currently requires the auditor to perform auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles.<sup>130</sup> AU sec. 560 currently does not require the auditor to inquire regarding the

company's relationships and transactions with its related parties and its significant unusual transactions.

The amendments to AU sec. 560.12 require that during the "subsequent period" the auditor inquire regarding related party transactions and significant unusual transactions. Events or transactions that occur subsequent to the balance sheet date, but prior to the issuance of the financial statements, may have a material effect on the financial statements. Making specific inquiries during the "subsequent period" regarding a company's relationships and transactions with its related parties and its significant unusual transactions can benefit the auditor's identification of matters that might require disclosure in the financial statements.

##### *Discussion of the Comments Received on the Reproposed Amendments to AU sec. 560*

The Board considered all comments received, including the following significant comment:

*Clarifying the Auditor's Inquiries of Management:* One commenter recommended revising the inquiry in item v. of the repropoed amendments to AU sec. 560.12 to clarify that there are two separate inquiries. The Board considered this comment and in the interest of clarity, revised the repropoed amendments to place each inquiry into a separate bullet.

The Board is adopting the amendments to AU sec. 560 substantially as repropoed, with the clarifying change noted above.

##### *AU sec. 722, Interim Financial Information*

##### *Discussion of Amendments to Auditing Standard No. 12*

AU sec. 722 currently requires the auditor to inquire of management that has responsibility for financial and accounting matters concerning unusual or complex matters that might have an effect on the interim financial information. Generally, the amendments to AU sec. 722 require that the auditor obtain certain written representations each interim period regarding a company's relationships and transactions with its related parties. The other amendments revise AU sec. 722 to be consistent with the amendments to AU sec. 333 that require the auditor to obtain written representations each interim period regarding the company's related parties and the absence of side agreements or other arrangements.

##### *Discussion of the Comments Received on the Reproposed Amendments to AU sec. 722*

The Board considered all comments received, including the following significant comment:

*Revising the First Illustrative Letter in AU sec. 722:* One commenter recommended that a change that had been made in the repropoal to expand item 2.a. of the *second* illustrative letter of AU sec. 722 should also be made to the corresponding item in the *first* illustrative representation letter. That commenter recommended that item 2.a. in the first illustrative letter be revised to state that management has made available to the auditor "all financial records and related data, including the names of all related parties and all relationships and transactions with related parties." The Board considered this comment and made the revisions suggested by the commenter so that the letters were consistent.

The Board is adopting the amendments to AU sec. 722 substantially as repropoed, with the clarification discussed above.

#### Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>131</sup> provided the Board with oversight authority with respect to audits of brokers and dealers that are registered with the SEC. On July 30, 2013, the SEC adopted amendments to SEC Rule 17a-5 under the Exchange Act to require, among other things, that audits of brokers' and dealers' financial statements be performed in accordance with the standards of the PCAOB for fiscal years ending on or after June 1, 2014.<sup>132</sup>

In its repropoal, the Board solicited comment regarding whether there were specific issues relating to audits of brokers and dealers of which the Board should be aware. Commenters did not provide examples of specific audit issues, but did provide views on the applicability of the standard and amendments to audits of brokers and dealers. For example, many commenters stated that the repropoed standard and amendments should apply to audits of brokers and dealers and provided various rationales. Some commenters noted that the financial reporting risks that the repropoal is designed to target also exist at these entities and in some

<sup>131</sup> Public Law 111-203, 124 Stat. 1376 (July 21, 2010).

<sup>132</sup> See Rule 17a-5, 17 CFR 240.17a-5 SEC, *Broker-Dealer Reports*, Exchange Act Release No. 34-70073, (July 30, 2013), 78 *Federal Register* 51910 (August 21, 2013), <http://www.sec.gov/rules/final/2013/34-70073.pdf>.

<sup>130</sup> See AU sec. 560.12.

cases more prevalently. Other commenters noted that the scalability of the standard and amendments allow the auditor to focus on the specifics of the company, making the standard and amendments appropriate for audits of brokers and dealers.

Further, at the May 17, 2012 SAG meeting, the point was raised that a robust auditing standard on related parties was important for both regulators of brokers and dealers and for users of their financial statements. Several scenarios were discussed by which related party transactions might be improperly used by brokers and dealers, including scenarios where the brokers and dealers could use related party transactions to: (i) Overpay for goods and services and disguise capital withdrawals; (ii) avoid the imposition of higher capital requirements and capital charges; (iii) structure a broker's or dealer's business model to appear smaller; and (iv) transfer customer assets to parties that are not approved custodians.

Additionally, the results of the Board's oversight activities regarding audits of brokers and dealers have identified deficiencies regarding the auditor's efforts in the area of related parties, suggesting that this is an area warranting heightened scrutiny.<sup>133</sup>

The standard and amendments, if approved by the SEC, will be applicable to all audits performed pursuant to PCAOB standards, including audits of brokers and dealers.

#### Effective Date

The Board determined that the standard and amendments will be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of interim financial information within those fiscal years.

In determining the effective date, the Board considered the comments received. Many commenters noted that the effective date in the reproposing release was reasonable, if the final standard and amendments were approved three to four months prior to the effective date contemplated in the reproposing release. Those commenters generally indicated that this would have allowed sufficient time for firms to incorporate the new requirements into their methodologies, guidance, audit programs, and staff training. Given the

<sup>133</sup> See The Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers (August 20, 2012) and the Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers (August 19, 2013).

date of the adoption of the standard and amendments, the Board determined that the standard and amendments should be applicable, subject to SEC approval, to audits of financial statements for fiscal years beginning on or after December 15, 2014.

One commenter recommended that the amendments to AU sec. 722 become effective in the first interim period following the first annual period that the standard and amendments are effective. The Board considered this comment but noted that the amendments to AU sec. 722, which encompass inquiries of and representations from management, are designed to complement the standard and amendments. Performing those procedures for reviews of interim financial information during the first year of implementation (the fiscal year beginning on or after December 15, 2014) can inform the auditor's efforts in these critical areas for the audit performed during the first year of implementation.

#### 2. Comparison of the Objective and Key Requirements of the Proposed Rules With the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants Introduction

This comparison, which was prepared for informational purposes only, compares certain significant differences between the objective and certain key requirements of the standard and amendments with the analogous standards of the IAASB and the ASB of the AICPA.

This comparison is not a summary of, or a substitute for, the standard or the amendments. This comparison may not represent the views of the IAASB or the ASB regarding the interpretations of their standards.

The analogous standards of the IAASB discussed in this comparison include:

- International Standard on Auditing 550, *Related Parties* ("ISA 550");
- International Standard on Auditing 210, *Agreeing the Terms of Audit Engagements* ("ISA 210");
- International Standard on Auditing 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* ("ISA 240");
- International Standard on Auditing 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* ("ISA 315");

- International Standard on Auditing 510, *Initial Audit Engagements—Opening Balances* ("ISA 510");

- International Standard on Auditing 560, *Subsequent Events* ("ISA 560");

- International Standard on Auditing 580, *Written Representations* ("ISA 580");

- International Standard on Auditing 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* ("ISA 600"); and

- International Standard on Review Engagements 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*, ("ISRE 2410").

The analogous standards of the ASB discussed in this comparison include:

- AU-C Section 550, *Related Parties* ("AU-C Section 550");

- AU-C Section 210, *Terms of Engagement* ("AU-C Section 210");

- AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit* ("AU-C Section 240");

- AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* ("AU-C Section 315");

- AU-C Section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements* ("AU-C Section 510");

- AU-C Section 560, *Subsequent Events and Subsequently Discovered Facts* ("AU-C Section 560");

- AU-C Section 580, *Written Representations* ("AU-C Section 580");

- AU-C Section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* ("AU-C Section 600"); and

- AU-C Section 930, *Interim Financial Information* ("AU-C Section 930").<sup>134</sup>

This comparison is organized in the following sections: The auditing standard; the amendments regarding significant unusual transactions; and the other amendments to PCAOB auditing standards.<sup>135</sup> This comparison does not

<sup>134</sup> These AU-C sections are contained in Statement on Auditing Standards No. 122, *Statement on Auditing Standards: Clarification and Recodification* ("SAS No. 122"). In October 2011, the ASB adopted SAS No. 122, which contains 39 clarified SASs with "AU-C" section numbers for each clarified SAS. The "AU-C" is a temporary identifier to avoid confusion with references to existing "AU" sections in AICPA Professional Standards.

<sup>135</sup> This comparison does not cover the requirements contained in the risk assessment standards. Appendix 11 of PCAOB Release No. 2010-004, *Auditing Standards Related to Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, contains a comparison of the objectives and requirements of

cover the application and explanatory material in the analogous standards of the IAASB or ASB.<sup>136</sup>

Auditing Standard, Related Parties

Introduction (Paragraph 1 of the Standard)

PCAOB

The standard refers auditors to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company, including the definition of the term “related parties,” and the financial statement disclosure requirements with respect to related parties. The standard does not include a definition for an arm’s-length transaction.

IAASB

Paragraph 10(b) of ISA 550 defines a related party as a party that is either:

- i. A related party as defined in the applicable financial reporting framework; or
- ii. Where the applicable financial reporting framework establishes minimal or no related party requirements:
  - a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
  - b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
  - c. Another entity that is under common control with the reporting entity through having:
    - (i) Common controlling ownership;
    - (ii) Owners who are close family members; or
    - (iii) Common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

those standards with the analogous standards of the IAASB and the ASB.

<sup>136</sup> Paragraph A59 of International Standard on Auditing 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, states that the Application and Other Explanatory Material section of the ISAs “does not in itself impose a requirement,” but “is relevant to the proper application of the requirements of an ISA.” Paragraph A63 of AU–C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that although application and other explanatory material “does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU–C section.”

ISA 550 also defines an arm’s-length transaction as a transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

ASB

AU–C Section 550 defines a related party as that term is defined in generally accepted accounting principles. AU–C Section 550 also contains a definition of arm’s-length transaction that is similar to the definition in ISA 550.

Objective (Paragraph 2 of the Standard)

PCAOB

Paragraph 2 of the standard states that the auditor’s objective is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

IAASB

Paragraph 9 of ISA 550 states that the objectives of the auditor are:

(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements to obtain an understanding of related party relationships and transactions sufficient to be able:

- i. To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
- ii. To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:

- a. Achieve fair presentation (for fair presentation frameworks); or
- b. Are not misleading (for compliance frameworks); and

(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

ASB

Paragraph 9 of AU–C Section 550 contains a similar objective to the objective in ISA 550 for fair presentation frameworks.

Performing Risk Assessment Procedures To Obtain an Understanding of the Company’s Relationships and Transactions With Its Related Parties (Paragraphs 3–9 of the Standard)

PCAOB

Paragraph 3 of the standard requires that the auditor perform procedures to obtain an understanding of the company’s relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Paragraph 3 of the standard states that the procedures performed to obtain an understanding of the company’s relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company’s process (paragraph 4);
- b. Performing inquiries (paragraphs 5–7); and
- c. Communicating with the audit engagement team and other auditors (paragraphs 8–9).

A note to paragraph 3 of the standard states that obtaining an understanding of the company’s relationships and transactions with its related parties includes obtaining an understanding of the nature of the relationships between the company and its related parties and of the terms and business purposes (or the lack thereof) of the transactions involving related parties.

Another note to paragraph 3 of the standard states that performing the risk assessment procedures described in paragraphs 4–9 of the standard in conjunction with the risk assessment procedures required by Auditing Standard No. 12 is intended to provide the auditor with a reasonable basis for identifying and assessing risks of material misstatement associated with related parties and relationships and transactions with related parties.

IAASB

Paragraph 11 of ISA 550 states that as part of the risk assessment procedures and related activities required by ISA 315 and ISA 240, the auditor shall perform the audit procedures and related activities set out in paragraphs 12–17 of ISA 550 to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.

## ASB

AU–C Section 550 contains similar requirements to those in ISA 550.

*Obtaining an Understanding of the Company's Process (Paragraph 4 of the Standard)*

## PCAOB

Paragraph 4 of the standard requires that in conjunction with obtaining an understanding of internal control over financial reporting, the auditor obtain an understanding of the company's process for:

- a. Identifying related parties and relationships and transactions with related parties;
- b. Authorizing and approving transactions with related parties; and
- c. Accounting for and disclosing relationships and transactions with related parties in the financial statements.

## IAASB

Paragraph 14 of ISA 550 requires that the auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to:

- a. Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
- b. Authorize and approve significant transactions and arrangements with related parties; and
- c. Authorize and approve significant transactions and arrangements outside the normal course of business.

## ASB

Paragraph 15 of AU–C Section 550 contains similar requirements to those in ISA 550.

*Performing Inquiries (Paragraphs 5–7 of the Standard)*

## PCAOB

Paragraph 5 of the standard requires the auditor to inquire of management regarding:

- a. The names of the company's related parties during the period under audit, including changes from the prior period;
- b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);
- c. The nature of any relationships, including ownership structure, between the company and its related parties;
- d. The transactions entered into, modified, or terminated, with its related

parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;

- e. The business purpose for entering into a transaction with a related party versus an unrelated party;
- f. Any related party transactions that have not been authorized and approved in accordance with the company's established policies or procedures regarding the authorization and approval of transactions with related parties; and
- g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

Paragraph 6 of the standard requires the auditor to inquire of others within the company regarding their knowledge of the matters in paragraph 5 of the standard. Paragraph 6 also requires the auditor to identify others within the company to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding:

- a. The company's related parties or relationships or transactions with related parties;
- b. The company'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 the auditor.

Paragraph 7 of the standard requires the auditor to inquire of the audit committee, or its chair, regarding:

- a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
- b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties, and, if so, the substance of those concerns.

## IAASB

Paragraph 13 of ISA 550 requires the auditor to inquire of management regarding:

- a. The identity of the entity's related parties, including changes from the prior period;
- b. The nature of the relationships between the entity and these related parties; and
- c. Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

## ASB

Paragraph 14 of AU–C Section 550 contains similar requirements to those in ISA 550.

*Identifying and Assessing Risks of Material Misstatement (Paragraph 10 of the Standard)*

## PCAOB

Paragraph 10 of the standard aligns with the existing requirements for the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level. Paragraph 10 states that this includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties or relationships or transactions with related parties. Paragraph 59 of Auditing Standard No. 12 requires that the auditor identify which risks are significant risks. Further, paragraph 71 of Auditing Standard No. 12 provides factors that the auditor should evaluate in determining which risks are significant risks. Those factors include: (i) whether the risk involves significant transactions with related parties; (ii) whether the risk involves significant transactions that are outside the normal course of business; and (iii) whether the risk is a fraud risk. The amendments regarding significant unusual transactions revise paragraph .85A.2 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, to state that a related party transaction that is also a significant unusual transaction (e.g., a significant related party transaction outside the normal course of business) is an example of a fraud risk factor.

A note to paragraph 10 of the standard states that, in identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties, the auditor should take into account the information obtained from performing the procedures in paragraphs 4–9 of the standard and from performing the risk assessment procedures required by Auditing Standard No. 12.

## IAASB and ASB

Paragraph 18 of ISA 550 and paragraph 19 of AU–C Section 550 require that the auditor identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are

significant risks. ISA 550 and AU–C Section 550 require the auditor to treat identified significant related party transactions outside the normal course of business as giving rise to significant risks.

Responding to the Risks of Material Misstatement (Paragraphs 11–13 of the Standard)

PCAOB

Paragraph 11 of the standard aligns with existing requirements that the auditor design and implement audit responses that address the identified and assessed risks of material misstatement. Paragraph 11 of the standard states that this includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.

A note to paragraph 11 of the standard states that the auditor should look to the requirements of AU secs. 316.66–.67A for related party transactions that are also significant unusual transactions (for example, significant related party transactions outside the normal course of business). That note further states that for such related party transactions, AU sec. 316.67 requires that the auditor evaluate whether the business purpose (or the lack thereof) of the transactions indicates that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

IAASB

Paragraph 20 of ISA 550 requires that the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21–24 of ISA 550.

ASB

Paragraph 21 of AU–C Section 550 contains similar requirements to those in ISA 550.

Transactions With Related Parties Required to Be Disclosed in the Financial Statements or Determined to Be a Significant Risk (Paragraph 12 of the Standard)

PCAOB

Paragraph 12 of the standard requires that for each related party transaction that is either required to be disclosed in the financial statements or determined

to be a significant risk, the auditor should:

a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

b. Determine whether the transaction has been authorized and approved in accordance with the company's established policies and procedures regarding the authorization and approval of transactions with related parties;

c. Determine whether any exceptions to the company's established policies or procedures were granted;

d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and

e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

A note to paragraph 12 of the standard states that the applicable financial reporting framework may allow the aggregation of similar related party transactions for disclosure purposes. If the company has aggregated related party transactions for disclosure purposes in accordance with the applicable financial reporting framework, the auditor may perform the procedures in paragraph 12 for only a selection of transactions from each aggregation of related party transactions (versus all transactions in the aggregation), commensurate with the risks of material misstatement.

IAASB

Paragraph 23 of ISA 550 requires that for identified significant related party transactions outside the entity's normal course of business, the auditor shall:

a. Inspect the underlying contracts or agreements, if any, and evaluate whether:

i. The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;

ii. The terms of the transactions are consistent with management's explanations; and

iii. The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and

b. Obtain audit evidence that the transactions have been appropriately authorized and approved.

ASB

Paragraph 24 of AU–C Section 550 contains similar requirements to those in ISA 550.

Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions With Related Parties (Paragraphs 14–16 of the Standard)

PCAOB

Paragraph 14 of the standard requires that the auditor evaluate whether the company has properly identified its related parties and relationships and transactions with related parties. Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company, taking into account information gathered during the audit. Paragraph 14 requires that as part of that evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

A note to paragraph 14 of the standard states that Appendix A contains examples of information and sources of information that may be gathered during the audit that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

Other PCAOB auditing standards might impose requirements relating to the sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist (e.g., reading confirmation responses and responses to inquiries of the company's lawyers).<sup>137</sup>

Paragraph 15 of the standard requires that if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Paragraph 15 also states that those

<sup>137</sup> See, e.g., AU sec. 330, *The Confirmation Process*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

procedures should extend beyond inquiry of management.

Paragraph 16 of the standard describes the procedures that the auditor is required to perform if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists. Paragraph 16 of the standard requires that the auditor:

a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;

b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;

c. Promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;

d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;

e. Perform the procedures required by paragraph 12 of the standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk;

f. Perform the following procedures, taking into account the information gathered from performing the procedures in a. through e. above:

(i) Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;

(ii) Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and

(iii) Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, the auditor must determine his or her responsibilities under AU secs. 316.79-.82, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. 78j-1.

#### IAASB and ASB

Paragraph 15 of ISA 550 requires the auditor to remain alert, during the audit, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. Paragraph 15 of ISA 550 further requires that, in particular, the auditor inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

(a) Bank and legal confirmations obtained as part of the auditor's procedures;

(b) Minutes of meetings of shareholders and of those charged with governance; and

(c) Such other records and documents as the auditor considers necessary in the circumstances of the entity.

Paragraph 21 of ISA 550 requires that if the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships and transactions.

Paragraph 22 of ISA 550 requires that if the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

a. Promptly communicate the relevant information to the other members of the engagement team;

b. Where the applicable financial reporting framework establishes related party requirements;

(i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation;

(ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;

c. Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions;

d. Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor and perform additional audit procedures as necessary; and

e. If the nondisclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit.

#### ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

Evaluating Financial Statement Accounting and Disclosures (Paragraphs 17-18 of the Standard)

#### PCAOB

Paragraph 17 of the standard aligns with the existing requirement that the auditor evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. Paragraph 17 states that this includes evaluating whether the financial statements contain the information regarding relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.

#### IAASB

Paragraph 25 of ISA 550 requires that in forming an opinion on the financial statements, the auditor shall evaluate:

a. Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and

b. Whether the effects of the related party relationships and transactions:

(i) Prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or

(ii) Cause the financial statements to be misleading (for compliance frameworks).

#### ASB

Paragraph 26 of AU-C Section 550 contains similar requirements to the requirements in ISA 550 for fair presentation frameworks.

Assertions That Transactions With Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (Paragraph 18 of the Standard)

#### PCAOB

Paragraph 18 of the standard requires that if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts

management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.

A note to paragraph 18 of the standard further states that a preface to a statement such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities.

#### IAASB

Paragraph 24 of ISA 550 states that if management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion.

#### ASB

Paragraph 25 of AU-C Section 550 contains similar requirements to those in ISA 550.

#### Communications With the Audit Committee (Paragraph 19 of the Standard)

#### PCAOB

Paragraph 19 of the standard requires that the auditor communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. Paragraph 19 of the standard also requires that the auditor communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties including, but not limited to:

a. The identification of related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;

b. The identification of significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;

c. The identification of significant related party transactions for which exceptions to the company's established policies or procedures were granted;

d. The inclusion of a statement in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction and the evidence obtained by the auditor to support or contradict such an assertion; and

e. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

#### IAASB

Paragraph 27 of ISA 550 requires that the auditor communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

#### ASB

Paragraph 27 of AU-C Section 550 contains similar requirements to those in ISA 550.

#### Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions Identifying Significant Unusual Transactions

#### PCAOB

The amendments to paragraph 56.a. of Auditing Standard No. 12 require the auditor to inquire of management regarding whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involve related parties. The amendments regarding significant unusual transactions to paragraph 56.b. of Auditing Standard No. 12 require that the auditor inquire of the audit committee or equivalent, or its chair, regarding whether the company has entered into any significant unusual transactions. The amendments regarding significant unusual transactions to paragraph 56.c. of Auditing Standard No. 12 require similar inquiries of internal audit personnel.

A note to AU sec. 316.66 states that the auditor should take into account information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist when identifying significant unusual transactions.

That note refers the auditor to paragraphs 14–16 of Auditing Standard No. 18. That note further states that Appendix A of the standard includes examples of such information and examples of sources of such information.

#### IAASB and ASB

ISA 315, ISA 550, AU-C Section 315, and AU-C Section 550 do not contain similar requirements for the auditor to those in the PCAOB's amendments described above.

#### Evaluating Significant Unusual Transactions

#### PCAOB

The amendments regarding significant unusual transactions add paragraph .66A to AU sec. 316. That paragraph requires the auditor to design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction that the auditor has identified. AU sec. 316.66A requires that those procedures include the following:

a. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

b. Determining whether the transaction has been appropriately authorized and approved in accordance with the company's established policies and procedures;

c. Evaluating the financial capability of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and

d. Performing other procedures as necessary depending on the identified and assessed risks of material misstatement.

The amendments to AU sec. 316.67 require that the auditor evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. The amendments require that, in making that evaluation, the auditor evaluate whether:

- The form of the transaction is overly complex (e.g., the transaction involves multiple entities within a consolidated group or unrelated third parties);

- The transaction involves unconsolidated related parties, including variable interest entities;

- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor;

- The transaction involves other parties that do not appear to have the financial capability to support the transaction without assistance from the company, or any related party of the company;

- The transaction lacks commercial or economic substance, or is part of a



larger series of connected, linked, or otherwise interdependent arrangements that lack commercial or economic substance individually or in the aggregate (e.g., the transaction is entered into shortly prior to period end and is unwound shortly after period end);

- The transaction occurs with a party that falls outside the definition of a related party (as defined by the accounting principles applicable to that company), with either party able to negotiate terms that may not be available for other, more clearly independent, parties on an arm's-length basis;

- The transaction enables the company to achieve certain financial targets;

- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction (e.g., accounting-motivated structured transaction); and

- Management has discussed the nature of and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Further, the amendments add paragraph 11A to Auditing Standard No. 13. That paragraph requires that because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AU secs. 316.66–.67A.

The amendments to AU sec. 316.67A require that the auditor evaluate whether significant unusual transactions identified by the auditor have been properly accounted for and disclosed in the financial statements.

#### IAASB

Paragraph 16 of ISA 550 requires that if the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required by paragraph 15 or through other audit procedures, the auditor shall inquire of management about:

- (a) The nature of these transactions; and
- (b) Whether related parties could be involved.

Paragraph 32(c) of ISA 240 requires the auditor to evaluate whether the business rationale (or the lack thereof) of a significant transaction outside the normal course of business suggests that the transaction may have been entered

into to engage in fraudulent financial reporting or to conceal misappropriation of assets. Paragraph 23 of ISA 550 requires the auditor to perform certain procedures for identified significant related party transactions outside the entity's normal course of business.

#### ASB

AU–C Section 550 and AU–C Section 240 contain similar requirements to those in ISA 550 and ISA 240.

#### Other Amendments to PCAOB Auditing Standards

Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement

#### PCAOB

The other amendments to paragraph 10A of Auditing Standard No. 12 require that to assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers. The other amendments to Auditing Standard No. 12 also include a definition of executive officer that aligns with definitions used in SEC filings.

In addition, the other amendments amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider:

- Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and
- Obtaining an understanding of the company's established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

#### IAASB and ASB

ISA 315 and AU–C Section 315 do not contain similar requirements for the auditor to those in the PCAOB's amendments described above.

#### AU sec. 315, Communications Between Predecessor and Successor Auditors

#### PCAOB

The other amendments to other PCAOB Auditing Standards amend AU sec. 315, *Communications Between Predecessor and Successor Auditors*, to require the auditor to inquire of the predecessor auditor regarding the predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions. The other amendments also require the successor auditor to review documentation regarding related parties and significant unusual transactions.

#### IAASB and ASB

Neither ISA 210 and ISA 510, nor AU–C Section 210 and AU–C Section 510 contain similar requirements to those in the PCAOB's amendments described above.

#### AU sec. 316, Consideration of Fraud in a Financial Statement Audit

#### PCAOB

The other amendments to AU sec. 316.81A describe the auditor's responsibility, under certain conditions, to disclose possible fraud to the SEC to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change on Form 8–K and the fraud or related risk factors constitute a *reportable event* or are the source of a *disagreement*, as these terms are defined in Item 304 of Regulation S–K and Item 16F of Form 20–F. These requirements also include reports that may be required pursuant to Section 10A(b) of the Securities Exchange Act of 1934 (the "Exchange Act") relating to an illegal act that the auditor concludes has a material effect on the financial statements.

#### IAASB and ASB

ISA 240 and AU–C Section 240 do not inform the auditor of certain obligations under Section 10A of the Exchange Act, which is applicable to auditors of U.S. public companies registered with the PCAOB.

AU sec. 333, *Management Representations*

PCAOB

The other amendments to AU sec. 333, *Management Representations*, require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The other amendments to AU sec. 333 also require the auditor to obtain written representation from management if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction.

IAASB and ASB

Neither ISA 580 and ISRE 2410, nor AU-C Section 580, and AU-C Section 930 contain similar requirements to those in the PCAOB's amendments described above.

AU sec. 560, *Subsequent Events*

PCAOB

The other amendments amend paragraph .12 of AU sec. 560, *Subsequent Events*, to require that during the "subsequent period" the auditor inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:

- Whether there have been any changes in the company's related parties;
- Whether there have been any significant new related party transactions; and
- Whether the company has entered into any significant unusual transactions.

IAASB and ASB

ISA 560 and AU-C Section 560 do not contain similar requirements to those in the PCAOB's amendments described above.

AU sec. 722, *Interim Financial Information*

PCAOB

The other amendments to AU sec. 722, *Interim Financial Information*, require that the auditor obtain written representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. The other amendments to AU sec. 722 also require the auditor to obtain written representations from management when management has made an assertion that

a transaction with a related party was conducted on terms equivalent to those prevailing in arm's-length transactions.

IAASB

ISA 550 and ISRE 2410 do not contain similar requirements to those in the PCAOB's amendments described above.

ASB

AU-C Section 550 and AU-C Section 930 do not contain similar requirements to those in the PCAOB's amendments described above.

*D. Economic Considerations, Including for Audits of Emerging Growth Companies*

This discussion describes the Board's approach in adopting the standard and amendments as well as the Board's consideration of the economic impacts of the standard and amendments, including economic considerations pertinent to audits of EGCs.<sup>138</sup> Additionally, this discussion summarizes the views of commenters with respect to the economic impacts of the standard and amendments.

*Introduction and Statutory Background*

The Board is adopting the standard and amendments pursuant to its authority under the Act.<sup>139</sup> The standard and amendments must be approved by the Commission before they are effective. Pursuant to Section 107(b)(3) of the Act, the Commission shall approve a proposed standard if it finds that the standard is "consistent with the requirements of [the] Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors."

In the Board's view, the adoption of the standard and amendments is in the public interest and contributes to investor protection by establishing specific auditor performance requirements designed to heighten the auditor's attention to areas associated with risks of fraudulent financial

<sup>138</sup> Section 3(a)(80) of the Exchange Act defines the term "emerging growth company."

<sup>139</sup> Public Law 107-204. Pursuant to Section 101 of the Act, the mission of the Board is to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Section 103 of the Act authorizes the Board to adopt auditing standards for use in public company audits "as required by this Act or the rules of the [U.S. Securities and Exchange] Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." In addition, Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") expanded the authority of the PCAOB to oversee the audits of registered brokers and dealers, as defined in the Exchange Act. See Public Law 111-203.

reporting and that may also involve risks of error. New required audit procedures are intended to improve the auditor's identification, understanding, and evaluation of transactions in the critical areas, which can pose difficult measurement, recognition, and disclosure issues due to factors such as transaction structure, complexity, and/or relationship to company financial targets. Additionally, the standard and amendments establish audit committee communication requirements designed to promote and enhance communications and understanding between the auditor and the audit committee.

The auditor's heightened scrutiny of transactions in the critical areas, and the enhanced understanding of such transactions both by the auditor and the audit committee, should improve the quality of the audit and also may result in improvements in companies' accounting and disclosures in these areas. Additionally, the new requirements are aligned with the Board's risk assessment standards<sup>140</sup> and reflect a cohesive audit approach that should improve the auditor's risk-based consideration of the critical areas, as well as provide opportunities for efficient implementation.

The Act was amended by Section 104 of the Jumpstart Our Business Startups Act JOBS Act<sup>141</sup> to provide that any additional rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation."<sup>142</sup> As a result, if the standard and amendments are approved by the SEC, they will be subject to a separate determination by the SEC regarding their applicability to audits of EGCs.

The Board is recommending that the SEC determine that the standard and amendments should apply to audits of

<sup>140</sup> In 2010, the Board adopted eight auditing standards to establish a framework for the auditor's assessment of and response to the risks of material misstatement in an audit (the "risk assessment standards"), which reflect the Board's view of the auditor's fundamental approach to the audit. The risk assessment standards cover the entire audit process, from initial planning activities to evaluating audit evidence to forming the opinion to be expressed in the auditor's report. See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release 2010-004 (August 5, 2010).

<sup>141</sup> Public Law 112-106 (April 5, 2012).

<sup>142</sup> See Section 103(a)(3)(C) of the Act, as added by Section 104 of the JOBS Act.

EGCs. To assist the SEC in making this determination, the Board is providing information herein specifically related to audits of EGCs.

The discussion below includes information regarding: (i) The Need for the Standard and Amendments; (ii) The Baseline (encompassing both existing requirements and audit practices); (iii) The Board's Approach and Consideration of Alternatives; (iv) The Economic Impacts of the Standard and Amendments, including Benefits and Costs; and (v) Economic Considerations Pertaining to Audits of EGCs, including Efficiency, Competition, and Capital Formation.

### Need for the Standard and Amendments Introduction

Investors are often widely dispersed and significant in number and thus must rely on management to operate and control the company. As a result, investors possess less information about the company than the company's management, a situation that can be described as information asymmetry<sup>143</sup> between investors and management. Management prepares the company's financial statements that investors use to evaluate a company's financial performance and management's stewardship of the company. An audit provides investors with independent, reasonable assurance that the company's financial statements are fairly presented, in accordance with the relevant accounting framework, and comply with applicable requirements.

A key objective of PCAOB standards is to improve the likelihood that the auditor will detect material misstatements in company financial statements, whether due to error or

fraud.<sup>144</sup> The auditor, as a gatekeeper<sup>145</sup> in the financial reporting system, can mitigate risks of material misstatement in the financial statements and, thus, risks to investors arising out of their reliance on misstated financial statements, by focusing appropriate auditing effort in areas that warrant heightened scrutiny. Increased attention by the auditor should, in the Board's view, increase the likelihood of the auditor identifying material misstatements.

In considering the need to improve existing auditing standards relating to the critical areas, the Board took into account a variety of factors. Most significantly, the Board considered the need for the standard and amendments against the backdrop of several decades of financial reporting frauds involving related party transactions, significant unusual transactions and financial relationships and transactions with executive officers. Prominent corporate scandals involving these critical areas include many that served as a catalyst for the enactment of the Act.<sup>146</sup> The

<sup>144</sup> Strengthening the requirements for auditing in the critical areas should similarly promote improved performance on audits of broker-dealer financial statements. The approach set forth in the standard should direct auditors to devote more time to areas requiring heightened scrutiny. The auditor's enhanced focus on these areas should improve the reliability of information used in regulatory oversight, which, in turn, should enhance investor protection.

<sup>145</sup> According to the SEC, "The federal securities laws, to a significant extent, make independent auditors 'gatekeepers' to the public securities markets. These laws require, or permit us to require, financial information filed with us to be certified (or audited) by independent public accountants. Without an opinion from an independent auditor, the company cannot satisfy the statutory and regulatory requirements for audited financial statements and cannot sell its securities to the public. The auditor is the only professional that a company must engage before making a public offering of securities and the only professional charged with the duty to act and report independently from management." See SEC Securities Act Release No. 33-7870, *Proposed Rule: Revision of the Commission's Auditor Independence Requirements* (June 30, 2000) at Section II.A. See also, SEC Securities Act Release No. 33-7919, *Final Rule: Revision of the Commission's Auditor Independence Requirements* (November 21, 2000) at Section III.A.

<sup>146</sup> The following illustrative list provides examples of prominent corporate scandals that involve the critical areas. The following list is not all-inclusive and, in some cases, examples involve more than one critical area: (i) With respect to related party transactions: Hollinger, Inc., see SEC Complaint, *SEC, Plaintiff v. Conrad M. Black, F. David Radler and Hollinger, Inc.* (November 15, 2004); MCA Financial Corporation, see SEC AAER No. 2076, *In The Matter of Grant Thornton LLP, Doeren Mayhew & Co. P.C., Peter M. Behrens, CPA, Marvin J. Morris, CPA, and Benedict P. Rybicki, CPA, Respondent* (August 5, 2004); and Adelphia Communications Corporation, see SEC AAER No. 1599, *SEC v. Adelphia Communications Corporation, John J. Rigas, Timothy J. Rigas, Michael J. Rigas, James P. Rigas, James R. Brown,*

critical areas addressed by the standard and amendments have continued to be contributing factors in more recent enforcement cases.<sup>147</sup> These corporate scandals undermine investor confidence and have resulted in significant losses to investors, as well as the loss of many jobs.<sup>148</sup> As discussed below, the Board's oversight activities indicate that auditors' scrutiny of these critical areas continues to be an area of concern.

Additionally, the Board considered: (i) Input from the SAG; (ii) studies that suggested the need to improve existing auditing standards to address areas that could pose increased risks of material misstatement; (iii) the actions of other standard setters, such as the IAASB and the ASB of the AICPA, who had revised their auditing standards in certain analogous areas in 2008 and 2011, respectively; and (iv) information obtained through the Board's oversight activities. The Board also considered input from commenters on its

and Michael C. Mulcahey, 02 Civ. 5776 (KW) (S.D.N.Y.) (July 24, 2002); (ii) with respect to significant unusual transactions: Enron Corporation, see SEC Spotlight on Enron, <https://www.sec.gov/spotlight/enron.htm>; Refco, Inc., see SEC Complaint, *SEC, Plaintiff v. Phillip R. Bennett, Defendant* (February 19, 2008); and (iii) with respect to financial relationships and transactions with executive officers: Tyco International, Ltd., see SEC AAER No. 3010, *SEC v. L. Dennis Kozlowski, Mark H. Swartz, and Mark A. Belnick, 02-CV-7312 (RWS)* (S.D.N.Y. filed Sept. 12, 2002) (July 14, 2009); WorldCom, Inc., see *Restoring Trust, Report to The Hon. Jed S. Rakoff The United States District Court for the Southern District of New York On Corporate Governance for the Future of MCI* (August 2003) at 17-19. Additionally, Section 704 of the Act directed the SEC to study enforcement actions over the five years preceding its enactment "to identify areas of issuer financial reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management" (the "SEC Section 704 Study"). As part of the study, the SEC examined 227 enforcement matters and found that 23 cases included the failure to disclose related party transactions. See *Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002* (January 24, 2003) at 6.

<sup>147</sup> See, e.g., SEC AAER No. 3447, *SEC v. Keyuan Petrochemicals, Inc. and Aichun Li* (February 28, 2013), and SEC AAER No. 3385, *SEC v. China Natural Gas, Inc. and Qinan Ji* (May 14, 2012).

<sup>148</sup> For example, Enron Corporation was the nation's largest natural gas and electric marketer, with reported annual revenue of more than \$150 billion. When it filed for bankruptcy on December 2, 2001, its stock price had dropped in less than a year from more than \$80 per share to less than \$1. See *SEC Settles Civil Fraud Charges Filed Against Richard A. Causey, Former Enron Chief Accounting Officer; Causey Barred From Acting as an Officer or Director of a Public Company* SEC Litigation Release No. 19996 (February 9, 2007).

<sup>143</sup> Information asymmetry refers to situations involving two or more parties in a relationship in which one party has more, or better, information than the other party. For more information on matters related to the separation of ownership and control of companies and the implications on financial markets, see, e.g., Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property*, 2 Harcourt, Brace and World, New York *passim* (1967); Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 *Journal of Financial Economics* 305 *passim* (1976); and Paul M. Healy and Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 *Journal of Accounting and Economics* 405 *passim* (2001).

proposal<sup>149</sup> and reproposal.<sup>150</sup> Commenters were broadly supportive of the Board's standard-setting efforts and generally agreed that improvements to the existing auditing standards were appropriate.<sup>151</sup>

#### The Need for Improved Requirements in the Critical Areas

The following discussion describes the need for improvements to existing auditing requirements in each critical area. As more fully described below, the Board believes that its existing standards do not contain sufficient required procedures and are not sufficiently risk-based in critical areas that warrant heightened scrutiny. Increased auditor attention to the critical areas should, in the Board's view, increase the likelihood of the auditor identifying material misstatements.

*Relationships and Transactions With Related Parties:* The auditor's attention to a company's transactions with its related parties is important because the substance of such transactions may differ materially from their form.<sup>152</sup> A related party relationship provides the parties with the ability to negotiate transactions on terms that may not be available to other parties on an arm's-length basis. Such non-arm's length transactions potentially provide more of an opportunity for management to act in its own interests,<sup>153</sup> rather than in the

interests of the company and its investors and, in some instances, such transactions have been used to facilitate financial statement fraud and asset misappropriation.<sup>154</sup> Related party transactions also may involve difficult measurement and recognition issues that can lead to errors in financial statements.

The importance to investors of the auditing of related party transactions was emphasized by the U.S. Congress in 1995 through the enactment of Section 10A of the Exchange Act, which requires that each audit of financial statements of an issuer include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."<sup>155</sup> Additionally, SEC actions have identified related party transactions as warranting heightened scrutiny by auditors.<sup>156</sup>

The Board's existing standard for the auditing of related party transactions, AU sec. 334, *Related Parties*,<sup>157</sup> was issued in 1983, and has not been substantively revised since then. Among other things, AU sec. 334 has not been revised to align with the Board's risk assessment standards, which provide an overall framework for the auditor's assessment of and response to the risks of material misstatement. Additionally, as discussed below, the existing standard does not reflect an approach

that promotes heightened scrutiny by the auditor of a company's relationships and transactions with related parties.

AU sec. 334 provides guidance for the auditor, rather than explicitly requiring the performance of specific procedures.<sup>158</sup> For example, AU sec. 334 includes examples of procedures that the auditor could perform, and indicates that such procedures may not be required in every audit. Such an approach can lead to inadequate auditor effort in an area that historically has posed increased risks of material misstatement. Additionally, the existing standard suggests that related party transactions need not be considered by the auditor as outside the ordinary course of business for a company, unless the auditor is aware of evidence to the contrary. As a result, the auditor may not exercise sufficient professional skepticism in an area that Congress and the SEC have indicated requires heightened scrutiny.

The need to revise and strengthen AU sec. 334 has been supported by a number of prominent studies, including studies conducted by the auditing profession prior to the enactment of the Act and the establishment of the Board. For example, the AICPA recommended, after studying over 200 cases reported by their members in which allegations of an audit failure were made, that "required audit procedures be broadened to help ensure the auditor gains a more complete understanding of related party transactions, including the business aspects of transactions."<sup>159</sup>

Additionally, the Board considered a synthesis of the academic literature on auditing related party transactions that states that various high profile frauds demonstrate how related party transactions can be used to mislead users of financial statements.<sup>160</sup> The authors find that related party transactions are as common in companies alleged to have committed fraud as in companies in which no fraud has been detected. However, the authors also find that ". . . when fraud does exist, the presence of related party transactions is one of the top reasons

<sup>149</sup> See the proposing release, which included: (i) An auditing standard, *Related Parties* ("proposed standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions ("proposed amendments regarding significant unusual transactions"); and (iii) other amendments to PCAOB auditing standards ("other proposed amendments"). Collectively, these are referred to as the "proposed standard and amendments."

<sup>150</sup> See the reproposing release, which included: (i) An auditing standard, *Related Parties* ("reproposed standard"); (ii) amendments to certain PCAOB auditing standards regarding significant unusual transactions ("reproposed amendments regarding significant unusual transactions"); and (iii) other proposed amendments to PCAOB auditing standards ("other reproposed amendments"). Collectively, these are referred to as the "reproposed standard and amendments."

<sup>151</sup> Section C provides additional discussion of the standard and amendments, as well as discussion of significant comments received and the Board's consideration of such comments.

<sup>152</sup> For example, to improve the appearance of its financial condition, a company and a related party could attempt to "dress up" the appearance of the company's balance sheet at period end by agreeing to have the company temporarily pay down its related party debt prior to the balance sheet date while having an undisclosed side agreement to subsequently borrow the same or a comparable amount shortly after period end.

<sup>153</sup> See, e.g., paragraph 15 of FASB Statement No. 57, *Related Parties*, which states "[w]ithout disclosure to the contrary, there is a general presumption that transactions reflected in financial statements have been consummated on an arm's-

length basis between independent parties. However, that presumption is not justified when related party transactions exist because the requisite conditions of competitive, free-market dealings may not exist. Because it is possible for related party transactions to be arranged to obtain certain results desired by the related parties, the resulting accounting measures may not represent what they usually would be expected to represent."

<sup>154</sup> As noted above, the SEC Section 704 Study identified areas of issuer financial reporting that are most susceptible to fraud, inappropriate manipulation or inappropriate earnings management. As part of that study, the SEC examined 227 enforcement matters and found that 23 cases included the failure to disclose related party transactions. See SEC Section 704 Study.

<sup>155</sup> Section 10A(a)(2) of the Exchange Act, 15 U.S.C. 78j-1(a)(2).

<sup>156</sup> See, e.g., SEC AAER No. 3427, *In the Matter of the Application of Wendy McNeely, CPA*, at 10-12 (December 13, 2012), which states, in part, that the SEC and the courts have repeatedly held that related party transactions require heightened scrutiny by auditors. See also *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005) (citing *Howard v. SEC*, 376 F.3d 1136, 1149 (D.C. Cir. 2004) noting that related-party transactions "are viewed with extreme skepticism in all areas of finance," *aff'g James Thomas McCurdy, CPA*, 57 S.E.C. 277 (2004)).

<sup>157</sup> AU sec. 334 is one of the Board's interim auditing standards. Shortly after the Board's inception, the Board adopted the existing standards of the AICPA, as in existence on April 16, 2003, on an initial, transitional basis. See *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (April 18, 2003).

<sup>158</sup> See discussion of The Baseline for a detailed discussion of the existing requirements applicable to the critical areas.

<sup>159</sup> The Quality Control Inquiry Committee of the AICPA's SEC Practice Section issued a report (the "QCIC Report") making this recommendation in 2002. See AICPA SEC Practice Section, *Memo To Managing Partners of SECPS Member Firms, "Recommendations for the Profession Based on Lessons Learned from Litigation"* (October 2002), which includes the QCIC Report as an attachment.

<sup>160</sup> See Elizabeth A. Gordon, Elaine Henry, Timothy J. Louwers, and Brad J. Reed, *Auditing Related Party Transactions: A Literature Overview and Research Synthesis*, *Accounting Horizons* 21 (1): 81-102 (2007).

cited for audit failures.”<sup>161</sup> The authors conclude that the findings in academic literature, combined with the significance of related party transactions in corporate scandals, “are consistent with the PCAOB’s reconsideration of auditing of related party transactions.”<sup>162</sup>

While the Board recognizes that transactions with related parties are also used for legitimate purposes, including the efficient procurement of resources,<sup>163</sup> the Board has concluded that the auditing of related party transactions warrants heightened scrutiny. Notably, the Board has observed, through its oversight activities, deficiencies in the auditing of related party transactions, particularly with respect to audits of smaller public companies. Additionally, as prominent corporate scandals over the past several decades illustrate, issues involving the scrutiny of related party transactions also arise in the audits of large public companies.

As a result of these and other considerations discussed throughout this release, the Board has determined that there is a need to improve its existing auditing standard regarding related parties. In the Board’s view, AU sec. 334 does not contain sufficient required procedures, is not risk-based, and does not promote the necessary heightened scrutiny of related party transactions.

**Significant Unusual Transactions:** The identification and evaluation of a company’s significant unusual transactions is important to the audit because such transactions can create complex accounting and financial

disclosure issues that create risks of error. Additionally, in some cases, significant unusual transactions have been used to engage in fraudulent financial reporting. For example, significant unusual transactions that are close to period end may be entered into to obscure a company’s financial position or operating results (e.g., so-called “window-dressing”). Others may involve counterparties that are willing to structure transactions to achieve desired accounting results. In such cases, company management may place more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction.

The Board has considered studies that highlight the risks of material misstatements associated with a company’s significant unusual transactions. For example, the *Report Prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs* found that “some U.S. financial institutions and public companies have been misusing structured finance vehicles . . . to carry out sham transactions that have no legitimate business purpose and mislead investors, analysts, and regulators about companies’ activities, tax obligations, and true financial condition.”<sup>164</sup> Another study attributed an increased risk of financial misstatement to transactions in which the substance of the transactions might differ materially from their form.<sup>165</sup>

Additionally, SEC enforcement actions have highlighted the need for the auditor to scrutinize complex unusual transactions, including understanding their underlying economic purpose.<sup>166</sup> Other SEC cases have addressed instances in which structured transactions obscured the economic substance of transactions that

had a material impact on the company’s financial statements.<sup>167</sup>

The risk assessment standards require the auditor to consider the risks of material misstatement posed by significant unusual transactions as part of the auditor’s risk assessment during the financial statement audit.<sup>168</sup> However, the auditing requirements regarding significant unusual transactions are principally contained in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.<sup>169</sup> That standard provides that the auditor considers the risks of fraud relating to a significant transaction outside the normal course of business for a company if the auditor “becomes aware” of such a transaction.<sup>170</sup> There is no express requirement in AU sec. 316, however, for the auditor to perform specific procedures to identify such transactions or to obtain the information necessary to evaluate the accounting for and disclosure of such transactions, which are key considerations in promoting the auditor’s heightened scrutiny of a company’s significant unusual transactions.

The Board’s staff identified areas of potential weaknesses in the auditor’s consideration of significant unusual transactions and in April 2010 issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*.<sup>171</sup> That alert discusses a range of auditor practice issues pertaining to significant unusual transactions, including the auditor’s understanding of transactions close to period end that pose difficult substance over form issues. Similarly, the IAASB staff issued guidance in August 2010 that addressed the auditing of significant unusual or highly complex transactions.<sup>172</sup>

As a result of these and other considerations discussed throughout

<sup>167</sup> See, e.g., SEC AAER No. 1631, *In the Matter of Dynege, Inc., Respondent* (September 24, 2002). In that action, the Commission determined that Dynege entered into two massive “round-trip” electricity transactions, that is, simultaneous, pre-arranged buy-sell trades at the same price, terms and volume, in which neither Dynege nor its trading counterparty earned a profit or incurred a loss and that such transactions lacked economic substance.

<sup>168</sup> See, e.g., paragraph 71.g. of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

<sup>169</sup> See paragraphs .66–.67 of AU sec. 316.

<sup>170</sup> See discussion of The Baseline for a more detailed discussion of the existing standards applicable to the critical areas.

<sup>171</sup> See Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010).

<sup>172</sup> See IAASB Staff Questions and Answers, *Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions* (August 2010).

<sup>161</sup> *Id.* at 82.

<sup>162</sup> *Id.* at 81. A subsequent study conducted by the same authors analyzes 43 SEC enforcement actions against auditors related to the examination of related party transactions and identified audit practice issues in that area. The authors found that the majority of this sample involved inadequate examination of the related party transaction by the auditor. Although the authors concluded that the audit failures described in these SEC cases were more likely attributable to a lack of professional skepticism and due professional care than deficiencies in the existing standards, the authors provide suggestions to improve audit practice regarding the auditing of related party transactions. Among other things, the authors suggest that auditors use guidance published by the AICPA in a 2001 “Related Party Transaction Toolkit” that suggests that the auditor should perform many of the procedures described as guidance in AU sec. 334 to determine the existence of related parties and identify transactions with known related parties. See Timothy J. Louwers, Elaine Henry, Brad J. Reed, and Elizabeth A. Gordon, *Deficiencies in Auditing Related-Party Transactions: Insights from AAERs, Current Issues in Auditing 2* (2): A10–A16 (2008).

<sup>163</sup> See Elizabeth A. Gordon, Elaine Henry, and Darius Palia, *Related Party Transactions and Corporate Governance 9 Advances in Financial Economics 1–27*, (2004).

<sup>164</sup> See Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, *Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions* (January 2, 2003), <http://www.gpo.gov/fdsys/pkg/CPRT-107SPRT83559/pdf/CPRT-107SPRT83559.pdf>.

<sup>165</sup> See SEC Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 *On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (June 15, 2005), <http://sec.gov/news/studies/soxoffbalancrpt.pdf>.

<sup>166</sup> See, e.g., SEC AAER No. 2775, *In the Matter of Michael Lowther, CPA, Respondent* (January 28, 2008), which discusses the 2001 financial reporting fraud at Enron, which included the use of complex structured transactions to obscure the economic substance of certain financing transactions that had a material impact on Enron’s financial statements.

this release, the Board has determined that there is a need to improve its existing auditing standards regarding significant unusual transactions. In the Board's view, the existing standards in this area do not contain sufficient required procedures to promote the heightened scrutiny necessary for the auditor to identify and evaluate transactions that may be used to intentionally obscure a company's financial results or that may result in erroneous financial reporting.

*Financial Relationships and Transactions with Executive Officers:* Understanding a company's relationships and transactions with its executive officers is important to an auditor because a company's executive officers are generally in a position to determine or influence a company's accounting and disclosures. A company's financial relationships and transactions with its executive officers (e.g., executive compensation) can create incentives and pressures for executive officers to meet financial targets, which can result in risks of material misstatement of a company's financial statements. Additionally, a company's executive officers, because of their role in the financial reporting process, are in a unique position to commit fraud.<sup>173</sup>

Cases involving fraudulent financial reporting illustrate how a company's financial relationships and transactions with its executive officers can create incentives and pressures that can result in risks of material misstatement, including fraud risks.<sup>174</sup> Research that analyzed SEC AAERs from 1998 to 2007 also identified potential motivations for engaging in fraudulent financial reporting that relate to a company's financial targets.<sup>175</sup> For example, the study noted that the most commonly cited motivations for fraud included the need to: (i) Meet internal or external earnings expectations of analysts and others; (ii) meet internally set financial

targets or make the company look better; (iii) conceal the company's deteriorating financial condition; (iv) increase the stock price; (v) bolster financial position for pending equity or debt financing; (vi) increase management compensation through achievement of bonus targets and through enhanced stock appreciation; and (vii) cover up assets misappropriated for personal gain. The cited motivations support a conclusion that a company's financial relationships and transactions with its executive officers can create incentives and pressures that can result in risks of material misstatement to a company's financial statements. That study noted that the chief executive officer and/or the chief financial officer were named in 89 percent of the cases involving fraudulent financial reporting brought by the SEC during that period.

Under the Board's risk assessment standards, the auditor is required to consider obtaining an understanding of compensation arrangements with the company's "senior management" as part of obtaining an understanding of the company.<sup>176</sup> In the Board's view this continues to be an important consideration for the auditor during the risk assessment process. However, the Board's risk assessment standards require the auditor to "consider" performing procedures to obtain an understanding of certain compensation arrangements as part of "obtaining an understanding of the company" during the auditor's overall risk assessment, but does not require the performance of specific procedures to obtain such an understanding.<sup>177</sup> Most significantly, the Board's risk assessment standards do not require the auditor to perform specific procedures to obtain an understanding of financial relationships and transactions with executive officers, which can motivate or affect company accounting or reporting decisions.

As a result of these and other considerations discussed throughout this release, the Board has determined that there is a need to improve its existing risk assessment standards relating to the auditor's consideration of a company's financial relationships and transactions with its executive officers. In the Board's view, its risk assessment standards in this area are not sufficiently targeted to promote heightened scrutiny of potential risks of material misstatement arising from a company's financial relationships and transactions with its executive officers,

in view of the unique role played by the company's executive officers in the company's financial reporting process.

#### How the Standard and Amendments Address the Need

The Board has determined to improve its requirements relating to identifying, understanding, and addressing certain areas that are widely acknowledged to represent increased risks of material misstatement in company financial statements. As more fully discussed below, these improvements are intended to strengthen the audit of the company's financial statements by improving the auditor's ability to identify and address such risks. In the Board's view, a more focused approach with specific performance requirements should foster the heightened scrutiny that the Board believes is warranted in the critical areas. Such an approach should help mitigate the information asymmetry between company management and investors.

The following sections describe key aspects of the standard and amendments being adopted by the Board, with a focus on how they address the need for improvement described above.<sup>178</sup>

*Auditing Standard No. 18, Related Parties:* The Board is superseding AU sec. 334 and adopting a new standard that establishes specific procedures intended to strengthen auditor performance requirements regarding the auditing of related party transactions. The new requirements establish specific procedures, rather than the approach in the existing standard, which provides guidance and example procedures for the auditor's consideration.

The standard reflects the following key improvements from the existing standard:

- *Adding Basic Requirements:* AU sec. 334 suggests procedures for the auditor's consideration, noting that not all of them may be required in every audit. The standard requires basic procedures for the auditor's response to risks of material misstatement associated with a company's relationships and transactions with its related parties. Specifically, the standard focuses on those related party transactions that require disclosure in the financial statements or that are determined to be a significant risk. The basic procedures are designed to assist the auditor in identifying red flags that indicate potential risks of material misstatement. The standard also requires more in-depth procedures that are designed to be scalable and

<sup>173</sup> See, for example, AU sec. 316.08.

<sup>174</sup> For example, over the last decade, the SEC has brought a number of cases where management allegedly manipulated compensation expense recognized in the financial statements, while simultaneously obtaining additional compensation for themselves through options backdating. See SEC Spotlight on Stock Options Backdating, which lists AAERs, Commission speeches and testimony, Commission staff speeches, testimony and letters; and non-SEC documents relating to stock options backdating, <http://www.sec.gov/spotlight/optionsbackdating.htm>.

<sup>175</sup> See Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson, and Terry L. Neal, 2010. *Fraudulent Financial Reporting 1998–2007: An Analysis of U.S. Public Companies*, Committee of Sponsoring Organizations of the Treadway Commission (May 2010) at 3, [http://www.coso.org/documents/COSOFRAUDSTUDY2010\\_001.pdf](http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf).

<sup>176</sup> See paragraph 11 of Auditing Standard No. 12.

<sup>177</sup> See discussion of The Baseline for a detailed discussion of the existing standards applicable to the critical areas.

<sup>178</sup> A section-by-section discussion of the standard and amendments is located in Section C.

commensurate with the company's facts and circumstances.

- *Enhancing Procedures to Obtain an Understanding of the Company's Relationships and Transactions With Its Related Parties:* Unlike AU sec. 334, which includes limited direction for obtaining an understanding of the company's relationships and transactions with its related parties, the standard requires the performance of specific procedures in this area, including obtaining an understanding of the terms and business purposes (or the lack thereof) of related party transactions.

- *Aligning With the Risk Assessment Standards:* The standard is designed to align with and build upon the risk assessment standards. The procedures are intended to be performed in conjunction with the procedures performed during the auditor's risk assessment.

- *Improving the Auditor's Focus on Accounting:* AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions. The standard requires that the auditor evaluate both the accounting for, and disclosure of, related party transactions.

- *Emphasizing a Complementary Audit Approach:* The standard specifically requires the auditor to take into account other work performed during the audit, for example, information gathered with respect to significant unusual transactions, when evaluating the company's identification of its related party transactions.

- *Adding Audit Committee Communications:* AU sec. 334 does not mention communications with audit committees regarding related party transactions. The standard being adopted by the Board anticipates two-way communication between the auditor and the audit committee regarding such transactions. This reflects the fact that the new performance requirements contained in the standard and amendments relate to sensitive areas of the audit that potentially involve the interests of company management and, thus, warrant discussion with the audit committee. Specifically, the auditor is required to make inquiries of the audit committee (or its chair) when the auditor is obtaining an understanding of the company, which should occur during the auditor's risk assessment. During these initial communications, the auditor obtains information regarding a company's significant related party transactions and any such relationships or transactions that are of concern to members of the audit

committee. The standard further requires that the auditor communicate to the audit committee regarding the auditor's overall evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, including any significant matters the auditor identified during the audit. Among other things, the matters to be communicated related to the auditor's evaluation include the identification of any related parties (or relationships or transactions with related parties) that were previously undisclosed to the auditor.

*Amendments Regarding Significant Unusual Transactions:* In this area, the Board is: (i) Revising AU sec. 316; (ii) making targeted amendments to certain risk assessment standards (e.g., Auditing Standards Nos. 12 and 13); and (iii) making related changes to other PCAOB auditing standards. These amendments include specific procedures designed to improve the auditor's identification and evaluation of a company's significant unusual transactions. Among other things, they require the auditor to perform specific procedures to (i) identify significant unusual transactions and (ii) obtain an understanding of the business purpose (or the lack thereof) of the company's significant unusual transactions, including whether the transaction was entered into to engage in fraud. In the Board's view, adding specific procedures promotes audit quality by providing the auditor with more insight into the nature of a company's significant unusual transactions, which should enable the auditor to better evaluate whether the financial statements are fairly stated.

The amendments regarding significant unusual transactions are designed to improve existing Board standards in the following key respects:

- *Improving Requirements for Identifying Significant Unusual Transactions:* The amendments regarding significant unusual transactions require the performance of specific procedures intended to improve the auditor's identification of significant unusual transactions, for example, by amending Auditing Standard No. 12 to require the auditor to make inquiries of management and others.

- *Improving the Auditor's Evaluation of Significant Unusual Transactions:* The amendments to AU secs. 316.66–.67A include basic procedures for obtaining information for evaluating significant unusual transactions. The basic procedures include: (i) Reading the underlying documentation relating to significant unusual transactions and evaluating whether the terms and other

information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction; (ii) determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures; and (iii) evaluating the financial capability of the other parties to the transaction with respect to significant uncollected balances, guarantees, and other obligations.

- *Enhancing Attention to the Business Purpose (or the Lack Thereof) of Significant Unusual Transactions:* The amendments to AU secs. 316.66–.67 enhance the auditor's evaluation of the business purpose of significant unusual transactions by, among other things, expanding the factors considered by the auditor in evaluating whether the business purpose (or the lack thereof) indicates that such transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

- *Emphasizing Accounting and Disclosure:* The amendments regarding significant unusual transactions to AU sec. 316.67A are intended to heighten the auditor's attention to accounting matters relative to significant unusual transactions by emphasizing that existing requirements include evaluating whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework.

- *Emphasizing a Complementary Audit Approach:* The amendments regarding significant unusual transactions specifically require the auditor to take into account other work performed during the audit, for example, information gathered with respect to related party transactions, when identifying significant unusual transactions.

- *Enhancing Audit Committee Communications:* The amendments regarding significant unusual transactions are intended to improve the quality of the auditor's communications with the audit committee regarding the business purpose (or the lack thereof) of significant unusual transactions.<sup>179</sup>

- *Conforming Descriptions of Significant Unusual Transactions:* The amendments introduce a uniform description of "significant unusual transactions" throughout the Board's standards.

<sup>179</sup> See, e.g., paragraph 13.d of Auditing Standard No. 16, *Communications with Audit Committees*.



*Amendments Regarding Financial Relationships and Transactions With Executive Officers:* The Board is revising Auditing Standard No. 12 to require the auditor to perform specific procedures during the risk assessment process to obtain an understanding of the company's financial relationships and transactions with its executive officers. In doing so, the auditor would consider, among other things, the potential for increased risks of material misstatement that could arise out of the company's compensation arrangements with its executive officers.<sup>180</sup>

The revisions improve the existing audit requirements by requiring the auditor to perform specific procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers, as part of the auditor's risk assessment. Specifically, the amendments revise Auditing Standard No. 12 to state that the auditor "should perform" specified procedures to obtain an understanding of the company's financial relationships and transactions with its "executive officers" as part of the auditor's risk assessment.

As noted previously, under the existing risk assessment standards, the auditor is required to "consider" obtaining an understanding of compensation arrangements with senior management as part of obtaining an understanding of the company during the auditor's risk assessment.<sup>181</sup> The Board's standards currently do not explicitly require that the auditor obtain information regarding incentives or pressures for the company's executive officers to achieve a particular financial position or operating result as a result of performance based compensation arrangements. The Board has determined to supplement its existing requirements, and has determined that the requirement that the auditor "should perform" procedures relating to executive officer compensation arrangements is appropriate to promote heightened scrutiny.

In the Board's view, a focus on the company's executive officers during the risk assessment process is appropriate in that they generally play a key role in the company's accounting decisions and in a company's financial reporting. However, the new required procedures do not require the auditor to make a determination regarding the

appropriateness of a company's compensation agreements with its executive officers.

#### The Baseline

To consider the economic impacts (including likely benefits and costs) of the standard and amendments, a "baseline" has been identified that can be used as a benchmark against which the standard and amendments can be compared. The baseline, described below, includes existing requirements and also considers audit practices.

#### Existing Requirements

The auditor's overall responsibility to perform a risk-based audit is contained in the Board's risk assessment standards, Auditing Standards Nos. 8 through 15, which became effective for auditors in December 2010.<sup>182</sup> Among other things, the risk assessment standards require the auditor to consider the risks of material misstatement, whether due to error or fraud, throughout the audit.<sup>183</sup>

The existing requirements that the Board is strengthening through adoption of the standard and amendments are discussed below.

*Relationships and Transactions With Related Parties:* The risk assessment standards anticipate that the auditor will consider certain risks inherent in significant transactions with related parties in determining the significant risks of the audit<sup>184</sup> and in establishing the materiality level for the audit of the financial statements.<sup>185</sup> However, the existing auditing requirements relating to relationships and transactions with related parties are contained primarily in AU sec. 334, one of the Board's interim standards.

AU sec. 334 recognizes that the auditor performs procedures to identify and evaluate a company's relationships and transactions with its related parties as part of performing an audit of financial statements. However, as noted

<sup>182</sup> See PCAOB Release 2010-004 (August 5, 2010).

<sup>183</sup> More generally, auditors are required to comply with all standards of the PCAOB, including existing requirements to perform the audit with due professional care, and to obtain sufficient appropriate audit evidence to support the audit opinion. See, e.g., AU sec. 230, *Due Professional Care in the Performance of Work*, and Auditing Standard No. 15, *Audit Evidence*.

<sup>184</sup> See paragraph 71.e. of Auditing Standard No. 12.

<sup>185</sup> See paragraph 7 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, which states that lesser amounts of misstatements could influence the judgment of a reasonable investor because of qualitative factors, e.g., because of the sensitivity of circumstances surrounding misstatements, such as conflicts of interest in related party transactions.

above, it provides guidance and examples of procedures for the auditor's consideration, rather than specific required procedures.

Examples of procedures in AU sec. 334 include: (i) Procedures to obtain information from management (such as obtaining the names of all related parties and inquiring whether there were any transactions with these parties during the period); (ii) procedures intended to assist the auditor in identifying related parties that have not been disclosed to the auditor by management (such as reviewing filings with the SEC, reviewing company accounting records and certain invoices, and making inquiries of other auditors); and (iii) procedures the auditor considers, as necessary, to understand the purpose, nature, and extent of identified related party transactions (such as obtaining an understanding of the business purpose of the transaction). Notably, AU sec. 334 states that not all of the procedures may be required in every audit.

AU sec. 334 states that the auditor should place primary emphasis on the adequacy of disclosure of related party transactions. Significantly, the existing standard also states that, in the absence of evidence to the contrary, related party transactions should not be assumed to be outside the ordinary course of business.<sup>186</sup> Thus, AU sec. 334 could be misunderstood to create a "presumption of validity" for the business purpose of related party transactions in situations where experience suggests a need for heightened scrutiny.<sup>187</sup>

*Significant Unusual Transactions:* The risk assessment standards anticipate that the auditor will consider risks of material misstatement in a company's financial statements, including those posed by significant unusual transactions.<sup>188</sup> However, the more specific auditing requirements regarding significant unusual transactions are principally contained in AU sec. 316.<sup>189</sup> Specifically, AU sec. 316.66 recognizes that during a financial statement audit, the auditor may become aware of significant 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

<sup>186</sup> See AU sec. 334.06.

<sup>187</sup> This is in contrast to the approach reflected in the standard, which emphasizes the auditor's responsibilities for identifying and assessing risks of material misstatement associated with related parties and relationships and transactions with related parties.

<sup>188</sup> See paragraph 71.g. of Auditing Standard No. 12.

<sup>189</sup> See AU secs. 316.66-67.

<sup>180</sup> The population of the company's "executive officers" is determined by reference to SEC rules and forms. See Section C—Other Amendments to PCAOB Auditing Standards for a discussion of the applicable definition of the term "executive officer."

<sup>181</sup> See paragraph 11 of Auditing Standard No. 12.

company and its environment. AU sec. 316.66 requires that, if the auditor becomes aware of significant unusual transactions during the course of an audit, the auditor should gain an understanding of the business rationale of such transactions and whether that rationale (or the lack thereof) suggests that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. However, AU sec. 316 does not specify the procedures to perform to identify significant unusual transactions or to obtain necessary information to understand their business purpose (or the lack thereof).

*Financial Relationships and Transactions With Executive Officers:* The risk assessment standards require the auditor to consider obtaining an understanding of compensation arrangements with senior management (including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses) as part of obtaining an understanding of the company.<sup>190</sup> While this encompasses a company's executive officers, the existing standards do not specifically require the auditor to obtain an understanding of the incentives and pressures posed by executive officer compensation arrangements that can influence a company's accounting and disclosures.

#### Audit Practices

The Board's understanding of audit practices is based on the Board's general knowledge of audit firm practice arising out of information gathered from its oversight activities, including its inspection, enforcement, and standard-setting activities. Additionally, the Board's understanding also has been informed by a range of studies and other materials it considered in determining the need for improvement of its existing standards. Based on this understanding, the Board believes that audit practices associated with the auditor's efforts regarding the critical areas are inconsistent.

The Board is aware that some firms have adopted audit methodologies that require their engagement teams to perform specific procedures regarding related party transactions not currently required by AU sec. 334. This may have occurred for a number of reasons. For example, the analogous standards of the IAASB and ASB require the auditor to inquire of management regarding the

entity's related parties.<sup>191</sup> Audit practice also may have been impacted by guidance issued by the AICPA encouraging auditors to perform many of the procedures suggested in AU sec. 334 for the auditor's consideration.<sup>192</sup> Additionally, some auditors may already perform additional procedures arising out of their consideration of the risks of significant transactions with related parties as potential significant risks.<sup>193</sup>

Further, some auditors may already perform additional procedures regarding significant unusual transactions as a result of robust risk assessments and as a result of guidance from Board staff and the IAASB.<sup>194</sup> Additionally, there has been considerable interest in issues relating to executive compensation, which may have resulted in heightened attention to such issues by some auditors.<sup>195</sup>

The Board also is aware through its oversight activities that some firms have exhibited deficient auditing practices with respect to the critical areas. For example, the Board has identified deficiencies regarding the auditing of related party transactions through its triennial inspection program, which focuses on inspections of smaller domestic audit firms. Deficiencies identified include failures to test for undisclosed related parties or transactions with related parties, as well as failures to obtain an understanding of the business purpose of known related party transactions.<sup>196</sup>

<sup>191</sup> See paragraph 13 of ISA 550, *Related Parties*, and paragraph 14 of AU-C 550, *Related Parties*.

<sup>192</sup> See AICPA Practice Alert No. 95-3, *Auditing Related Parties and Related-Party Transactions*, which indicated the auditor should perform most, if not all, of the examples of procedures in AU sec. 334 for determining the existence of related parties and identifying transactions with known related parties, and AICPA Toolkit, *Accounting and Auditing for Related Parties and Related Party Transactions* (2001).

<sup>193</sup> See paragraph 71.e. of Auditing Standard No. 12.

<sup>194</sup> See Staff Audit Practice Alert No. 5 (April 7, 2010). See also IAASB Staff Questions and Answers, *Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions* (August 2010).

<sup>195</sup> See, e.g., Staff Audit Practice Alert No. 1, *Matters Related To Timing And Accounting For Option Grants* (July 28, 2006).

<sup>196</sup> See Report on 2007-2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies, PCAOB Release No. 2013-001, at 29 (February 25, 2013), [http://pcaobus.org/Inspections/Documents/02252013\\_Release\\_2013\\_001.pdf](http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf), which states, in part, "Inspections staff have observed deficiencies related to firms' failures to test for undisclosed related parties or transactions with undisclosed related parties. Some of those firms failed to identify and address the lack of disclosure of related party transactions in the financial statements. Inspections staff have also identified deficiencies relating to the firms' failure to obtain an understanding of the nature and

Additionally, a number of the Board's settled enforcement cases have involved related party transactions.<sup>197</sup> Those PCAOB enforcement actions have identified, among other things:

- Failures to perform sufficient procedures for known related party transactions;<sup>198</sup>
- Failures to address management's failure to disclose known related party transactions;<sup>199</sup> and
- Failures to take sufficient steps to determine whether a transaction was a related party transaction, when available information indicated that it was.<sup>200</sup>

The types of deficiencies observed by the Board through its oversight activities

business purpose of transactions with related parties and to evaluate whether the accounting for those transactions reflects their economic substance." See also, *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms*, PCAOB Release No. 2007-010, at 7 (October 22, 2007), [http://pcaobus.org/Inspections/Documents/2007\\_10-22\\_4010\\_Report.pdf](http://pcaobus.org/Inspections/Documents/2007_10-22_4010_Report.pdf).

<sup>197</sup> See, e.g., *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of P. Parikh & Associates, Ashok B. Rajagiri, CA, Sandeep P. Parikh, CA, and Sundeeep P S G Nair, CA, Respondents*, PCAOB Release No. 105-2013-002 (April 24, 2013); *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Jaspers + Hall, PC, Thomas M. Jaspers, CPA, and Patrick A. Hall, CPA, Respondents*, PCAOB Release No. 105-2008-002 (October 21, 2008); *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Williams & Webster, P.S., Kevin J. Williams, CPA, and John G. Webster, CPA, Respondents*, PCAOB Release No. 105-2007-1 (June 12, 2007); and *Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions: In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA, Respondents*, PCAOB Release No. 105-2005-022 (November 22, 2005).

<sup>198</sup> See *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA, Respondents*, PCAOB Release No. 105-2005-022 (November 22, 2005) and *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Williams & Webster, P.S., Kevin J. Williams, CPA, and John G. Webster, CPA, Respondents*, PCAOB Release No. 105-2007-1 (June 12, 2007).

<sup>199</sup> See *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Turner Stone & Company, LLP and Edward Turner, CPA, Respondents*, PCAOB Release No. 2006-010 (December 19, 2006) and *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Timothy L. Steers, CPA, LLC, and Timothy L. Steers, CPA, Respondents*, PCAOB Release No. 105-2007-004 (November 14, 2007).

<sup>200</sup> See *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Cordovano and Honeck, P.C. and Samuel D. Cordovano, CPA, Respondents*, PCAOB Release No. 2008-004 (December 18, 2008) and *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Clyde Bailey, P.C., and Clyde B. Bailey, CPA, Respondents*, PCAOB Release No. 2005-021 (November 22, 2005).

<sup>190</sup> See paragraph 11 of Auditing Standard No. 12.

indicate that auditor practice regarding related parties is inconsistent under the existing auditing framework in a wide range of areas, suggesting that this is a challenging area warranting additional auditor effort and focus.

#### The Board's Approach and Consideration of Alternatives

During the standard-setting process, the Board considered a number of alternatives and made a number of key policy choices with the goal of improving audit quality in the critical areas, while also providing opportunities for an efficient implementation. The following discussion highlights alternatives and policy choices considered by the Board as part of its economic considerations.

#### Consideration of Alternatives

Prior to the Board's decision to propose the standard and amendments, the Board requested input from its SAG, as early as 2004.<sup>201</sup> During these meetings, the Board engaged the SAG in a discussion of issues relating to the auditing of related party transactions. Additionally, the Board discussed whether and, if so, how, to improve its existing standards in complementary areas that might be considered to pose similar risks of material misstatement.

As part of its standard-setting process, the Board initially considered whether new requirements were necessary. This included a review of the Board's oversight efforts through the Board's inspection and enforcement programs to determine the type, range, and prevalence of audit deficiencies cited. In addition, before issuing its proposal, the Board issued Staff Audit Practice Alert No. 5 in April 2010, which discussed a range of auditor practice issues identified by the PCAOB staff pertaining to significant unusual transactions.<sup>202</sup>

Staff Audit Practice Alert No. 5 was issued to remind auditors of the risks associated with significant unusual transactions and to compile selected, relevant requirements from existing PCAOB auditing standards into one document. Given that the alert only highlights circumstances for auditor consideration, it did not alter audit requirements with respect to significant unusual transactions.

In considering whether new requirements were necessary, the Board

assessed a range of factors, and concluded that it was appropriate to develop standards with more specific requirements to address the critical areas.

As part of its considerations, the Board considered whether AU sec. 334 could be amended to include new specific procedures. The Board determined that the nature and extent of revisions necessary, including changes to align a revised AU sec. 334 with the risk assessment standards, would essentially result in a new standard. Thus, the Board determined that it was appropriate to propose a new standard regarding related parties, rather than amend the existing standard.

In considering how to address the other types of relationships and transactions that the Board had identified as posing similar risks—significant unusual transactions and a company's financial relationships and transactions with executive officers—the Board determined that issuing staff guidance could not make the changes that were necessary to strengthen the existing audit requirements to address the risks that had been identified in these areas. However, the Board determined that new stand-alone standards were not necessary but that appropriate improvements in audit quality could be achieved by amendments to its existing audit requirements in those areas.

As the Board considered the types and extent of changes to make in its existing standards, it considered several alternatives, including some discussed with its SAG.<sup>203</sup> Some alternatives considered included:

*Consideration of Related Party Transactions as Fraud Risk:* In view of the potential for increased risks of material misstatement arising from these critical areas, the Board considered whether relationships and transactions with related parties should be presumed to be a fraud risk. Under existing auditing standards, this approach would require auditors to devote considerable audit effort to identifying and evaluating relationships and transactions with related parties, in all instances. However, the Board recognizes that many related party transactions might not, in fact, represent fraud risks or other significant risks, a view that was further informed by discussions with the SAG.<sup>204</sup> Accordingly, as such an alternative could have resulted in

potentially unnecessary audit effort, the Board determined to take a targeted approach that would focus on the auditor obtaining sufficient information to identify, assess, and respond to transactions that pose increased risks of material misstatement, while, at the same time aligning the new requirements with the risk assessment standards.

*Consideration of Relationships and Transactions Positing Similar Risks:* The Board also considered whether to address relationships and transactions that might fall outside the definition of a "related party" but that might pose similar risks. After obtaining input from the SAG regarding this approach,<sup>205</sup> the Board decided that the auditor should consider transactions that might pose similar risks, such as a company's significant unusual transactions, because these transactions not only may involve related parties previously undisclosed to the auditor but also could pose increased risks of material misstatement. Additionally, the Board concluded that linking the auditor's efforts regarding related parties and significant unusual transactions should help auditors "connect the dots" between these areas.

#### The Board's Approach and Choices Considered in Developing the Board's Standard and Amendments

The following discussion describes key policy choices considered by the Board as it developed the standard and amendments, and as the Board moved from its proposal to its reproposal and then to the adoption of the standard and amendments. In developing the standard and amendments, the Board determined to develop an audit approach that would promote heightened scrutiny in the critical areas, but that would also provide opportunity for efficient implementation. Key policy choices included:

*Aligning With the Risk Assessment Standards:* In the Board's view, its overall risk assessment approach promotes a cohesive audit, with opportunities to integrate audit effort where appropriate, and positions the auditor to identify areas in which there may be increased risks of material misstatement in company financial statements. Such an approach could also serve to minimize audit costs. The Board, thus, determined that its new requirements should be explicitly aligned with its risk assessment standards. In response to comments on its proposal, the Board took steps in its reproposal to more closely align the

<sup>201</sup> Prior to the issuance of the proposal, the SAG discussed the topic of related parties at meetings on September 8–9, 2004, June 21, 2007, and October 14–15, 2009. See the SAG Meeting Archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>.

<sup>202</sup> See Staff Audit Practice Alert No. 5 (April 7, 2010).

<sup>203</sup> See the SAG Meeting Archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>, for the October 14–15, 2009 SAG meeting.

<sup>204</sup> See SAG Meeting Archive for the October 14–15, 2009 SAG meeting.

<sup>205</sup> Id.

reproposed standard and amendments with its risk assessment standards. Those who commented on this aspect of the reproposal generally agreed that the revisions improved the alignment with the risk assessment standards. This risk assessment focus is retained in the standard and amendments being adopted by the Board.

*Providing Opportunity for a Scaled Approach:* Similar to the risk assessment standards, the Board determined that the standard should reflect a scaled approach, which establishes basic required procedures that are supplemented by more in-depth procedures that are commensurate with the company's facts and circumstances. Such facts and circumstances may include the size or complexity of the transaction, the nature of the company's relationships or transactions with its related parties, and the related risk of material misstatements in the financial statements.

Most commenters, including several large audit firms, agreed that the repropose standards and amendments provide a scaled approach, permitting the auditor to vary the level of audit work in proportion to the nature and number of a company's relationships and transactions with related parties and significant unusual transactions. Some of these commenters supported the Board's view that the level of audit effort will vary in proportion to the number and nature of a company's related party relationships and transactions, its significant unusual transactions, its financial relationships and transactions with executive officers, and the company's process to identify such matters. Another commenter stated that an audit approach that begins with basic procedures, and supplements them with more in-depth procedures as needed, is a scalable approach that allows the auditor to focus on the significant risks, regardless of the size or nature (e.g., broker or dealer or EGC) of the issuer. A few commenters, however, objected to the concept of basic required procedures and advocated for an approach that would leave the determination of the procedures necessary to the auditor's judgment.

The Board considered commenter views and determined that requiring the auditor to perform basic procedures in areas that could pose increased risks of material misstatement would heighten attention by the auditor to such areas and also provide a basis for the auditor to identify red flags that require further attention. However, as discussed below, the Board did revise certain aspects of its proposal to permit additional auditor

judgment in certain areas of the audit that it determined appropriate.

*Addressing Complementary Audit Areas:* The Board determined that the standard and amendments should include linkages that would address risks of material misstatement arising from complementary areas of the audit. For example, the auditor's work in identifying and evaluating significant unusual transactions could assist the auditor in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor by management. This linked approach encourages the auditor to "connect the dots" between different aspects of the audit, which could improve audit effectiveness, as well as provide opportunities for efficient implementation. In its reproposal, the Board made revisions to improve the linkages between the repropose standard and amendments. This approach is retained in the standard and amendments being adopted by the Board.

*Using Existing Concepts and Procedures:* The Board determined to include some existing auditing concepts and procedures in its proposal. This approach was intended to permit audit firms to build on existing methodologies and training. Further, this approach could minimize the costs of implementing the standard and amendments. In its reproposal, the Board sought comment on such issues. Several audit firms who commented on the reproposal indicated that they would be able to update their methodologies and train staff to apply the standard and amendments in a short period, suggesting that the implementation of the standard and amendments would not be unduly burdensome.

Additionally, commenters raised a variety of policy choices for consideration by the Board, including the following:<sup>206</sup>

*Expanding Auditor Judgment:* In response to comments, the Board made some changes to allow for additional auditor judgment than originally provided for in the proposal. For example, in its proposal, any related party relationships or transactions not previously disclosed to the auditor would have been considered to be a significant risk and would have required the auditor to perform specific procedures in response. Some commenters stated that an undisclosed

related party transaction could be inconsequential in nature and, in such circumstances, treating the transaction as a significant risk and performing all of the procedures set forth in the proposed standard would be unnecessary. Other commenters suggested it might be appropriate to perform some, but not all, of the related procedures in the proposed standard. After consideration of comments, the Board removed the proposed requirement that the auditor always treat undisclosed related party transactions as a significant risk. Instead, the additional procedures would only be required in circumstances where previously undisclosed transactions were determined by the auditor to require disclosure in the financial statements or consideration as a significant risk. This change, which is being retained in the standard being adopted by the Board, could eliminate potentially unnecessary audit work.

*Clarifying the Auditor's Responsibilities to Identify a Company's Related Parties:* In response to comments, the Board made clarifications to the proposed standard to emphasize that the auditor's efforts to identify a company's related parties and relationships and transactions with its related parties begins with management's work. The clarified approach taken in the Board's reproposal recognizes that the company is responsible, in the first instance, for the preparation of its financial statements, including the identification of the company's related parties, and that the auditor begins the audit with information obtained from the company. This approach has been retained in the standard being adopted by the Board. Additionally, in response to other comments made regarding the repropose standard, several other clarifying changes have been made in this area. Those changes include emphasizing more prominently the auditor's responsibility to perform procedures to test the accuracy and completeness of the company's identification of its related parties, and that in doing so, the auditor takes into account the information gathered during the audit.

*Clarifying the Requirements Regarding a Company's Financial Relationships and Transactions With Its Executive Officers:* The Board made two key policy choices relating to the amendments pertaining to a company's financial relationships and transactions with its executive officers: (i) The relationship of the amendments to the risk assessment process; and (ii) the

<sup>206</sup> Additionally, see Appendix 4 of the repropose release for discussion more generally of the Board's response to significant comments received on the Board's February 28, 2012 proposal.

appropriate scope of the population for the auditor's required procedures.

As discussed previously, the Board determined to supplement its existing risk assessment requirements regarding a company's financial relationships and transactions with its executive officers. As proposed, the other amendments provided that the auditor should perform procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers. While some commenters were fully supportive of this requirement and recognized that it did not represent a radical departure from existing standards, other commenters expressed concern that this would require the auditor to make an assessment regarding the appropriateness or reasonableness of executive compensation arrangements. In its reproposal, the Board clarified that these procedures would be performed as part of the risk assessment process and explicitly stated that its amendment does not require the auditor to make any determination regarding the appropriateness or reasonableness of the company's compensation arrangements with its executive officers. Commenters who addressed this area of the Board's reproposal generally indicated that the revisions were appropriate. The amendments being adopted by the Board retain the approach taken in its reproposal.

Additionally, the Board also considered the appropriate population for the auditor's consideration of financial relationships and transactions. The Board determined that the auditor's consideration of a company's financial relationships and transactions need not extend to the company's entire senior management population, but that a focus on a potentially smaller group within that population—executive officers—was appropriate. This focus is appropriate because a company's executive officers generally are in a unique position to determine the company's accounting and financial statement disclosures.

In considering the appropriate population for the auditor's consideration, the Board took note of a range of diverse comments, including those from commenters who advocated that the auditor's procedures should include a broader group than the company's executive officers; others who stated that the auditor's focus on a company's executive officers was the most appropriate group; and another who argued for a narrower group, for example, a company's "named executive officers," ("NEOs"). Under SEC rules, NEOs generally consist of

five individuals—the principal executive officer, the principal financial officer, and the next three most highly paid executive officers of a company as of the end of the most recently completed fiscal year.<sup>207</sup> The Board considered the use of the NEO approach, but determined that it might focus the auditor's attention on highly paid individuals (with high compensation due to activity unrelated to financial reporting), rather than individuals with more direct involvement in the financial reporting process.

After considering these comments, the Board determined that a company's executive officers is the most appropriate population for the auditor's efforts.<sup>208</sup> In the Board's view, this targeted approach could serve to limit potentially unnecessary audit effort and related costs.

#### The Economic Impacts of the Standard and Amendments, Including Benefits and Costs

This section contains a discussion of the economic impacts considered as the standard and amendments were developed, including consideration of likely benefits and costs.

At present, there is limited data and research available regarding the economic impact of discrete changes to auditing standards.<sup>209</sup> As a result, many of the benefits and costs discussed below are difficult to quantify reliably. The resulting benefits to investors, markets, and others from more reliable financial reporting are complex and not capable of reliable quantification at this time. Likewise, limited, if any, public data exists to forecast the costs of performing additional audit procedures in the critical areas or the spillover effect on companies. Therefore, the economic discussion below is qualitative in nature.

The Board's consideration of the impacts of the standard and amendments, as with all aspects of the

Board's standard-setting process, takes into account commenters' views.<sup>210</sup> As part of the standard-setting process, the Board asked commenters to provide information, as well as empirical data, regarding both benefits and costs, and other effects related to the repropose standard and amendments. In response, commenters provided views regarding whether the standard and amendments would improve audit quality, as well as their views regarding potential audit costs and implementation issues. However, commenters did not provide empirical data.<sup>211</sup>

In general, commenters largely supported the Board's standard-setting efforts, and agreed that the existing standards should be improved in the critical areas. Commenters also generally agreed that the standard and amendments could benefit audit quality. Some commenters also noted the standard and amendments could result in improvements in the auditor's: (i) Identification of material misstatements; (ii) risk assessment for the audit; and (iii) application of professional skepticism. In addition, benefits noted also included improvements to audit committee communications and company financial statement disclosures.

Commenters who addressed potential costs provided qualitative information that was generally consistent with the discussion of potential costs in the repropose release. While commenters noted that there would be some increased costs, they did not provide data regarding the extent of such costs. However, commenters generally agreed that the standard and amendments were appropriate and should apply to audits of companies of all types and sizes.

Commenters also provided views on issues relating to scalability and costs. For example, one commenter stated that the repropose standard and amendments would not require significant incremental management or auditor resources, but the amount of resources required could be meaningfully greater for companies with a significant number of related party transactions or significant unusual transactions. In general, the Board would not expect there to be significant cost implications for audits of companies that do not have complex or extensive: (i) Relationships or transactions with related parties; (ii)

<sup>207</sup> See Item 402(a)(3) of Regulation S-K.

<sup>208</sup> In considering the appropriate population for the auditor's inquiry, the Board took note of a study that indicated that the median number of "executive officers" for the Standard and Poor's 500 is 8 (the mean is 8.71), and the median number of executive officers for the Russell 2000 is 5 (the mean is 6.12). See Broc Romanek, *Study: Benchmarking the Number of "Executive Officers,"* The Corporate Counsel.net and LogixData (March 2, 2011).

<sup>209</sup> The Board established a Center for Economic Analysis to, among other things, promote and encourage academic research relating to the role of the audit in capital formation and investor protection. See *PCAOB Announces Center for Economic Analysis*, (November 6, 2013) [http://pcaobus.org/News/Releases/Pages/11062013\\_CenterEconomicAnalysis.aspx](http://pcaobus.org/News/Releases/Pages/11062013_CenterEconomicAnalysis.aspx).

<sup>210</sup> The comment letters are available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket038Comments.aspx>.

<sup>211</sup> Additionally, Section C provides detail regarding the Board's consideration of significant comments received relating to the specific requirements of the standard and amendments.

significant unusual transactions; or (iii) financial relationships and transactions with the company's executive officers.

The following sections include a description of the Board's consideration of: Benefits; Costs; Smaller Audit Firms and Smaller Companies; and Other Economic Considerations.

#### Benefits

The Board believes that the standard and amendments will benefit investors by requiring auditors to focus appropriate auditing effort on areas that represent increased risks and, thus, warrant heightened scrutiny during the audit. As noted previously, to the extent that the standard and amendments improve the likelihood that the auditor will detect material misstatements in the financial statements, audit quality will be improved in ways that should also improve financial statement accounting and disclosures, which should in turn reduce the information asymmetry between investors and company management.

The standard and amendments take a targeted approach that is intended to focus the auditor's attention on accounting and disclosures relating to potentially complex and risky relationships and transactions that historically have been associated with cases involving fraudulent financial reporting. The magnitude and number of such cases, which have resulted in significant losses to investors, underscore the benefits to investors of strengthening the existing auditing requirements in these areas. Increased focus on the critical areas by auditors should increase the probability of auditors detecting potential fraudulent or erroneous financial reporting<sup>212</sup> and should also deter fraudulent financial reporting because management will be aware that auditors are likely to expend additional effort assessing the economic substance of transactions in the critical areas.

Existing auditing standards addressing the critical areas largely provide guidance and examples of procedures, rather than requiring specific procedures. This can result in inadequate and inconsistent application of existing standards, as well as the auditor's failure to perform sufficient procedures in the critical areas, which warrant heightened scrutiny. Rather than providing examples of procedures that may not be required in every audit, the standard and amendments require the auditor to perform specific

procedures. The new specific requirements in the standard and amendments are designed to assist the auditor in identifying red flags that warrant heightened scrutiny. The performance of basic required procedures should increase the probability of the auditor uncovering events that impact investors, such as fraud and material errors, and provide investors with increased confidence regarding the reliability of the audited financial statements.

Additionally, the standard and amendments take a holistic view of the audit by requiring the auditor to consider the links and relationships between a company's related party transactions and significant unusual transactions. For example, the auditor's work in identifying and evaluating significant unusual transactions should assist the auditor in identifying and evaluating related parties, or transactions with related parties previously undisclosed to the auditor. Emphasizing the complementary nature of the auditor's efforts regarding these areas should help the auditor to "connect the dots" between different aspects of the audit. The complementary approach is intended to enhance audit efficiency as well as audit effectiveness in that it may increase the probability of the auditor's uncovering potential material fraud or error in a company's financial statements.

Likewise, the standard and amendments are aligned with the Board's risk assessment standards and, thus, should enhance the auditor's overall risk assessment more generally by making the auditor more effective in identifying and assessing risks of material misstatement in the critical areas, and in designing and performing better audit procedures to address such risks. Additionally, the standard and amendments feature a scaled approach that requires the auditor to supplement the basic required procedures with more in-depth procedures in response to risks identified. Alignment with the risk assessment standards and the use of a scaled approach promotes a cohesive audit approach that should contribute to improved audit quality and provide opportunities for efficient implementation.

The auditor's heightened attention to transactions in the critical areas also could result in the auditor obtaining more information about the company's financial position. For example, the standards and amendments emphasize the auditor's understanding of the business purpose (or the lack thereof) of transactions in the critical areas. A better understanding of the business

purpose should better position the auditor to understand and address such transactions, which often pose difficult measurement and recognition issues, due to factors such as transaction structure, complexity, and/or relationship to company financial targets. Such an approach should promote audit quality by providing the auditor with more insight into the nature of transactions in the critical areas, which could allow the auditor to better evaluate whether the financial statements are fairly stated.

The auditor's increased attention to the critical areas also may result in increased attention by companies to their accounting and disclosures, which could result in higher quality financial reporting. Higher quality financial reporting improves the quality of information available to the market and reduces information asymmetry between investors and company management. Improving the quality of financial reporting can reduce investors' uncertainty about the information being provided in company financial statements, foster increased public confidence in the financial markets, and enhance capital formation and the efficiency of capital allocation decisions. Research shows that decreasing the level of information asymmetry reduces the cost of capital for issuers.<sup>213</sup> In addition, if management produces more accurate disclosures, research shows that this increased quality of disclosures to financial statement users also reduces the cost of capital.<sup>214</sup>

Further, new audit committee communication requirements would promote communications regarding, and improve the auditor's understanding of, the critical areas. For example, the auditor's understanding of related party transactions would be informed by an initial audit committee communication during the risk assessment that is intended to help the auditor identify the company's significant related party transactions, as well as to inform the auditor of any concerns audit committee members may have regarding the company's relationships or transactions with its related parties. Later in the audit, the auditor is required to discuss with the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of, the company's related

<sup>213</sup> See David Easley and Maureen O'Hara, 2004. Information and the Cost of Capital. *The Journal of Finance* 59 (4): 1553-1583.

<sup>214</sup> See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, 2012. Information Asymmetry, Information Precision, and the Cost of Capital. *Review of Finance* 16 (1): 1-29.

<sup>212</sup> See Mark Zimbelman, *The Effects of SAS No. 82 on Auditors Planning Decisions*, 35 *Journal of Accounting Research*, 75 passim (1997).

party transactions, including any that were previously undisclosed to the auditor. In addition, improving the auditor's understanding of: (i) The business purpose (or the lack thereof) of a company's significant unusual transactions and (ii) a company's financial relationships and transactions with its executive officers, can enhance already existing required audit committee communications related to significant unusual transactions and significant risks.

These improved communication requirements should result in both auditors and audit committees becoming better informed and thus better equipped to fulfill their respective roles in the company's financial reporting. Through these communications, the auditor becomes better informed about the company, enabling the auditor to be more effective in identifying and addressing risks of material misstatement in the company's financial statements. A better informed audit committee can contribute to management oversight, which may lead management to improve the company's financial reporting. As noted above, research has indicated that improving the quality of financial reporting reduces investors' uncertainty about the information being provided in companies' financial reports and, thus, increases efficiency in capital allocation and fosters capital formation. For example, increased level and/or quality of financial reporting has been found to decrease the cost of equity, decrease the cost of debt, and decrease bid-ask spreads.<sup>215</sup>

Commenters largely agreed with the Board that the standard and amendments could improve audit quality. In addition, specific benefits suggested by commenters included: (i) Higher quality financial statement disclosures; (ii) improving investors' confidence in audited financial statements; (iii) improving the audit's effectiveness and informational value; (iv) more relevant consideration of issues facing the company; (v) increasing audit committee knowledge; and (vi) improving the audit committees' abilities to fulfill their duties. Additionally, another commenter stated that management may be more attentive to written procedures

<sup>215</sup> See Christine A. Botosan, and Marlene A. Plumlee. 2002. *A Re-examination of Disclosure Level and the Expected Cost of Equity Capital*, 40 *Journal of Accounting Research* 21–40, (2002), Partha Sengupta, *Corporate Disclosure Quality and the Cost of Debt*, 73 *The Accounting Review* 459–474, (1998), and Michael Welker, *Disclosure Policy, Information Asymmetry, and Liquidity in Equity Markets*, 11 *Contemporary Accounting Research* 801–827 (1995), respectively.

and responsibilities for related party transactions as a result of the repropose standard. Specific comments in each area include:

- *Relationships and Transactions With Related Parties:* Many commenters stated that the repropose standard would improve the auditor's overall understanding of a company's relationships and transactions with its related parties. Some commenters suggested that obtaining such an understanding would: (i) Assist the auditor in obtaining sufficient appropriate audit evidence and increase the likelihood of identifying material misstatements; and (ii) enhance the exercise of professional skepticism in the performance of the audit.

- *Significant Unusual Transactions:* A few commenters suggested that requiring procedures to improve the auditor's identification and evaluation of a company's significant unusual transactions could improve audit quality by: (i) Increasing the likelihood of identifying material misstatements; (ii) promoting the exercise of professional skepticism; (iii) improving financial statement disclosures; and (iv) improving audit committees' abilities to fulfill their duties.

- *Financial Relationships and Transactions with Executive Officers:* Commenters providing views on audit quality issues indicated that obtaining an understanding of a company's financial relationships and transactions with its executive officers could improve audit quality by: (i) Improving the auditor's identification of risks of material misstatement; (ii) resulting in more relevant audit testing; and (iii) improving the auditor's assessment of fraud risk.

With respect to the baseline, the Board notes that, as described previously, some firms may perform procedures that go beyond existing requirements. Consequently, the application of the standard and amendments should generate greater benefits to audits of companies whose auditors are not currently performing a comprehensive risk-based audit or are performing only the most cursory of procedures under AU sec. 334. Benefits also include promoting consistency in audit practices among audit firms by establishing auditor performance requirements.

#### Costs

In general, the Board recognizes that imposing new requirements will involve some additional audit effort and related costs, both to audit firms and companies.

The Board anticipates costs include direct compliance costs to auditors that will reflect changes necessary to address the introduction of new requirements. The Board anticipates initial and ongoing costs for audit firms will include costs for updating and maintaining methodologies and audit programs, implementation, and staff training. Additionally, depending on the degree of effort currently expended by audit firms, there may be increased costs in terms of incremental audit effort, including increased audit partner time, and potential costs for the time of specialists to review complex transactions.

The increased audit effort and resulting costs may be limited as the standard and amendments are based on the Board's existing risk assessment standards and retain many existing auditing concepts and procedures that are common in practice today. For example, AU sec. 334 suggests procedures for the auditor's consideration, certain of which have been incorporated into the standard as specific required procedures. To the extent that audit firms have already incorporated these procedures into their current practices, those firms should incur lower costs in updating their methodologies. As a result, costs should be greater where auditors are not currently performing a comprehensive risk-based audit or are performing only the most cursory of procedures under AU sec. 334. In general, audit firms that audit companies of all sizes were supportive of the Board's efforts to improve audit quality in the critical areas and did not raise concerns regarding costs or provide data regarding the extent of such costs for the Board's consideration.

To the extent that there are increased costs for auditors as a result of the application of the standard and amendments, such costs may be passed on, in whole, or part (or not at all), to companies and their investors in the form of higher audit fees.<sup>216</sup> The Board

<sup>216</sup> It is not clear to what extent the increased auditor performance requirements would result in increased audit fees. The Board is aware of public reports that have analyzed historical and aggregate data on audit fees, and which suggest that audit fees generally have remained stable in recent years, notwithstanding the fact that the Board and other auditing standard-setters have issued new standards during that period. See, e.g., *Audit Analytics Audit Fees and Non-Audit Fees: An Eleven Year Trend* (July 2013). Because amendments to, and adoption of, new Board standards typically involve discrete parts of an audit, which is not accounted for, or priced, on a standard-by-standard basis, it is difficult to obtain data that isolates the costs of particular new audit standards, and that would be comparable between firms. In its reproposal, the



is aware, however, that there may be increased costs for companies whose auditors must change their methodologies and practices to address the new requirements. These potential costs to companies include increased audit fees and costs for the additional time and expense of responding to auditor inquiries.

Additionally, other costs could include costs associated with enhanced audit committee communications, to the extent the areas addressed by the standard and amendments are not already discussed. Company audit committees may require additional time and expense to participate in new audit committee communication relating to related party transactions and also may require expanded discussions relating to significant unusual transactions. While companies may need additional time or resources to conduct the new audit committee communications, the standard and amendments build on, and work in concert with, the approach taken in Auditing Standard No. 16. Thus, the new requirements in this area provide additional substance for an integrated meeting with the audit committee. This should not add significantly to the time or resources companies spend with respect to audit committee communications.

The Board also considered potential unintended consequences in conjunction with its consideration of costs. For example, the Board considered whether, to the extent that potential costs stemming from the standard and amendments increase audit costs related to transactions with related parties, this could serve as a deterrent against their use. In such cases, any cost advantage a company may have from engaging in related party transactions during its normal course of operations could be reduced by higher audit-related costs.

Two commenters provided their views that the repropoed standard and amendments could serve as a deterrent against the use of related party transactions. One commenter suggested that requiring auditors to obtain evidence supporting management's arm's-length assertion regarding a related party transaction had corresponding negative economic consequences, such as, management avoiding the use of related party transactions. Another commenter stated that the increased audit effort will result in a pass through of marginally

higher audit costs to companies also noted that there could be changed behavior in structuring transactions so that they are not related party transactions.

The Board considered these comments and acknowledges that, as noted in the reproposal, potential costs stemming from the standard and amendments could increase audit costs related to transactions with related parties, which could conceivably serve as a deterrent against their use. While the Board recognizes this potential, the Board notes that companies are already required to disclose material related party transactions in their financial statements, and auditors already should be performing some procedures, under the existing standards, with respect to these transactions and related disclosures. Additionally, in considering these comments, the Board notes that the requirement in the standard for auditors to obtain evidence supporting management's arm's-length assertion regarding a related party transaction is consistent with the requirement in AU sec. 334.12, as applicable financial reporting frameworks only permit an arm's-length assertion regarding a related party transaction to be included in the financial statements when supported by evidence.

In general, the Board's assessment of the impact of the adoption of the standard and amendments relative to costs was informed by the fact that commenters did not raise issues regarding costs that were inconsistent with those described by the Board in its reproposal. Additionally, while some commenters noted that there would be some increased costs to audit firms and companies, they did not provide data regarding the extent of such costs. A number of commenters suggested that the costs of the standard and amendments were appropriate. For example, one commenter stated that the benefits of the repropoed standard and amendments would outweigh the associated costs. Another commenter stated that the repropoed standard and amendments benefit users without placing too high a burden on preparers or auditors. However, a few commenters indicated that the costs associated with the standard and amendments may be difficult to measure prior to implementation.

One commenter stated that the repropoed standard and amendments would not require significant incremental management or auditor resources, but resources required could be meaningfully greater for companies with a significant number of related

party transactions or significant unusual transactions. Several other commenters also indicated that smaller audit firms might be disproportionately impacted by the Board's reproposal. However, commenters in general noted that the standard and amendments were appropriate for, and should apply to, audits of companies of all types and sizes, including broker-dealers and EGCs. As noted above, the Board received comments from a wide spectrum of commenters, including firms that audit companies of various sizes. Further discussion of the potential impact on smaller audit firms and smaller companies is discussed below.

#### Smaller Audit Firms and Smaller Companies

The Board recognizes that the adoption of the standard and amendments may impose disproportionately greater costs on smaller audit firms than on larger audit firms. For example, the one-time costs to update audit methodologies and training may represent a relatively larger share of audit costs for smaller audit firms compared to larger audit firms. Further, to the extent that a smaller audit firm has not already incorporated procedures suggested by AU sec. 334 into its current practices, such a firm would likely incur higher incremental costs to comply with the standard and amendments.

As described above, the costs incurred by the auditor to comply with the standard and amendments may be passed on, in whole, or in part (or not at all), to companies and their investors in the form of increased audit fees. To the extent this occurs, it may particularly affect smaller companies that rely on related party transactions as part of their business model. This point also was asserted by some commenters on the proposal and reproposal, many of whom also noted the particular risks posed by related party transactions engaged in by smaller companies. Increasing the costs of audits for smaller companies could negatively impact their profitability.

In considering this potential impact, the Board also has taken note of its oversight findings, which indicate that the audits of smaller companies are more frequently the subject of inspection findings and enforcement actions that involve related party transactions. Additionally, the Board notes that there is likely less information available regarding smaller companies (e.g., they have fewer brokerage research analysts, and less press coverage). Thus, while there is the potential for greater cost impact on

Board sought data that might provide information or insight into such costs. As noted above, commenters did not provide data regarding the extent of such costs.

smaller companies arising from the standard and amendments, there is also the potential that investors in such companies would accrue relatively larger benefits from the standard and amendments, such as a lower cost of capital.

As noted above, the Board believes that any additional audit costs would likely vary based on the size and complexity of the company's transactions in the critical areas, and would be commensurate with the risk of material misstatement arising out of such transactions. As noted in the reproposing release, a company that has extensive relationships and transactions with related parties or significant unusual transactions, or that has financial relationships and transactions with executive officers that give rise to risks of material misstatement, could anticipate a greater increase in audit-related costs than a company without such relationships or transactions.<sup>217</sup> Thus, the Board would not expect there to be a significant increase in audit fees for a company that does not have complex or extensive: (i) Relationships or transactions with related parties; (ii) significant unusual transactions; or (iii) financial relationships and transactions with the company's executive officers. In addition, to the extent that some auditors are already performing procedures similar to those in the standard and amendments, there would be a lesser impact. However, if the auditor identifies related parties or relationships or transactions with related parties that were previously undisclosed to the auditor, there would be incremental costs, as well as benefits, associated with the auditor's response to the increased risks of material misstatement.

#### Other Economic Considerations

As noted above, commenters generally supported the Board's efforts to promote audit quality in the areas addressed by the standard and amendments. However, a few expressed concerns. For example, one commenter acknowledged that the Board had repropounded the standard and amendments to obtain more information regarding economic considerations generally, but the commenter was nonetheless critical of the Board's economic analysis in its reproposal. This commenter stated that the Board had failed to provide adequate specifics in its reproposal supporting the need for the standard and stated that the reproposal did not adequately address potential alternatives to the proposed

requirements, including any rationale for not choosing to converge with the IAASB and ASB standards, which, in that commenter's view, introduced unnecessary complexity and cost. This same commenter also asked why the Board thought it necessary to adopt new requirements after the issuance of Staff Audit Practice Alert No. 5.

The Board considered the issues raised by this commenter and believes that the need for the standard and amendments, and the alternatives considered by the Board, have been fully described in the Board's proposals and throughout this release. The standards and amendments being adopted represent a targeted approach that appropriately responds to areas of the audit that have historically represented risks of material misstatement in company financial statements. In the Board's view, the need to improve the Board's existing standards addressing the critical areas, including alignment with the Board's risk assessment standards, cannot be adequately addressed through staff interpretations of existing standards. More specific requirements are warranted to promote heightened scrutiny in the critical areas. While the new auditor performance requirements will involve some additional effort and related costs in some cases, to avoid unnecessary audit efforts and costs, the Board developed the standard to align with existing audit procedures that the auditor already is required to perform as part of the auditor's risk assessment and requires the auditor to perform procedures that are commensurate with the risks of material misstatement.

The Board also considered the comment that the Board did not set forth a rationale for not choosing to converge the proposed auditing requirements with the standards of the IAASB and the ASB. As a matter of practice, the Board regularly considers the work of other standard-setters, such as the IAASB and the ASB, for insights as it develops its standards. In developing the standard and amendments, the Board considered the analogous standards of the IAASB and the ASB and incorporated a number of similar audit procedures and requirements that the Board believed were useful and appropriate.<sup>218</sup>

<sup>218</sup> For example, paragraph 5 of the standard being adopted by the Board contains similar requirements to paragraph 13 of ISA 550 (and paragraph 14 of AU-C 550), which require the auditor to inquire of management regarding: The identity of the entity's related parties, including changes from the prior period; the nature of the relationships between the entity and these related parties; and whether the entity entered into any

The Board, however, has determined that the critical areas require heightened scrutiny and, thus, the standard and amendments contain auditing requirements that are not reflected in the analogous standards of the IAASB and the ASB. For example, the standard and amendments contain requirements for the auditor to focus heightened audit attention on the business purpose (or the lack thereof) of a company's related party transactions.<sup>219</sup> Also, in view of the importance of the audit committee's role in the oversight of the company's financial reporting, the standard requires the auditor to make inquiries of the audit committee (or its chair) regarding the audit committee's understanding of the company's related parties and transactions, as well as regarding whether any member of the audit committee has concerns regarding such matters. Additionally, the other amendments require the auditor to perform risk assessment procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers.

Two commenters raised concerns regarding economic considerations of a more general nature, suggesting that the Board develop a specific framework for considering costs and benefits more generally. The Board has addressed these matters separately.<sup>220</sup>

Finally, in its reproposal, the Board specifically asked for comment regarding any considerations relating to efficiency, competition and capital formation that the Board should take into account with respect to the repropounded standard and amendments. Other than the general comments described above, the Board did not receive comments noting specific concerns regarding efficiency, competition and capital formation in response to its request.

In summary, after considering these factors and public comments, the Board believes that its new requirements reflect a reasoned approach that considers and is intended to limit unnecessary audit effort and related costs.

transactions with these related parties during the period and, if so, the type and purpose of the transactions.

<sup>219</sup> See, e.g., paragraphs 5.d., 12.a., and 19.e. of the standard.

<sup>220</sup> See, e.g., *PCAOB Strategic Plan: Improving the Quality of the Audit for the Protection and Benefit of Investors 2013–2017* (November 26, 2103) at 5 and 13, and *PCAOB Releases Staff Guidance on Economic Analysis in PCAOB Standard Setting* (May 15, 2014) [http://pcaobus.org/News/Releases/Pages/05152014\\_Economic\\_Analysis.aspx](http://pcaobus.org/News/Releases/Pages/05152014_Economic_Analysis.aspx).

<sup>217</sup> See page A4–97 of the repropounding release.

### Economic Considerations Pertaining to Audits of EGCs, Including Efficiency, Competition, and Capital Formation

The PCAOB has been monitoring implementation of the JOBS Act in order to understand the characteristics of EGCs<sup>221</sup> and inform the Board's considerations regarding whether it should recommend that the SEC apply the standard and amendments to audits of EGCs. To assist the SEC, the Board is providing the following information regarding EGCs that it has compiled from public sources.<sup>222</sup>

#### Characteristics of Self-Identified EGCs

As of November 20, 2013, based on the PCAOB's research, 1,227 SEC registrants had identified themselves as EGCs in SEC filings. These companies operate in diverse industries. The five most common Standard Industrial Classification ("SIC") codes applicable to these companies are codes for: (i) Blank check companies; (ii) pharmaceutical preparations; (iii) real estate investment trusts; (iv) prepackaged software services; and (v) computer processing/data preparations services.

The five SIC codes with the highest total assets as a percentage of the total assets of the population of EGCs are codes for: (i) Federally chartered savings institutions; (ii) real estate investment trusts; (iii) national commercial banks; (iv) state commercial banks; and (v) crude petroleum or natural gas. Total

<sup>221</sup> Pursuant to the JOBS Act, an EGC is defined in Section 3(a)(80) of the Exchange Act. In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than \$1 billion during its most recently completed fiscal year (and its first sale of common equity securities pursuant to an effective Securities Act of 1933 (the "Securities Act") registration statement did not occur on or before December 8, 2011). See JOBS Act Section 101(a), (b), and (d). Once an issuer is an EGC, the entity retains its EGC status until the earliest of: (i) The first year after it has total annual gross revenue of \$1 billion or more (as indexed for inflation every five years by the SEC); (ii) the end of the fiscal year after the fifth anniversary of its first sale of common equity securities under an effective Securities Act registration statement; (iii) the date on which the company issues more than \$1 billion in non-convertible debt during the prior three year period; or (iv) the date on which it is deemed to be a "large accelerated filer" under the Exchange Act (generally, an entity that has been public for at least one year and has an equity float of at least \$700 million).

<sup>222</sup> To obtain data regarding EGCs, the PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and November 20, 2013, for disclosures by entities related to their EGC status. Only those entities that have voluntarily disclosed their EGC status have been identified. The PCAOB has not validated these entities' self-identification as EGCs. The information presented also does not include data for entities that have filed confidential registration statements and have not subsequently made a public filing.

assets of EGCs in these five SIC codes represent approximately 35% of the total assets of the population of EGCs. EGCs in three of these five SIC codes (federally chartered savings institutions, national commercial banks, and state commercial banks) represent financial institutions and the total assets for these three SIC codes represent approximately 22% of the total assets of the population of EGCs.

Approximately 19% of the EGCs identified themselves in registration statements and were not previously reporting under the Exchange Act as of November 20, 2013. Approximately 64% of the companies that have identified themselves as EGCs began reporting under the Exchange Act in 2012 or later. The remaining 17% of these companies have been reporting under the Exchange Act since 2011 or earlier. Accordingly, a majority of the companies that have identified themselves as EGCs began reporting information under the securities laws since 2012.

Approximately 63% of the companies that have identified themselves as EGCs and filed an Exchange Act filing with information on smaller reporting company status indicated that they were smaller reporting companies.<sup>223</sup>

Approximately 32% of the companies that have identified themselves as EGCs provided a management report on internal control over financial reporting. Of those companies that provided a report, approximately 46% stated in the report that the company's internal control over financial reporting was not effective.<sup>224</sup>

<sup>223</sup> The SEC adopted its current smaller reporting company rules in *Smaller Reporting Company Regulatory Relief and Simplification*, Securities Act Release No. 33-8876 (December 19, 2007). Generally, companies qualify to be smaller reporting companies ("SRCs") and, therefore, have scaled disclosure requirements if they have less than \$75 million in public equity float. Companies without a calculable public equity float will qualify if their revenues were below \$50 million in the previous year. Scaled disclosure requirements generally reduce the compliance burden of SRCs compared to other issuers. Notably, the only area in which SRC requirements may be more extensive than requirements for other issuers is with respect to the disclosure of related party transactions. The SEC justified this difference in treatment based on the importance of disclosing related party transactions, particularly for issuers with lower materiality thresholds.

<sup>224</sup> For purposes of comparison, the PCAOB compared the data compiled with respect to the population of companies that identified themselves as EGCs with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The Russell 3000 was chosen for comparative purposes because it is intended to measure the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market (as marketed on the Russell Web site). To contrast, approximately 95% of the companies in the Russell

Audited financial statements were available for nearly all of the companies that identified themselves as EGCs.<sup>225</sup> For those companies for which audited financial statements were available and based on information included in the most recent audited financial statements filed as of November 20, 2013:

- The reported assets ranged from zero to approximately \$18.2 billion. The average and median reported assets were approximately \$184.4 million and \$0.4 million, respectively.<sup>226</sup>

- The reported revenue ranged from zero to approximately \$962.9 million. The average and median reported revenue were approximately \$59.6 million and \$3 thousand, respectively.

- The average and median reported assets among companies that reported revenue greater than zero were approximately \$359.5 million and \$68.1 million, respectively. The average and median reported revenue among these companies that reported revenue greater than zero were approximately \$116.2 million and \$20.7 million, respectively.

- Approximately 49% identified themselves as "development stage entities" in their financial statements.<sup>227</sup>

- Approximately 54% had an explanatory paragraph included in the auditor's report describing that there is substantial doubt about the company's ability to continue as a going concern.<sup>228</sup>

3000 Index provided a management report on internal control over financial reporting. Of those companies that provided a management report, approximately 4% stated in the report that the company's internal control over financial reporting was not effective.

<sup>225</sup> Audited financial statements were available for 1,216 of the 1,227 self-identified EGCs. Audited financial statements were not available for some EGCs that had filed registration statements that had not been declared effective by the SEC.

<sup>226</sup> As noted above, for purposes of comparison, the PCAOB compared the data compiled with respect to the population of companies that identified themselves as EGCs with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The average and median reported assets of issuers in the Russell 3000 were approximately \$12.2 billion and approximately \$1.6 billion, respectively. The average and median reported revenue from the most recent audited financial statements filed as of November 20, 2013 of issuers in the Russell 3000 were approximately \$4.6 billion and \$725.8 million, respectively.

<sup>227</sup> According to the Financial Accounting Standards Board ("FASB") standards, development stage entities are entities devoting substantially all of their efforts to establishing a new business and for which either of the following conditions exists: (i) Planned principal operations have not commenced or (ii) planned principal operations have commenced, but there has been no significant revenue from operations. See FASB Accounting Standards Codification Subtopic 915-10, *Development Stage Entities—Overall*.

<sup>228</sup> Approximately 1% of the population of companies in the Russell 3000 Index have an explanatory paragraph describing that there is

- Approximately 38% were audited by firms that are annually inspected by the PCAOB (that is, firms that have issued auditor's reports for more than 100 public company audit clients in a given year) or are affiliates of annually inspected firms. Approximately 62% were audited by triennially inspected firms (that is, firms that have issued auditor's reports for 100 or fewer public company audit clients in a given year) that are not affiliates of annually inspected firms.

The PCAOB's Office of Research and Analysis has reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and November 20, 2013, for related party disclosures by EGCs. An analysis of 1,103 of the most recent audited financial statements filed through November 20, 2013 of the 1,227 self-identified EGCs indicates that approximately 68% of these companies disclosed at least one related party relationship or transaction.<sup>229</sup>

#### Economic Considerations Pertaining to Audits of EGCs, Including Comments Received

The Board's analysis of the potential economic impacts on EGCs is based on the EGC data described above, which has been collected and analyzed by the Board's staff. The Board's analysis is also informed by the Board's oversight activities, as well as by the other considerations described herein and the release more generally. Additionally, the Board's analysis has been informed by information provided by commenters. The Board's discussion of potential economic impacts on EGCs follows.

Based on the data outlined above, a majority of EGCs are smaller public companies. EGCs also appear to be companies that are relatively new to the SEC reporting process. This indicates that there is less information available to investors regarding such companies relative to the broader population of public companies. It is generally acknowledged that investors are less informed about companies that are smaller and newer, suggesting there is a higher degree of information asymmetry for smaller and newer companies.

Self-identified EGCs disclosed related party relationships or transactions at a significantly higher rate as compared to companies in the Russell 3000 Index.

substantial doubt about the company's ability to continue as a going concern.

<sup>229</sup> A similar analysis of SEC filings for the population of companies in the Russell 3000 Index found that approximately 45% of those companies have disclosed at least one related party relationship or transaction.

The data also suggests that EGCs are more likely than the population of companies in the Russell 3000 Index to have a management report on internal control over financial reporting stating that the company's internal control over financial reporting was not effective. The higher propensity of EGCs to engage in related party transactions coupled with an increased likelihood for control deficiencies suggests that applying the standard in audits of EGCs is particularly relevant.

Given the characteristics of EGCs as newer and smaller companies, some might assume that EGCs would have operations that are less complex. However, this may not be true for many EGCs. Audits of EGCs appear to reflect a wide range of complexity and risk. For example, 580 of the 1,227 companies that have identified themselves as EGCs did not recognize revenue in the most recently filed financial statements. Financial institutions represent at least 22% of the total assets of EGCs. Given the nature of the operations of financial institutions, these EGCs could engage in transactions that involve complex accounting and financial statement disclosure issues.

Further, the data presented above indicates that for 54% of the EGCs the auditor's report on the most recent audited financial statements includes an explanatory paragraph describing that there is substantial doubt about the company's ability to continue as a going concern, as compared to 1% for the population of companies in the Russell 3000 Index.

Thus, applying the standard and amendments to the audits of EGCs may be particularly pertinent because of the characteristics of EGCs described above (e.g., potential for higher rates of material weaknesses in internal control, use of related party transactions, and substantial doubt about the company's ability to continue as a going concern).

In the reproposal, the Board specifically sought comment on the application of the repropose standard and amendments to audits of EGCs. Commenters generally considered the requirements of the standard to be applicable and appropriate to companies of varying sizes and industries. All those who commented on the applicability of the standard and amendments to EGCs stated that the repropose standard and amendments should be applicable to audits of EGCs. Those commenters provided various reasons, including that the risks regarding related parties, significant unusual transactions and financial relationships and transactions with executive officers are the same, if not

greater at EGCs and that EGCs may enter into such matters more frequently than non-EGCs.

No commenters stated that the repropose standard and amendments should not apply to audits of EGCs. One commenter, however, was concerned that the repropose did not contain a substantive analysis of the economic impacts of the proposed requirements on EGCs. This commenter acknowledged, however, that after the enactment of the JOBS Act, the Board repropose the standard and amendments to seek comment and obtain additional information regarding the economic impacts on EGCs.

Some commenters stated that the repropose standard is scalable for application to audits of EGCs. One commenter stated that firm implementation costs should not differ when implementing the repropose standard for audits of EGCs or other issuers; however, increased recurring costs may fall relatively disproportionately on EGCs. One commenter stated that the implementation and training costs that a firm would incur would not depend upon whether the repropose standard is applicable to EGCs and there should be little or no additional costs to apply the repropose standard to EGCs. Another commenter noted that although smaller companies (some of which may be EGCs) may engage in more related party transactions compared to other companies, which will result in higher audit costs, the costs are commensurate with the risks of material misstatement.

Some commenters noted that regardless of the applicability to audits of EGCs, firms would perform the same procedures for all audits. One commenter suggested that it would be more costly not to apply the repropose standard and amendments to audits of EGCs as this would, in the commenter's view, require firms to maintain two methodologies. One commenter stated that it would perform the same procedures for audits of EGCs, regardless of the applicability of the repropose standard and amendments to audits of EGCs, as the cost to develop and maintain two separate methodologies and the related training would be cost-prohibitive. One commenter, representing a committee, stated that the standard should be applicable to audits of EGCs. However, that commenter also noted that its committee members had a mixed response; some believed the standard ought to be universally applicable, as a "carve-out" for EGCs would be more costly, but a minority believed that a carve out would be easy to implement.

One commenter suggested that applying different rules to financial statement audits performed in accordance with PCAOB standards could be confusing to investors and other stakeholders.

The standard and amendments are designed to improve the auditor's efforts regarding a company's relationships and transactions with its related parties, significant unusual transactions and financial relationships and transactions with its executive officers. As previously discussed, a significant number of the Board's oversight findings from its inspections and enforcement programs regarding related party transactions involve smaller public companies, which have characteristics that are similar to EGCs.

Thus, enhanced auditor consideration of the areas addressed in the standard and amendments may be particularly important to investors in EGCs given that: (i) Information asymmetry may be more pronounced at EGCs; (ii) there is the potential for greater reliance by EGCs on related party transactions; and (iii) there is a significant number of findings regarding related party transactions in audits of financial statements of smaller companies identified through PCAOB oversight activities.

Improving the auditor's efforts in the areas addressed in the standard and amendments should promote audit quality in ways that also should improve financial statement accounting and disclosure, which in turn should improve financial reporting, reduce information asymmetry, and reduce the company's cost of capital. These benefits should accrue to all types of companies, including EGCs.

EGCs will incur some incremental costs in connection with auditor compliance with the standard and amendments. As noted earlier, these costs may be disproportionately higher for smaller companies, including EGCs, relative to the broader population of public companies. The additional audit-related costs, as discussed above, could conceivably serve as a deterrent against the use of related party transactions by EGCs. Likewise, additional audit-related costs may deter certain EGCs from entering public markets, if those costs weigh heavily on their potential profitability. To the extent that EGCs tend to be smaller and newer companies, the enhanced audit performance requirements may place a disproportionately higher burden on them, which may impact their profitability and competitiveness. As noted above, however, no commenter stated that the repropose standard and amendments should not apply to audits

of EGCs and no commenter discussed the impact on competitiveness of EGCs.

The standard and amendments are designed to mitigate cost impacts by aligning the auditor's efforts with the risk assessment standards and providing opportunities for a scaled approach. This allows auditors to integrate the audit to avoid unnecessary audit effort.

Additionally, in its reproposal, the Board specifically asked for comment regarding any considerations regarding efficiency, competition and capital formation that the Board should take into account when determining whether to recommend to the SEC the application of the repropose standard and amendments to audits of EGCs. No commenter expressed concerns regarding efficiency, competition and capital formation with respect to the application of the repropose standard and amendments to audits of EGCs.

#### Recommendation

The Board believes that the standard and amendments will advance investor protection and promote audit quality. In addition, more effective audits and more informed communications between the auditor and the audit committee should enhance the quality of a company's financial reporting.

Additionally, the Board believes that its new requirements reflect a reasoned approach to considering and limiting unnecessary audit effort and related costs. Many commenters agreed that the repropose standard and amendments would lead to improvements in audit quality, with many commenters stating that the requirements of the repropose standard and amendments should be applicable to, and were appropriate for, companies of different sizes and industries.

The JOBS Act was enacted after the Board issued its proposing release. Subsequently, the Board issued a reproposal, in part to request comment specifically on matters relating to the application of the standard and amendments to audits of EGCs. A variety of commenters noted particular risks posed by related party transactions pertinent to small companies, including EGCs. In addition, all those commenters who commented with respect to the applicability of the standard and amendments to EGCs stated that the standard and amendments should be applicable to audits of EGCs.

Based on data available to the Board regarding EGCs, it appears that a wide range of entities, of differing sizes and industries, identify themselves as EGCs. One key difference between EGCs and the broader population of public companies would appear to be the

length of time that EGCs have been subject to Exchange Act reporting requirements. Based on the information available to the Board, while there may be additional costs and potential competitive impacts on EGCs, there also may be additional benefits from enhanced scrutiny in the areas addressed by the standard and amendments. Given these considerations, there does not appear to be a compelling reason to treat audits of EGCs differently from the audits of other companies.

For the reasons explained above, the Board believes that the standard and amendments are in the public interest and, after considering the protection of investors and the promotion of efficiency, competition, and capital formation, recommends that the standard and amendments should apply to audits of EGCs. Accordingly, the Board recommends that the Commission determine that it is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation, to apply the standard and amendments to audits of EGCs. The Board stands ready to assist the Commission in considering any comments the Commission receives on these matters during the Commission's public comment process.

### III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Pursuant to Section 19(b)(2)(A)(ii) of the Exchange Act, and based on its determination that an extension of the period set forth in Section 19(b)(2)(A)(i) of the Exchange Act is appropriate in light of the PCAOB's request that the Commission, pursuant to Section 103(a)(3)(C) of the Sarbanes-Oxley Act, determine that the proposed rules apply to audits of emerging growth companies, as defined in Section 3(a)(80) of the Exchange Act, the Commission has determined to extend to October 22, 2014 the date by which the Commission should take action on the proposed rules.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rules are consistent with the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

*Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/pcaob.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number PCAOB-2014-01 on the subject line.

*Paper Comments*

- Send paper comments in triplicate to Kevin M. O'Neill, Deputy Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549-1090.

All submissions should refer to File Number PCAOB-2014-01. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use

only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/pcaob.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rules that are filed with the Commission, and all written communications relating to the proposed rules between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549-1090, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing will also

be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without charge; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number PCAOB-2014-01 and should be submitted on or before August 14, 2014.

For the Commission, by the Office of the Chief Accountant, by delegated authority.<sup>230</sup>

**Kevin M. O'Neill,**

*Deputy Secretary.*

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<sup>230</sup> 17 CFR 200.30-11(b)(2).