

PCAOB Issues Proposed Auditing Standard Regarding Related Parties

The Public Company Accounting Oversight Board (“PCAOB”) recently issued for public comment a proposed auditing standard, *Related Parties* (“the Proposed Standard”), which aims to improve the auditor’s evaluation of a public company’s identification of, accounting for and disclosure about its relationships and transactions with related parties.¹ The Proposed Standard would supersede interim standard AU sec. 334, *Related Parties* (the “Interim Standard”).

The PCAOB also issued proposed amendments (the “Proposed Amendments”) to other PCAOB auditing standards, including AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (“AU sec. 316”), and AS No. 12, *Identifying and Assessing Risks of Material Misstatement*, that would complement the Proposed Standard. The Proposed Amendments seek to enable auditors to more effectively identify risks of material misstatement by enhancing (i) the auditor’s identification and evaluation of a company’s accounting and disclosure of its significant unusual transactions (*i.e.*, significant transactions that are outside the normal course of business or that otherwise appear to be unusual due to their timing, size or nature) and (ii) the auditor’s understanding of a company’s financial relationships and transactions with its executive officers.

The PCAOB developed the Proposed Standard and the Proposed Amendments with the goal of improving existing audit standards and better protecting investors by more effectively addressing the role that related party transactions and significant unusual transactions can play in asset misappropriation and financial reporting errors, misstatements and fraud. In addition, the Proposed Standard and Proposed Amendments are designed to align with and build upon the foundational requirements in the PCAOB’s standards on risk assessment, including the consideration of fraud in a financial statement audit.² The Proposed Standard and Proposed Amendments were informed by observations from the PCAOB’s oversight activities, discussions with the PCAOB’s Standing Advisory Group and international developments.

I. The Proposed Standard

Pursuant to certain Securities and Exchange Commission (“SEC”) rules and applicable accounting principles, companies are required to identify related parties and disclose material related party transactions in their public filings.³ Section 10A of the Securities Exchange Act of 1934 (the “Exchange Act”) recognizes the importance to investors of auditing such disclosures and requires each audit of an issuer to include “procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein.”⁴ To that end, certain PCAOB auditing standards, including the Interim Standard, describe procedures for the auditor’s evaluation of a company’s relationships and transactions with related parties.⁵ The Interim Standard describes procedures to assist auditors in determining the existence of related parties, identifying

¹ See PCAOB Release No. 2012-001, *Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards* (February 28, 2012), available at http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2012-001_Related_Parties.pdf.

² See PCAOB Release No. 2010-004, *Auditing Standards Related to the Auditor’s Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (August 5, 2010), available at http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release_2010-004_Risk_Assessment.pdf.

³ See, *e.g.*, Item 404 of SEC Regulation S-K.

⁴ See Section 10A(a)(2) of the Exchange Act.

⁵ See, *e.g.*, Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

transactions with related parties, examining the substance of identified related party transactions and evaluating financial statement disclosures.

The Proposed Standard would strengthen existing audit procedures for identifying, assessing and responding to the risks of material misstatement associated with a company's related party transactions by:

- Aligning with and building upon the foundational requirements in the PCAOB's standards on risk assessment;⁶
- Requiring auditors to perform procedures to identify the company's related parties, obtain an understanding of the nature of the relationships between the company and its related parties and understand the terms and business purposes of the types of transactions involving related parties;
- Requiring auditors to perform specific procedures for each related party transaction, or type of related party transaction, that is either required to be disclosed or determined to be a significant risk;
- Requiring auditors to evaluate whether information that comes to their attention during the audit indicates that undisclosed related parties or relationships or transactions with related parties may exist;
- Requiring auditors to perform specific procedures if they determine that related parties or relationships or transactions with related parties previously undisclosed to them exist; and
- Requiring auditors to communicate to audit committees, in a timely manner and prior to the issuance of the auditor's report, their evaluation of the company's identification of, accounting for and disclosure of its relationships and transactions with related parties.

II. The Proposed Amendments

Some Proposed Amendments would amend AU sec. 316 and other auditing standards to strengthen an auditor's evaluation of significant unusual transactions. Among other things, these Proposed Amendments would:

- Require auditors to perform specific procedures to identify significant unusual transactions;
- Require auditors to perform specific procedures to obtain an understanding of the business purpose (or lack thereof) of identified significant unusual transactions;
- Enhance the auditor's evaluation of the business purpose of significant unusual transactions; and
- Require auditors to evaluate whether significant unusual transactions have been appropriately accounted for and adequately disclosed.

⁶ See PCAOB Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (August 5, 2010), available at http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release_2010-004_Risk_Assessment.pdf.

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The PCAOB also proposed other amendments to existing auditing standards that are designed to further complement its proposals with respect to related parties and significant unusual transactions. Among other things, these Proposed Amendments would:

- Address the auditor's consideration of a company's financial relationships and transactions with its executive officers;
- Require auditors to perform procedures to understand a company's financial relationships and transactions with its executive officers as part of its risk assessment;⁷
- Require auditors to obtain representations from management that there are no side agreements or other arrangements undisclosed to the auditors;
- Emphasize the auditor's existing responsibilities to communicate possible fraud to management, the audit committee and, under certain circumstances, the SEC and others; and
- Amend other PCAOB auditing standards to conform to the Proposed Standard and Proposed Amendments regarding significant unusual transactions.

III. Comment Period and Effective Dates

The Proposed Standard and Proposed Amendments would apply to all audits conducted in accordance with PCAOB standards. If adopted, the PCAOB anticipates that, subject to approval by the SEC, the Proposed Standard and Proposed Amendments would be effective for audits of financial statements for fiscal years beginning on or after December 15, 2012. Comments on the Proposed Standard and Proposed Amendments are due by May 15, 2012.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Abigail Darwin at 212.701.3240 or adarwin@cahill.com.

⁷ These rules would complement existing SEC rules that require companies to disclose compensation policies and practices that are reasonably likely to have a material adverse effect on the company. See Securities Act Release No. 33-9089, *Proxy Disclosure Enhancements* (December 16, 2009), available at <http://www.sec.gov/rules/final/2009/33-9089.pdf>.

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