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PROPOSED AUDITING STANDARD – )

RELATED PARTIES )

PROPOSED AMENDMENTS TO CERTAIN )  
PCAOB AUDITING STANDARDS REGARDING )  
SIGNIFICANT UNUSUAL TRANSACTIONS )

AND OTHER PROPOSED AMENDMENTS TO )  
PCAOB AUDITING STANDARDS )

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PCAOB Release No. 2012-001  
February 28, 2012

PCAOB Rulemaking  
Docket Matter No. 038

Summary: The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is proposing an auditing standard, *Related Parties*, amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other amendments to PCAOB auditing standards. The proposed standard would supersede the Board's interim standard AU sec. 334, *Related Parties*. The proposed auditing standard and proposed amendments would be applicable to all audits conducted in accordance with PCAOB standards.

Public

Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's Web site at [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to PCAOB Rulemaking Docket Matter No. 038 in the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on May 15, 2012.

Board

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### I. Introduction

The auditor's evaluation of a company's identification of, accounting for, and disclosure about its relationships and transactions with related parties is important to the protection of the interests of investors and to the preparation of informative, accurate, and independent audit reports. Transactions with related parties can pose significant risks of material misstatement, as their substance might differ materially from their form. Related party transactions not only may involve difficult measurement and recognition issues that can lead to errors in financial statements but also, in some instances, related party transactions have been used to engage in financial statement fraud and asset misappropriation.

The importance to investors of auditing disclosures regarding related parties is recognized by Section 10A of the Securities Exchange Act of 1934 ("Exchange Act"), which 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."<sup>1/</sup>

Likewise, significant transactions that are outside the normal course of business or that otherwise appear to be unusual due to their timing, size, or nature ("significant unusual transactions") can create complex accounting and financial statement disclosure issues and, in some instances, 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, might have been entered into to engage in fraudulent financial reporting or to obscure financial position or operating results. In such instances, management might place more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction.

In addition, incentives and pressures for executive officers to meet financial targets can result in risks of material misstatement to a company's financial statements. Such incentives and pressures can be created by a company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements).

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<sup>1/</sup> See Section 10A(a)(2) of the Exchange Act, 15 U.S.C. §78j-1(a)(2).

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The Board is proposing a new auditing standard, *Related Parties* (the "proposed standard"), amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other proposed amendments to PCAOB auditing standards. The proposed amendments regarding significant unusual transactions and the other proposed amendments to PCAOB auditing standards are collectively referred to as the "proposed amendments" in this release. The proposed standard would supersede the Board's existing standard AU sec. 334, *Related Parties*.

The proposed standard and proposed amendments address the following areas for auditors:

1. Evaluating a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties;<sup>2/</sup>
2. Identifying and evaluating a company's accounting and disclosure of its significant unusual transactions; and
3. Obtaining an understanding of a company's financial relationships and transactions with its executive officers that is sufficient to identify risks of material misstatement.<sup>3/</sup>

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<sup>2/</sup> The auditor should look to the requirements of the U.S. Securities and Exchange Commission ("SEC" or "Commission") for the company under audit with respect to the accounting principles applicable to that company, including the definition of "related parties" and the financial statement disclosure requirements with respect to related parties. Also, SEC rules require additional disclosure of information regarding executive compensation and related persons in the issuer's annual report. See Items 402 and 404 of SEC Regulation S-K and Items 6.B. and 7.B. of Form 20-F.

<sup>3/</sup> The term "executive officer" included in the proposed amendments to other PCAOB auditing standards is based on the definition contained in Rule 3b-7 under the Exchange Act, which includes a registrant's president, any vice president of the registrant 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 the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant. For brokers and dealers, the term "executive officer" is based on a list in Schedule A of Form BD, which includes

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The proposed amendments regarding significant unusual transactions are being exposed for public comment with the proposed standard because these amendments complement the proposed standard. For example, enhancing the auditor's identification and evaluation of significant unusual transactions might assist the auditor in identifying related parties or relationships or transactions with related parties previously undisclosed to the auditor. However, not all related party transactions are significant unusual transactions, and not all significant unusual transactions involve related parties.

The other proposed amendments to PCAOB auditing standards would further complement the improvements in the proposed standard and proposed amendments regarding significant unusual transactions. Among other things, the other proposed amendments to PCAOB auditing standards would require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. Obtaining such an understanding could assist the auditor in identifying incentives and pressures that could cause management to use related party transactions or significant unusual transactions to obscure a company's financial position or operating results. In addition, performing such procedures also might assist the auditor in identifying related party transactions previously undisclosed to the auditor.

## **II. Overview of the Proposed Standard and Proposed Amendments**

Appendices 1-3 to this release contain the text of the proposed standard, the proposed amendments regarding significant unusual transactions, and the other proposed amendments to PCAOB auditing standards, respectively. Appendix 4 to this release contains additional discussion on specific aspects of the proposed standard and proposed amendments, and describes how the proposed standard and proposed amendments would change existing requirements. Appendix 4 also contains questions for which the Board seeks specific comment. Appendix 5 to this release includes a comparison of the objectives and requirements of the proposed standard and proposed amendments with the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA"). In developing the proposed standard

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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.

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and proposed amendments, the Board considered the requirements of the analogous standards of the IAASB and the ASB.

### **A. Proposed Auditing Standard, *Related Parties***

AU sec. 334 and other PCAOB auditing standards describe procedures for the auditor's evaluation of a company's relationships and transactions with its related parties.<sup>4/</sup> An underlying premise of AU sec. 334 is that management is required by applicable accounting principles to identify a company's related parties and to disclose material related party transactions. AU sec. 334 describes procedures to assist the auditor in determining the existence of related parties, identifying 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. Among other things, the proposed standard would:

- Align with and build upon the foundational requirements in the Board's standards on risk assessment;<sup>5/</sup>
- Require the auditor 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;
- Require the auditor 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;

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<sup>4/</sup> See, for example, Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

<sup>5/</sup> 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).

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- Require the auditor to evaluate whether information that comes to the auditor's attention during the audit indicates that undisclosed related parties or relationships or transactions with related parties might exist;
- Require the auditor to perform specific procedures if the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist; and
- Require the auditor to communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.

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

Existing standards describe procedures for the auditor to perform as part of the auditor's evaluation of significant unusual transactions. For example, existing standards require that the auditor gain an understanding of the business rationale for significant unusual transactions and evaluate whether that rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets.<sup>6/</sup>

The Board is proposing amendments to AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and other auditing standards to strengthen the auditor's evaluation of significant unusual transactions. Among other things, the proposed amendments regarding significant unusual transactions would:

- Require the auditor to perform specific procedures to identify significant unusual transactions;

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<sup>6/</sup> See, for example, AU secs. 316.66-.67 and paragraph 14 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Certain requirements from these and other standards are compiled in Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010), available at: [http://pcaobus.org/Standards/QandA/04-07-2010\\_APA\\_5.pdf](http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf).

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

### C. Other Proposed Amendments to PCAOB Auditing Standards

The Board also is proposing other amendments to PCAOB auditing standards designed to further complement its proposals with respect to related parties and significant unusual transactions. One such amendment would address the auditor's consideration of a company's financial relationships and transactions with its executive officers. Executive officers are in a unique position to commit financial statement fraud or asset misappropriation through their ability to manipulate accounting records and present fraudulent financial information (e.g., through override of controls).<sup>7/</sup> Further, a company's financial relationships and transactions with its executive officers might create incentives and pressures that could create risks of material misstatement of the financial statements.

The other proposed amendments to PCAOB auditing standards would, among other things:

- Require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers as part of its risk assessment;
- Require the auditor to obtain representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor;

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<sup>7/</sup> See AU sec. 316.08.

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- Emphasize the auditor's existing responsibilities to communicate possible fraud to management, the audit committee and, under certain conditions, the U.S. Securities and Exchange Commission and others;<sup>8/</sup> and
- Amend other PCAOB auditing standards to conform to the proposed standard and proposed amendments regarding significant unusual transactions.

### III. **Considerations in Developing the Proposed Standard and the Proposed Amendments**

The Board has developed the proposed standard and proposed amendments in light of the magnitude and number of financial reporting frauds involving public companies' relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers. The Board's proposals also have been informed by observations from the PCAOB's oversight activities, discussions with the Board's Standing Advisory Group ("SAG"), and international developments.

These factors, as described further in this section, collectively indicate a need for the consideration of improvements to certain existing standards. Consequently, the Board is proposing specific requirements regarding the auditor's evaluation of a company's relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with its executive officers. The proposed requirements are designed to benefit investors by focusing the auditor's efforts on those areas that pose an increased risk of material misstatement to the financial statements and the auditor's responses to those risks.

In addition, as described in Section I. of Appendix 4 to this release, the proposed standard and proposed amendments are designed to align with and build upon the foundational requirements in the Board's standards on risk assessment, including the consideration of fraud in a financial statement audit. This alignment with the risk assessment process could provide opportunities for the auditor to implement the standard in an efficient way. The Board requests comments on the foregoing.

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<sup>8/</sup> See Section 10A(b)(3) of the Exchange Act, 15 U.S.C. §78j-1(b)(3).



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**A. Financial Reporting Frauds Involving Relationships and Transactions with Related Parties, Significant Unusual Transactions, and Financial Relationships and Transactions with Executive Officers**

Relationships and transactions with related parties have been a contributing factor in prominent corporate scandals, as discussed in the SEC study of five years of enforcement actions<sup>9/</sup> and in major enforcement cases, such as Enron Corporation, Tyco International, Ltd., and Refco, Inc.<sup>10/</sup> Likewise, significant unusual transactions reportedly have been considered to be a contributing factor in attempts to mislead investors about companies' financial conditions. Such transactions could occur when management places more emphasis on the need for a particular accounting treatment than on accounting that reflects the underlying economic substance of the transaction. For example, in studies conducted pursuant to the Act, the SEC staff noted that "deliberate attempts to work around the intent of accounting standards have contributed to many of the largest financial reporting failures."<sup>11/</sup>

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<sup>9/</sup> Section 704 of the Sarbanes-Oxley Act of 2002 (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." 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 page 6, available at: <http://sec.gov/news/studies/sox704report.pdf>.

<sup>10/</sup> See also the report of the Quality Control Inquiry Committee of the AICPA's SEC Practice Section, which analyzed more than 200 audit failures from December 1997 to October 2002 and recommended that, among other things, "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." 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).

<sup>11/</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), page 99, available at: <http://sec.gov/news/studies/soxoffbalancercpt.pdf>.

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In addition, the *Report Prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs* noted 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>12/</sup> Significant unusual transactions in which the substance of the transactions might differ materially from their form, or in which the transactions might represent "window dressing," also have raised concerns regarding the possible lack of transparency in financial statements.<sup>13/</sup>

Recent corporate scandals also illustrate that a company's financial relationships and transactions with its executive officers can create incentives and pressures that can

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<sup>12/</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), available at: <http://www.gpo.gov/fdsys/pkg/CPRT-107SPRT83559/pdf/CPRT-107SPRT83559.pdf>. Certain regulatory agencies subsequently issued guidance describing internal controls and risk management procedures that may help financial institutions identify, manage, and address the heightened reputational and legal risks that may arise from elevated-risk complex structured finance transactions. See Exchange Act Release No. 34-55043, *Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities* (January 5, 2007) available at: <http://sec.gov/rules/policy/2007/34-55043.pdf>.

<sup>13/</sup> Phrases such as "window dressing" or "dressing up" have been used to describe transactions entered into at or close to period end that improve the appearance of a company's financial statements, but which are unwound shortly after period end. Concerns over "window dressing" have been described in the report of the Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (January 2011), available at: <http://www.gpoaccess.gov/fcic/fcic.pdf>. See also Securities Act Release No. 33-9144, *Commission Guidance on Presentation of Liquidity and Capital Resources in Management's Discussion and Analysis* (September 17, 2010), available at: <http://www.sec.gov/rules/interp/2010/33-9144.pdf>.

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result in risks of material misstatement, including fraud risks.<sup>14/</sup> Notably, a May 2010 academic study that examined in detail SEC accounting and auditing enforcement releases from 1997 to 2008 noted that either the chief executive officer or chief financial officer was named in 89 percent of the enforcement actions involving fraudulent financial reporting.<sup>15/</sup> That study also noted that the SEC's most commonly cited motivations for fraud included the need to meet internal or external earnings expectations, an attempt to conceal the company's deteriorating financial condition, the need to increase the stock price, the need to bolster financial performance for pending equity or debt financing, or the desire to increase management compensation based on financial results.<sup>16/</sup>

Investor and regulatory concerns about a company's financial relationships and transactions with management (e.g., compensation) remain prevalent today.<sup>17/</sup> Certain risks resulting from compensation policies are now required to be disclosed in SEC filings. For example, in 2009, the SEC adopted new rules that require a company to disclose compensation policies and practices that are reasonably likely to have a material adverse effect on the company.<sup>18/</sup> Understanding the structure of compensation arrangements for executive officers can assist the auditor in identifying conditions and events that could represent fraud risk factors and, individually, or in conjunction with other fraud risk factors, could represent fraud risks.

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<sup>14/</sup> See generally, *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* (pages 17-19), available at: <http://www.sec.gov/spotlight/worldcom/wcomreport0803.pdf>.

<sup>15/</sup> See M. Beasley, J. Carcello, D. Hermanson, and T. Neal, *Fraudulent Financial Reporting 1998-2007 An Analysis of U.S. Public Companies*, available at: [http://www.coso.org/documents/COSOFRAUDSTUDY2010\\_001.pdf](http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf).

<sup>16/</sup> *Id* at pages 5 and 33.

<sup>17/</sup> See generally, The Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, (January 2011), available at: <http://www.gpoaccess.gov/fcic/fcic.pdf>.

<sup>18/</sup> 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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### B. Observations from PCAOB Oversight Activities

The PCAOB's Inspections program has identified deficiencies regarding the auditing of related party transactions.<sup>19/</sup> For example, inspection findings indicate that some auditors are not giving adequate consideration to the risks of material misstatement of financial statements resulting from related party transactions.<sup>20/</sup> In addition, PCAOB inspectors have sometimes observed deficiencies in firms' audit procedures related to off-balance sheet structures (e.g., consideration of implicit or informal guarantees or other arrangements to provide financial support between some financial services' issuers prior to the time such guarantees or arrangements became explicit during the economic crisis).<sup>21/</sup>

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<sup>19/</sup> Deficiencies cited in inspection reports do not necessarily warrant revision of the relevant standard. The Board considers inspection findings and other information from the PCAOB's inspections program in connection with other relevant information and data in determining whether or how to revise its rules and standards.

<sup>20/</sup> See page 7 of PCAOB Release No. 2007-010, *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms* (October 22, 2007), available at: [http://pcaobus.org/Inspections/Documents/2007\\_10-22\\_4010\\_Report.pdf](http://pcaobus.org/Inspections/Documents/2007_10-22_4010_Report.pdf), which states, in part:

Inspection teams have observed deficiencies related to firms' failures to identify and address the lack of disclosure of related party transactions. They also have identified deficiencies relating to the effectiveness of firms' testing of the nature, economic substance, and business purpose of transactions with related parties. For example, firms have failed to sufficiently test (a) the validity and classification of expenditures made by a controlling shareholder on behalf of an issuer, (b) the collectability of receivables due from entities owned or controlled by officers of an issuer, (c) the validity and accuracy of payables owed to related parties, and (d) the appropriateness of the accounting for the extinguishment of a note receivable from an officer of an issuer.

<sup>21/</sup> See PCAOB Release 2010-006, *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis* (September 29, 2010), available at: [http://pcaobus.org/Inspections/Documents/4010\\_Report\\_Economic\\_Crisis.pdf](http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf).

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Additionally, certain of the Board's disciplinary actions have involved auditors' failures to perform sufficient procedures regarding transactions with related parties and significant unusual transactions, including, for example, the failure to perform sufficient procedures regarding identified related party transactions and transactions with related parties previously undisclosed to the auditor.<sup>22/</sup>

### C. Standing Advisory Group Discussions

The PCAOB requested input from the SAG with respect to relationships and transactions with related parties on several occasions.<sup>23/</sup>

Many SAG members support the Board's efforts to enhance its standards regarding the auditing of related party transactions. Several SAG members indicated that related party transactions represent an area of increased audit risk and require heightened scrutiny. Some SAG members also noted that auditors often view related party transactions primarily as a disclosure issue, rather than an issue requiring increased focus on whether the accounting is appropriate in light of the transaction's

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<sup>22/</sup> See PCAOB Release No. 2005-022, 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 (November 22, 2005); PCAOB Release No. 105-2007-1, 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 (June 12, 2007); PCAOB Release No. 2006-010, Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Turner Stone & Company, LLP and Edward Turner, CPA, Respondents (December 19, 2006); PCAOB Release No. 105-2007-004, Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Timothy L. Steers, CPA, LLC, and Timothy L. Steers, CPA, Respondents (November 14, 2007); and PCAOB Release No. 2008-004, Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions: In the Matter of Jaspers and Hall, PC, Thomas M. Jaspers, CPA, and Patrick A. Hall, CPA, Respondents (October 21, 2008).

<sup>23/</sup> See SAG briefing papers: "Related Party Transactions" (September 8, 2004), "Related Parties" (June 21, 2007), and "Related Parties" (October 14, 2009). Copies of these SAG briefing papers and webcast archives are available at: <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>.

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business purpose. Some SAG members noted that often the issue is not the identification of a related party transaction but, rather, the extent of substantive procedures applied by an auditor (i.e., relying too heavily on management representations). Some SAG members did, however, express concern regarding whether imposing additional requirements for the auditor to perform procedures to identify related party relationships and transactions previously undisclosed to the auditor would result in unduly increased audit costs.

Moreover, some SAG members noted that there are risks associated with a company's financial relationships and transactions with management and that these relationships should be considered during the audit. However, other SAG members noted the need for specific guidance to address this issue, and expressed concern that, without specific guidance for the auditor, the auditor's efforts regarding financial relationships and transactions with management could become excessive.

### D. International Developments

Other regulators have noted a need for an improved focus on both related party and significant unusual transactions. For example, the United Kingdom's Financial Services Authority noted that auditors did not always appear to be willing to challenge key accounting judgments made by management that were fundamental to transactions structured to achieve a particular accounting treatment.<sup>24/</sup> Foreign securities regulators have issued communications regarding a need for better disclosures of related party transactions and relationships.<sup>25/</sup>

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<sup>24/</sup> See, for example, Financial Services Authority & Financial Reporting Council Discussion Paper 10/3, *Enhancing the auditor's contribution to prudential regulation* (June 2010), available at: [http://www.fsa.gov.uk/pubs/discussion/dp10\\_03.pdf](http://www.fsa.gov.uk/pubs/discussion/dp10_03.pdf). In addition, the Audit Inspection Unit of the United Kingdom's Professional Oversight Board, part of the Financial Reporting Council, has identified deficiencies regarding the identification and testing of related party transactions by auditors. Those public reports are available at: <http://www.frc.org.uk/pob/audit/firmreports1011.cfm>.

<sup>25/</sup> For example, in March 2011, the European Corporate Governance Forum of the European Commission issued a statement highlighting the importance of related party transactions to shareholders. See *Statement of the European Corporate Governance Forum on Related Party Transactions for Listed Entities* (10 March 2011),

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The risk of material misstatement associated with related party relationships and transactions applies not only to U.S. companies, but also to the foreign operations of U.S. companies and foreign private issuers.<sup>26/</sup> For example, the Organisation for Economic Co-Operation and Development, *Guide on Fighting Abusive Related Party Transactions in Asia*, noted that:

The complexity of group structures and the inter-connectedness of enterprises (most notably under the 'complicated network ownership' structure) means auditors face significant challenges in being sceptical of material information on related party transactions in Asia. The fact that, for the most part, external auditors are reliant on information provided by management magnifies this challenge.<sup>27/</sup>

A report published by the Asia-Pacific Office of the Chartered Financial Analysts ("CFA") Institute's Centre for Financial Market Integrity also expressed similar concerns stating, "[r]elated-party transactions are a constant corporate governance risk in Asia. Although the concept is identical to its meaning in the West, the practice differs as a result of the ownership structure characteristic to the region."<sup>28/</sup>

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available at:

[http://ec.europa.eu/internal\\_market/company/docs/ecgforum/ecgf\\_related\\_party\\_transactions\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf_related_party_transactions_en.pdf). Additionally, in March 2010, the Commissione Nazionale per le Società e la Borsa ("CONSOB") in Italy approved new regulations regarding related party transactions. See

[http://www.consob.it/mainen/press\\_release/comunicato\\_20100312.htm](http://www.consob.it/mainen/press_release/comunicato_20100312.htm).

<sup>26/</sup> See Rule 3b-4 under the Exchange Act for the definition of the term "foreign private issuer."

<sup>27/</sup> Organisation for Economic Co-Operation and Development, Corporate Governance Series, *Guide on Fighting Abusive Related Party Transactions in Asia* (September 2009), available at: <http://www.oecd.org/dataoecd/39/57/43626507.pdf>.

<sup>28/</sup> See Asia-Pacific Office of the CFA Institute Centre for Financial Market Integrity, *Related Party Transactions Cautionary Tales for Investors in Asia* (2009), available at: <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2009.n1.1>.

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In addition, in July 2008, the IAASB revised its auditing standard on related parties with the issuance of International Standard on Auditing No. 550, *Related Parties* ("ISA 550"). The IAASB emphasized that a 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>29/</sup> The ASB also has revised its auditing standard on 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.

### IV. Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>30/</sup> ("Dodd-Frank Act") gave the Board oversight of the audits of brokers and dealers registered with the SEC. In September 2010, the Commission issued interpretive guidance clarifying that the "references in Commission rules and staff guidance and in the federal securities laws to [Generally Accepted Auditing Standards] GAAS or to specific standards under GAAS, as they relate to non-issuer brokers or dealers, should continue to be understood to mean" the auditing and attestation standards established by the AICPA. The guidance noted that the Commission intended to revisit this interpretation in connection with a Commission rulemaking project to update the audit and attestation requirements for brokers and dealers in light of the Dodd-Frank Act.<sup>31/</sup>

On June 15, 2011, the SEC proposed to amend its rules to require, among other things, that audits of brokers' and dealers' financial statements and examinations of reports regarding compliance with Commission requirements be performed in accordance with the standards of the PCAOB.<sup>32/</sup> If the SEC adopts its proposed

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<sup>29/</sup> See IAASB Exposure Draft, *Related Parties* (December 2005).

<sup>30/</sup> See Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

<sup>31/</sup> See Exchange Act Release No. 34-62991, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers* (September 24, 2010).

<sup>32/</sup> See Exchange Act Release No. 34-64676, *Broker-Dealer Reports* (June 15, 2011).



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amendments to SEC Rule 17a-5 or provides other direction that auditors of brokers and dealers are to comply with PCAOB professional standards, the Board's auditing, attestation, quality control, and, where applicable, independence standards would then apply to audits of brokers and dealers required by Section 17 of the Exchange Act and SEC Rule 17a-5. The proposed standard and the proposed amendments would be applicable for all audits performed in accordance with PCAOB standards. The Board therefore requests comments from auditors of brokers and dealers and others on the proposed standard and the proposed amendments.

### **V. Effective Date of the Proposed Standard and Amendments**

Given the importance of the proposed standard and proposed amendments to improved audits and greater investor protection, the Board anticipates that the proposed standard and proposed amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2012. The Board seeks comment regarding the feasibility of this date.

### **VI. Opportunity for Public Comment**

The Board is seeking comment on the proposed standard, proposed amendments regarding significant unusual transactions, and proposed amendments to other PCAOB standards. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington DC 20006-2803. Comments also may be submitted by email to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's Web site at: [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to the PCAOB Rulemaking Docket Matter No. 038 on the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on May 15, 2012.

The Board will consider carefully all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are rules of the Board under the Act.

\* \* \*

**RELEASE**

On the 28<sup>th</sup> day of February, in the year 2012, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour  
Secretary

February 28, 2012

APPENDIX 1 – *Proposed Standard – Related Parties*

APPENDIX 2 – *Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions*

APPENDIX 3 – *Other Proposed Amendments to PCAOB Auditing Standards*

APPENDIX 4 – *Additional Discussion of the Proposed Standard and Proposed Amendments and Questions for Public Comment*

APPENDIX 5 – *Comparison of the Objectives and Requirements of the Proposed Standard and Proposed Amendments 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*

## **APPENDIX 1**

### **Proposed Standard, *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>

#### ***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>

#### ***Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties***

3. The auditor should 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 (or the lack thereof) of the types of transactions involving related parties.<sup>3/</sup> The procedures performed should be designed to identify likely sources of potential material misstatements in the financial

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<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 "related parties" and the financial statement disclosure requirements with respect to related parties.

<sup>2/</sup> See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*. See also paragraph .04(c)-(d) of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, and Rule 4-01 of Regulation S-X.

<sup>3/</sup> Paragraph 16 of Auditing Standard No. 9, *Audit Planning*, states that the auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

statements that may arise from the company's relationships and transactions with related parties, including related parties or relationships or transactions with related parties previously undisclosed to the auditor.<sup>4/</sup>

Note: For purposes of this standard, the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes (1) related parties that were not disclosed to the auditor or (2) relationships or transactions with known or previously unknown related parties that were not disclosed to the auditor.

4. In identifying related parties and obtaining an understanding of relationships and transactions with related parties, the auditor should take into account information obtained from the performance of risk assessment procedures (e.g., obtaining an understanding of the company and its environment, performing analytical procedures, and conducting a discussion among engagement team members regarding the risks of material misstatement) required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

*Obtaining an Understanding of Internal Control over Financial Reporting*

5. The auditor should obtain an understanding of the controls that management has established to:

- a. Identify related parties and relationships and transactions with related parties;
- b. Authorize and approve transactions with related parties; and
- c. Account for and disclose relationships and transactions with related parties in the financial statements.

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<sup>4/</sup> Paragraph 7 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, requires the auditor to evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. Paragraph 7 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.

*Performing Inquiries*

6. The auditor should 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 (e.g., physical location, industry, number of employees);
  - c. The nature of any relationships, including ownership structure, between the company and each related party;
  - d. The types of transactions entered into with each related party during the period under audit and the terms and business purposes (or the lack thereof) of each type of transaction;
  - e. The business reasons for entering into a transaction with a related party versus an unrelated party; and
  - f. Any significant related party transactions (i) 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 (ii) for which exceptions to the company's established policies or procedures were granted.
  
7. The auditor should inquire of others within the company regarding the matters identified in paragraph 6 of this standard. The auditor should 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 additional knowledge regarding (i) the company's related parties or relationships or transactions with related parties and (ii) the company's controls over relationships or transactions with related parties. The auditor also should consider whether such individuals are likely to have knowledge of related parties, or relationships or transactions with related parties previously undisclosed to the auditor. Examples of such individuals include, but are not limited to:
  - a. Personnel in a position to initiate, process, or record transactions with related parties and those who supervise or monitor such personnel;
  - b. Internal auditors;
  - c. In-house legal counsel;

- d. The chief compliance/ethics officer or person in equivalent position; and
  - e. The human resource director or person in equivalent position.
8. The auditor should inquire of the audit committee, or its chair, regarding:<sup>5/</sup>
- 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 particular concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

*Communications with the Audit Engagement Team and Other Auditors*

9. 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>6/</sup>

10. 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 related parties and the nature of the company's relationships and transactions with those related parties.<sup>7/</sup> The auditor also should inquire 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.

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<sup>5/</sup> In addition to this inquiry, paragraph 8 of the proposed auditing standard, *Communications with Audit Committees*, requires the auditor to make certain inquiries of the audit committee. Appendix A to the proposed auditing standard, *Communications with Audit Committees*, contains the definition of audit committee. See PCAOB Release No. 2011-008 (December 20, 2011).

<sup>6/</sup> See Auditing Standard No. 10, *Supervision of the Audit Engagement*, which establishes requirements regarding supervision of the audit engagement, including supervising the work of engagement team members.

<sup>7/</sup> See AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which describes 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.

*Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor*

11. The auditor should evaluate whether information that comes to the auditor's attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

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

12. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level.<sup>8/</sup> This includes identifying and assessing the risks of material misstatement associated with related parties and relationships and transactions with related parties.

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

13. The auditor must design and implement audit responses that address the assessed risks of material misstatement.<sup>9/</sup> 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.

Note: The auditor also should look to the requirements in proposed 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 (e.g., significant related party transactions outside the normal course of business).

14. The auditor should perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

*Transactions with Related Parties Required to be Disclosed in the Financial Statements or That are a Significant Risk*

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<sup>8/</sup> See paragraph 59 of Auditing Standard No. 12.

<sup>9/</sup> See paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

15. For each related party transaction, or type of 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 determine whether the terms and business purpose (or the lack thereof) of the transaction are consistent with explanations from inquiries and from other audit evidence;
- b. Determine (i) 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 and (ii) whether any exceptions to those established policies or procedures were granted;<sup>10/</sup>
- c. Evaluate the financial capability of the related parties with respect to significant uncollected balances, guarantees, and other obligations, if any;<sup>11/</sup> and
- d. Perform other procedures as appropriate, depending on the nature of the related party transaction and the related risks of material misstatement, to meet the objective of this standard.

*Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor*

16. 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 procedures to determine whether previously

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<sup>10/</sup> Information obtained from gaining an understanding of the company also might assist the auditor in identifying agreements prohibiting or restricting related party transactions (e.g., loans or advances to related parties).

<sup>11/</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.



undisclosed relationships or transactions with related parties, in fact, exist.<sup>12/</sup> These procedures should extend beyond inquiry of management.

Note: Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

17. 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. Determine why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;<sup>13/</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 relationships or transactions with the related party;
- d. Assess the need to perform procedures to identify additional relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 15 of this standard, treating the related party transaction as a significant risk;

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<sup>12/</sup> See paragraph 29 of Auditing Standard No. 15, *Audit Evidence*, 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.

<sup>13/</sup> See paragraph .04 of AU sec. 333, *Management Representations*, 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.

- f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
- g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
- h. 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 determines that it is likely that an illegal act has or may have occurred, the auditor should perform the appropriate procedures, including those required by AU sec. 316, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

### ***Evaluating Financial Statement Accounting and Disclosures***

18. The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.<sup>14/</sup> This includes evaluating whether the financial statements contain the information regarding related party transactions essential for a fair presentation in conformity 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***

19. 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>15/</sup>

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<sup>14/</sup> See paragraph 30 of Auditing Standard No. 14, *Evaluating Audit Results*.

<sup>15/</sup> See the proposed amendments to AU sec. 333, which would require 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*.

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

### ***Communications with the Audit Committee***

20. The auditor should communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. 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 (i) that have not been authorized or approved in accordance with the company's established policies or procedures and (ii) for which exceptions to the company's established policies or procedures were granted;
- c. 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 such assertions; and
- d. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

Note: An auditor may communicate significant matters to only the audit committee chair if done in order to communicate these matters in a timely manner during the audit. The auditor, however, should communicate significant matters to the full audit committee prior to the issuance of the auditor's report.

**APPENDIX A – Examples of Information and Sources of Information 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 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, and paragraph A3, similarly, 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 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 to customers;
- "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 could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist:

- Minutes of meetings of the board of directors;
- Periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies;
- Confirmation responses and responses to inquiries of the company's lawyers;
- Tax filings;
- 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 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.

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**APPENDIX 2 – Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions**

**A. Identifying Significant Unusual Transactions (Section II.A. of Appendix 4)**  
**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:

a. In paragraph 14:

- The first bullet point is replaced with:

Controls over 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*, is amended as follows:

a. In paragraph 12, item a. is replaced with:

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

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

- Footnote 7A is added after the semicolon (;) in 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) and footnote 31A at the end of 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>

<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.



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- 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.

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**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*, 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 unusual transactions indicates that the transactions may have been entered into to engage in fraudulent financial reporting or 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 .85.A.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 .85.A.2, section a., under "Opportunities" is replaced with:

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- 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 .85.A.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, paragraph B1., the tenth bullet is replaced with:
  - The occurrence of infrequent or significant unusual transactions

**B. Evaluating Significant Unusual Transactions (Section II.B. of Appendix 4)**

**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*, 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 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.

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**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 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).

- 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. The procedures should include:

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

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- 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, guarantees, and other obligations, if any;<sup>24A/</sup> and
- d. Performing other procedures as appropriate, depending on the nature of the transaction and the risks of material misstatement, to obtain an understanding of the business purpose (or the lack thereof) of the significant unusual transaction.

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

<sup>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.

- c. 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;

**RELEASE**

- The transaction involves related parties or relationships or transactions with related parties previously undisclosed to the auditor;<sup>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;
- 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 company's accounting for 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 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 additional requirements regarding the auditor's evaluation of whether identified misstatements might be indicative of fraud. In addition, the auditor considers management's disclosure (or the lack thereof) regarding significant unusual transactions in other parts of the company's Securities and Exchange

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Commission filing containing the audited financial statements in accordance with AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

- d. Footnote 25A is added at the end of the third bullet in paragraph .67:
- 25A/ Related parties or relationships or transactions with related parties previously undisclosed to the auditor includes: (1) related parties that were not disclosed to the auditor or (2) relationships or transactions with known or previously unknown related parties that were not disclosed to the auditor. The proposed auditing standard, *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.
- e. Paragraph .67A is added after paragraph 67:
- .67A** Paragraph 30 of 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. 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.

## APPENDIX 3 –Other Proposed Amendments to PCAOB Auditing Standards

### Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Section III.A. of Appendix 4)

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

- a. Paragraph 10A is added after paragraph 10:
  - 10A. The auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements). The procedures should be designed to identify risks of material misstatement and should include, but are not limited to (1) reading employment and compensation contracts and (2) reading 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**.
- b. 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, remove the word "and" at the end of the bullet.
  - Add a fifth bullet:

Inquiring of the chair of the compensation committee, or its 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.

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

A3A. Executive officer – 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.)

**AU sec. 315, "Communications Between Predecessor and Successor Auditors" (Section III.B. of Appendix 4)**

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 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. For 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, those related to relationships and transactions with related parties, and those related to significant unusual transactions.

**AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"**  
**(Section III.C. of Appendix 4)**

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 title 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. These requirements also include reports that may be required pursuant to Section 10A(b)(3) 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:

- The paragraph and footnotes 39 and 41 are 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 .85.A.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:

Proposed Auditing Standard, *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" (Section III.D. of Appendix 4)**

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 Proposed Auditing Standard, *Related Parties*, the auditor should obtain a written representation that management has no knowledge of any relationships and 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>fn9</sup>
- c. Footnote 9 to paragraph .06 is replaced with:  
  
*See Proposed Auditing Standard, Related Parties.*
- d. Paragraph .11A is added after paragraph 11:  
  
.11A 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 obtain written representation from management regarding that assertion in the financial statements.
- e. 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 Proposed Auditing Standard, *Related Parties*.
- f. 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. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543" (Section III.E. of Appendix 4)**

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543," as amended, is amended as follows:

- a. Paragraph .05 is replaced with:

*Interpretation*—Before issuing his or her report, the other auditor should inquire of the principal auditor as to matters significant to the audit. Those matters include 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.

**AU sec. 722, "Interim Financial Information" (Section III.F. of Appendix 4)**

SAS No. 100, as amended, 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 item 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 Proposed Auditing Standard, *Related Parties*.
- c. Within the second illustrative representation letter (2.) for a review of interim financial information (statements) contained in paragraph C6 of paragraph .56:
  - 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.

## **Appendix 4 – Additional Discussion of the Proposed Standard and Proposed Amendments and Questions for Public Comment**

This appendix discusses the proposed standard, *Related Parties* (the "proposed standard") in Appendix 1, the proposed amendments regarding significant unusual transactions in Appendix 2, and other proposed amendments to PCAOB auditing standards in Appendix 3. The proposed amendments regarding significant unusual transactions and the other proposed amendments to PCAOB auditing standards are collectively referred to as the "proposed amendments" in this appendix. This appendix provides additional background information regarding certain of the proposed requirements in the proposed standard and proposed amendments, discusses the basis for the proposals, and requests comment on specific questions as well as on the proposals in general.

### **I. Proposed Auditing Standard, *Related Parties***

The proposed standard would enhance the existing requirements for identifying, assessing, and responding to the risks of material misstatement associated with a company's relationships and transactions with related parties.

The proposed standard is designed to align with and build upon the foundational requirements contained in the Board's standards on risk assessment.<sup>1/</sup> Due to the increased risk of material misstatement to the financial statements associated with a company's related party transactions, as described in the release, the proposed requirements are contained in a separate auditing standard; however, the proposed standard is aligned with and refers to the standards on risk assessment.

In general, the proposed standard establishes procedures for the auditor to obtain from management, and others as appropriate, the names of the company's related parties and relevant information about relationships and transactions with those parties. Under the proposed standard, the auditor inquires whether any member of the audit committee has particular concerns regarding the company's relationships or transactions with related parties and, if so, the substance of those concerns. The auditor performs procedures regarding the identified relationships and transactions with related parties, and evaluates whether information that comes to the auditor's attention during

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<sup>1/</sup> 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).



the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. If the auditor identifies a related party or relationship or transaction with a related party previously undisclosed to the auditor, the proposed standard requires the auditor to perform specific audit procedures. The proposed standard also requires the auditor to communicate to the audit committee, in a timely manner and prior to the issuance of their audit report, its evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. The auditor also communicates significant matters arising during the audit regarding the company's related parties or relationships or transactions with related parties.

The discussion in this section describes the major topic areas of the proposed standard, as set forth below,<sup>2/</sup> including how the requirements in the proposed standard align with and build upon the Board's risk assessment standards and other considerations:

- Introduction (paragraph 1);
- Objective (paragraph 2);
- Identifying related parties and obtaining an understanding of relationships and transactions with related parties (paragraphs 3 – 11);
- Identifying and assessing risks of material misstatement (paragraph 12);
- Responding to the risks of material misstatement (paragraphs 13 – 17);
- Evaluating financial statement accounting and disclosures (paragraphs 18 – 19);
- Communications with the audit committee (paragraph 20); and
- Other considerations.

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<sup>2/</sup> The paragraph references in this section relate to provisions in the proposed standard contained in Appendix 1.

**A. Introduction (paragraph 1 of Appendix 1)**

The introduction of the proposed standard states that it 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. The existing standard, AU sec. 334, *Related Parties*, incorporates the U.S. generally accepted accounting principles ("U.S. GAAP") definition of a related party.<sup>3/</sup>

The proposed standard requires the auditor to look to the requirements of the U.S. Securities and Exchange Commission ("SEC") for the company under audit with respect to the accounting principles applicable to that company, including the definition of related parties and the financial statement disclosure requirements with respect to related parties.<sup>4/</sup> The proposed standard does not define the term "related party" because applicable financial reporting frameworks may contain different definitions of the term "related party." Applicable financial reporting frameworks also may contain different disclosure requirements.

Question:

1. Is the framework neutral approach described in the introduction of the proposed standard appropriate? If not, why not?

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<sup>3/</sup> See AU sec. 334.02. For auditors of financial statements prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board ("IFRS") or other comprehensive set of accounting principles, see Question 4 of *Staff Questions and Answers, References to Authoritative Guidance in PCAOB Standards*, available at: [http://pcaobus.org/Standards/QandA/2009-09-02\\_FASB\\_Codification.pdf](http://pcaobus.org/Standards/QandA/2009-09-02_FASB_Codification.pdf).

<sup>4/</sup> For SEC filings that include financial statements prepared in accordance with or reconciled to U.S. GAAP, see, for example, the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") Topic 850. For SEC filings that include financial statements prepared in accordance with International Financial Reporting Standards ("IFRS"), see, for example, International Accounting Standard No. 24, *Related Parties*.

**B. Objective (paragraph 2 of Appendix 1)**

AU sec. 334 does not identify an objective for the auditor's work regarding a company's relationships and transactions with its related parties. In contrast, paragraph 2 of the proposed 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.

Providing an overarching concept as an audit objective for the auditor to take into account while performing the procedures required by the proposed standard can assist the auditor in performing those procedures, including developing other procedures as required, and evaluating the results of those procedures. An overarching concept can be especially helpful when judgment is required, for example, when designing additional procedures not specifically required by the proposed standard. New auditing standards issued by the Board include an objective, and this standard is following the same format.

A broadly stated objective to guide the auditor's actions also may eliminate a mechanical approach for examining relationships and transactions with related parties, which could result in the auditor not appropriately considering all the facts and circumstances in determining and performing audit procedures. Given the increased risk of material misstatement associated with transactions with related parties, avoiding a mechanical approach could improve audit quality and potentially address concerns regarding the auditor's consideration of related party transactions.

Question:

2. Is the objective of the proposed standard appropriate? If not, why not?

**C. Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties (paragraphs 3 – 11 of Appendix 1)**

AU sec. 334.05 requires the auditor to obtain an understanding of management responsibilities and the relationship of each component to the total entity in determining the scope of work to be performed with respect to possible transactions with related parties. AU sec. 334.05 further requires that the auditor consider controls over management activities and the business purpose served by the various components of the entity. AU sec. 334.09 requires that, after identifying related party transactions, the

auditor perform the procedures necessary to obtain satisfaction concerning the purpose, nature, and extent of transactions with related parties and their effect on the financial statements. AU sec. 334.09 also requires that those procedures extend beyond inquiry of management, and that until the auditor understands the business sense of material transactions, he cannot complete his audit. If the auditor lacks sufficient specialized knowledge to understand a particular transaction, the auditor should consult with persons who do have the requisite knowledge.<sup>5/</sup>

The proposed standard would retain the general approach taken in AU sec. 334, and further require the auditor to perform specific procedures to identify the company's related parties and obtain an understanding of the relationships and types of transactions with related parties. Paragraphs 3 and 4 of the proposed standard introduce procedures necessary for the auditor's identification and assessment of risks of material misstatement, including fraud risks. A footnote to paragraph 3 provides that paragraph 16 of Auditing Standard No. 9, *Audit Planning*, states that the auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

The requirements in paragraphs 3 and 4 build upon the foundational risk assessment requirements contained in Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Specifically, paragraph 3 of the proposed standard requires that the auditor 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 (or the lack thereof) of the types of transactions involving related parties. The procedures performed should be designed to identify likely sources of potential material misstatements in the financial statements that may arise from the company's relationships and transactions with related parties, including related parties or relationships or transactions with related parties previously undisclosed to the auditor. Those procedures include the procedures in paragraphs 4 through 11 of the proposed standard.

The requirements in paragraph 3 of the proposed standard apply to related party transactions, whether they are required to be disclosed or not in the financial statements, such as intercompany transactions.

A note to paragraph 3 explains that the phrase "related parties or relationships or transactions with related parties previously undisclosed to the auditor" includes (1)

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<sup>5/</sup> See footnote 6 to AU sec. 334.09.

related parties that were not disclosed to the auditor or (2) relationships or transactions with known or previously unknown related parties that were not disclosed to the auditor. Auditors should be alert to the potential existence of related parties or transactions with related parties (including formal or informal arrangements) that were previously undisclosed to the auditor.

An additional footnote to paragraph 3 states that paragraph 7 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, requires the auditor to evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. Paragraph 7 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.

Paragraph 4 of the proposed standard requires the auditor to take into account information obtained from the performance of risk assessment procedures when identifying related parties and obtaining an understanding of relationships and transactions with related parties. For example, the auditor should take into account information resulting from the performance of risk assessment procedures (e.g., obtaining an understanding of the company and its environment, performing analytical procedures, and conducting a discussion among engagement team members regarding the risks of material misstatement) required by Auditing Standard No. 12. The procedures in paragraphs 5 through 11 represent incremental requirements to the risk assessment procedures described in Auditing Standard No. 12.

The auditor should understand how relationships with related parties might result in a material misstatement of the financial statements, for example, through gaining an understanding of the business purpose (or the lack thereof) of the transaction. The procedures performed should be sufficient to identify likely sources of potential material misstatements regarding related party transactions, and to identify fraud risk factors associated with related party transactions.<sup>6/</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

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<sup>6/</sup> Paragraph 26 of Auditing Standard No. 12 describes risks of material misstatement due to fraud.

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.

Understanding the nature of relationships and transactions with related parties is important for the auditor's evaluation of the company's accounting for and disclosure of related party transactions. Further, this understanding is critical to determining whether related parties might be involved in transactions indirectly through the use of an intermediary.

*Obtaining an Understanding of Internal Control over Financial Reporting (paragraph 5 of Appendix 1)*

Existing standards require the auditor to obtain a sufficient 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.<sup>7/</sup> Paragraph 5 of the proposed standard would specifically require that the auditor obtain an understanding of the controls that management has established to:

- a. Identify related parties and relationships and transactions with related parties;
- b. Authorize and approve transactions with related parties; and
- c. Account for and disclose relationships and transactions with related parties in the financial statements.

Obtaining an understanding of internal control over financial reporting includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.<sup>8/</sup>

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<sup>7/</sup> See paragraph 18 of Auditing Standard No. 12.

<sup>8/</sup> See paragraph 20 of Auditing Standard No. 12.

*Performing Inquiries (paragraphs 6 – 8 of Appendix 1)*

Paragraph 6 of the proposed standard would require the auditor to inquire of management regarding: the names of the company's related parties during the period under audit, including changes from the prior period; background information concerning the related parties (e.g., physical location, industry, number of employees); the nature of any relationships, including ownership structure, between the company and each related party; the types of transactions entered into with each related party during the period under audit and the terms and business purposes (or the lack thereof) of each type of transaction; the business reasons for entering into a transaction with a related party versus an unrelated party; and any significant related party transactions (i) that have not been authorized and approved in accordance with the company's established policies and procedures regarding the authorization and approval of transactions with related parties and (ii) for which exceptions to the company's established policies or procedures were granted.

Paragraph 7 of the proposed standard would extend the inquiries in paragraph 6 to other individuals within the company. Paragraph 7 would require the auditor to identify others within the company to whom those inquiries should be directed and determine the extent of such inquiries by considering whether such individuals are likely to have additional knowledge regarding (i) the company's related parties or relationships or transactions with related parties and (ii) the company's controls over relationships or transactions with related parties. The auditor also should consider whether such individuals are likely to have knowledge of related parties or relationships or transactions with related parties previously undisclosed to the auditor. Paragraph 7 states that examples of such individuals include, but are not limited to:

- a. Personnel in a position to initiate, process, or record transactions with related parties and those who supervise or monitor such personnel;
- b. Internal auditors;
- c. In-house legal counsel;
- d. The chief compliance/ethics officer or person in equivalent position; and
- e. The human resource director or person in equivalent position.

The requirements in paragraphs 6 and 7 of the proposed standard could assist the auditor in obtaining a sufficient understanding of the company's relationships and transactions with related parties to identify and assess risks of material misstatement.

Paragraph 8 of the proposed standard would require that the auditor 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<sup>9/</sup> has particular concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

The inquiries in paragraph 8 could be performed at the same time as the inquiries of the audit committee, or its chair, about the risks of material misstatement, including fraud risks, required by paragraphs 54 and 56.b. of Auditing Standard No. 12.<sup>10/</sup> These inquiries also could provide an opportunity for the auditor to discuss 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 financial relationships and transactions with its executive officers as discussed in Section III.A. of this release.

*Communications with the Audit Engagement Team and Other Auditors (paragraphs 9-10 of Appendix 1)*

Paragraph 9 of the proposed standard would require the auditor to communicate to the engagement team members relevant information about related parties, including the names of the related parties and the nature of the company's relationships with those related parties. Communicating such information might increase the engagement team's opportunity to identify related parties or relationships or transactions with related parties previously undisclosed to the auditor and to evaluate their effect on the financial statements. Effective two-way communication among the engagement team members also might highlight evidence that corroborates or contradicts information provided by management about relationships and transactions with related parties. Additionally, effective communications could enhance the auditor's understanding of the business purpose and terms of related party transactions.

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<sup>9/</sup> See Appendix A to the proposed auditing standard, *Communications with Audit Committees*, for the definition of audit committee; see PCAOB Release No. 2011-008 (December 20, 2011).

<sup>10/</sup> Paragraph 8 of the proposed auditing standard, *Communications with Audit Committees*, also requires the auditor to make certain inquiries of the audit committee; see PCAOB Release No. 2011-008 (December 20, 2011).



The requirement in paragraph 9 of the proposed standard would complement the requirement in paragraph 49 of Auditing Standard No. 12 that key engagement team members discuss the potential for material misstatement due to error or fraud. That discussion, in part, includes: (1) the susceptibility of the company's financial statement to material misstatement due to fraud, (2) how management could perpetrate and conceal fraudulent financial reporting, and (3) how assets of the company could be misappropriated, including the susceptibility of the financial statements to material misstatement through related party transactions.<sup>11/</sup>

Examples of matters regarding related parties that the engagement team might discuss include: (a) information that could indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor, (b) sources of information that could indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor, (c) how variable-interest entities controlled by management might be used to facilitate earnings management, and (d) how transactions between the company and a known business partner of a member of management could be arranged to facilitate asset misappropriation.<sup>12/</sup> Communicating information about related parties at an early stage of the audit would benefit such discussions and should continue throughout the audit.

As described in Section III.A. of this Appendix, the other proposed amendments to PCAOB auditing standards that would require the auditor to obtain an understanding of the company's financial relationships and transactions with its executive officers also could complement the discussion required by Auditing Standard No. 12.

AU sec. 334.07.g. provides that determining the existence of undisclosed related parties or related parties and related party transactions might require inquiry of other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions. AU sec. 9334.13 states that the principal auditor and other auditor should each obtain from the other the names of known related parties and that, ordinarily, the exchange should be made at an early stage of the audit.

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<sup>11/</sup> Paragraph 52 of Auditing Standard No. 12.

<sup>12/</sup> See *also* Section II.B. of Appendix 4 of this release, for a description of transactions with a party that falls outside the definition of a related party, but where either party may be able to negotiate terms that may not be available to other, more clearly independent, parties on an arm's-length basis.

When the auditor serves as a principal auditor, paragraph 10 of the proposed standard would require that the auditor, when using the work of another auditor, communicate to the other auditor 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. This requirement applies regardless of whether the auditor is taking responsibility for the work of the other auditor. Paragraph 10 would also require the auditor to inquire 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. Exchanging relevant information can assist the principal auditor in understanding the overall nature of the company's relationships and transactions with related parties.

*Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor (paragraph 11 and Appendix A of Appendix 1)*

The existing auditing standard provides that the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and related party relationships that require disclosure in the financial statements.<sup>13/</sup> 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 of the company to the total company and consider controls over management activities. AU sec. 334.08 lists procedures for identifying undisclosed related parties or related party relationships and transactions.

Paragraph 11 of the proposed standard requires that the auditor evaluate whether information that comes to the auditor's attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Paragraph 11 further states that Appendix A describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

The proposed standard includes Appendix A to assist the auditor's identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor. Specifically, paragraph A2 of Appendix A includes examples of information that could indicate that related parties or relationships or transactions with

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<sup>13/</sup> See AU sec. 334.04.

related parties previously undisclosed to the auditor might exist.<sup>14/</sup> For example, if the auditor identifies situations where the company is buying or selling goods or services at prices that differ significantly from prevailing market prices, the auditor should evaluate whether such transactions could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. Paragraph A3 of Appendix A includes examples of sources that could contain such information. The examples of sources of information in paragraph A3 include, among other things: minutes of meetings of the board of directors; periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies; and confirmation responses and responses to inquiries of the company's lawyers.

The proposed standard would not require an auditor to review each source of information referenced in Appendix A. However, an auditor may be required to perform auditing procedures with respect to certain of those sources (e.g., reading minutes of meetings of the board of directors) by other auditing standards or through the performance of auditing procedures in other areas.<sup>15/</sup> Appendix A also states that the examples contained in that Appendix are not intended to represent a comprehensive listing.

Questions:

3. Does the proposed standard clearly articulate the auditor's responsibility for identifying related parties and obtaining an understanding of the company's relationships and transactions with related parties?

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<sup>14/</sup> As described in Section I.E., if the auditor identifies information that indicates related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, whether included in a source in Appendix A or not, the auditor should perform procedures under paragraph 16 to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Those procedures should extend beyond inquiry of management.

<sup>15/</sup> See, for example, AU sec. 560, *Subsequent Events*, AU sec. 722, *Interim Financial Information*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

4. Are the procedures for identifying related parties and obtaining an understanding of relationships and transactions with related parties appropriate?
5. Are the proposed requirements regarding the auditor's responsibility for information that comes to the auditor's attention that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist appropriate? If not, why not? Are there additional examples that should be included in Appendix A?

**D. Identifying and Assessing Risks of Material Misstatement (paragraph 12 of Appendix 1)**

Paragraph 12 of the proposed standard aligns with the foundational risk assessment requirements contained in Auditing Standard No. 12. Auditing Standard No. 12 requires that the auditor identify and assess the risks of material misstatement at the financial statement level and the assertion level.<sup>16/</sup> Paragraph 12 of the proposed standard states that this includes identifying and assessing the risks of material misstatement associated with 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, related parties might buy or sell goods or services at prices that differ significantly from prevailing market prices or offer unusual rights of returns or extended payment terms. Additionally, the substance of related party transactions might differ materially from their form. Further, related parties that operate through an extensive and complex range of relationships and structures could result in an increased level of complexity.

Under existing requirements, the auditor should determine whether any of the identified and assessed risks of material misstatement are fraud risks or other significant risks.<sup>17/</sup> 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

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<sup>16/</sup> See paragraph 59 of Auditing Standard No. 12.

<sup>17/</sup> See paragraph 59.f. of Auditing Standard No. 12.

than the company's stated power may represent a fraud risk or other significant risk, especially in the presence of fraud risk factors. 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>18/</sup>

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. The existence of dominant influence is a factor considered by auditors when assessing the risks of material misstatement. Identifying the risks of material misstatement associated with dominant influence can assist the auditor's assessment of the risks of material misstatement. Paragraph .85 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, 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.

The other proposed amendments to PCAOB auditing standards contained in Appendix 3 would amend 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.<sup>19/</sup> The other proposed amendment to AU sec. 316.85.A.2 expands that concept to encompass all related parties outside of management of the company. The proposed amendments do not define dominant influence as doing so might result in some auditors being overly focused on the definition itself instead of the "red flags" associated with dominant influence that might create risks of material misstatement at the financial statement level. Examples of factors that may signal dominant influence exerted by a related party include:

- Significant transactions are referred to the related party for approval;

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<sup>18/</sup> See AU sec. 316.85.A.2, section a., under "Opportunities."

<sup>19/</sup> Paragraph A29 of International Standards on Auditing ("ISA") 550, *Related Parties*, also describes "dominant influence" and provides examples of indicators to assist the auditor in identifying instances of dominant influence with regard to a related party. The Auditing Standards Board of the American Institute of Certified Public Accountants also has described dominant influence.

- 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 part of management or the board of directors.<sup>20/</sup>

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.

Questions:

6. Is paragraph 12 of the proposed standard appropriately aligned with the existing requirements regarding the identification and assessment of risks of material misstatement?
7. Are there other examples of fraud risks factors, in addition to dominant influence, that should be included in the proposed amendments to assist the auditor when determining whether a related party transaction is a fraud risk or other significant risk?
8. Are there particular related party transactions that should be deemed a fraud risk or other significant risk?

**E. Responding to the Risks of Material Misstatement (paragraphs 13 – 17 of Appendix 1)**

AU sec. 334.11 requires that, for each material related party transaction that requires disclosure, the auditor should consider whether he or she has obtained sufficient appropriate audit evidence to understand the related party relationship and the effects of the related party transactions on the financial statements. AU sec. 334.11 also requires the auditor to evaluate such evidence to determine whether material related party relationships and transactions have been adequately disclosed in the financial statements. Footnote 6 of AU sec. 334.09 states that "[u]ntil the auditor understands the business sense of material transactions, he cannot complete his audit." AU secs.

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<sup>20/</sup> See, for example, paragraph A29 of ISA 550, which contains similar examples.

334.09-.10 provide procedures for examining identified related party transactions. Those paragraphs direct 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.

The auditor must design and implement audit responses that address the assessed risks of material misstatement.<sup>21/</sup> Paragraph 13 of the proposed standard states that 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. Paragraph 8 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, further 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.

A note to paragraph 13 of the proposed standard states that the auditor also should look to the requirements in proposed paragraphs AU secs. 316.66-.67A for related party transactions that are also significant unusual transactions (e.g. significant related party transactions outside the normal course of business).

Existing standards state that the auditor should 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.<sup>22/</sup> Existing standards also state that regardless of whether the principal auditor decides to make reference to the audit of the other auditor, the principal auditor should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.<sup>23/</sup>

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<sup>21/</sup> See paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

<sup>22/</sup> See AU sec. 334.09.e.

<sup>23/</sup> See paragraph .10 of AU sec. 543, *Part of Audit Performed by Other Independent Auditor*, which provides that those measures may include ascertaining

Paragraph 14 of the proposed standard would require that the auditor perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

*Transactions with Related Parties Required to be Disclosed in the Financial Statements or That are a Significant Risk (paragraph 15 of Appendix 1)*

Paragraph 15 of the proposed standard includes several required procedures designed to assist in the auditor's evaluation of transactions with related parties. Specifically, paragraph 15 of the proposed standard states that for each related party transaction, or type of related party transaction, that is required to be disclosed in the financial statements by the company in the financial statements or determined to be a significant risk, the auditor should:

- a. Read the underlying documentation and determine whether the terms and business purpose (or the lack thereof) of the transaction are consistent with explanations from inquiries and from other audit evidence;
- b. Determine (i) 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 and (ii) whether any exceptions to those established policies or procedures were granted;
- c. Evaluate the financial capability of the related parties with respect to significant uncollected balances, guarantees, and other obligations, if any;<sup>24/</sup> and

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through communication with the other auditor that a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.

<sup>24/</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.



- d. Perform other procedures as appropriate, depending on the nature of the related party transaction and the related risks of material misstatement, to meet the objective of this standard.

These procedures help the auditor evaluate whether the transaction has been properly accounted for and adequately disclosed. These procedures also are necessary to evaluate the business purpose of an identified related party transaction. A business purpose that appears inconsistent with the nature of the company's business might represent a fraud risk factor.

Paragraph 15.a. requires the auditor to read the underlying documentation and determine whether the terms and business purpose (or the lack thereof) of the transaction is consistent with explanations from inquiries and from other audit evidence. This requires the auditor to evaluate appropriate information regarding the transaction, including, for example, the executed contract and consider whether the contract and other underlying documentation is consistent with explanations from inquiries of management and others. The auditor would also consider how that information compares to other available audit evidence. For example, when evaluating the responses to inquiries of management and others, the auditor could take into account information obtained from other sources, such as 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>25/</sup>

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>26/</sup> This includes designing

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<sup>25/</sup> See Securities Act Release No. 33–8732A, *Executive Compensation and Related Person Disclosure* (August 29, 2006), available at: <http://www.sec.gov/rules/final/2006/33-8732afr.pdf>. For the definition of "related person," see Instruction 1 to item 404(a) of Regulation S-K. Disclosure requirements regarding "related persons" in Regulation S-K may differ from "related party" disclosures. See Section I. of the Release, at note 2.

<sup>26/</sup> See paragraph 8 of Auditing Standard No. 13. Further, paragraph 17 of Auditing Standard No. 13 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

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. The procedures contained in paragraph 15 of the proposed standard are designed to work in conjunction with the procedures that the auditor performs during the audit to address the relevant assertions associated with each related party transaction that requires disclosure. For example, if a company makes a material purchase of property, plant and equipment from an unconsolidated related party, the auditor should obtain audit evidence that supports management's assertion regarding the existence of the asset (e.g., inspection of the asset). Further, the auditor should examine the underlying documents supporting the transfer of title and ownership to obtain audit evidence that supports management's assertion regarding its rights and obligations.

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). In these cases, the auditor would be required to test the compilation and disclosure of these transactions and the extent of the auditor's testing on the underlying transactions, consistent with the requirements of Auditing Standard No. 13, should be commensurate with the risks of material misstatement.

Existing standards require the auditor to examine identified related party transactions, and AU sec. 9334, *Related Parties: Auditing Interpretations of Section 334* notes that the higher the assessment of risk, the more extensive the audit procedures should be.<sup>27/</sup> AU sec. 9334 provides that when there is a higher risk of material misstatement, the auditor may have to, among other things, refer to audited or unaudited financial statements of the related party, apply procedures at the related party or, in some cases, audit the financial statements of the related party.<sup>28/</sup> Existing standards further state that the auditor should be aware that the substance of a particular related party transaction could be significantly different from its form and that

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auditor's reliance on the accuracy and completeness of financial information used in performing other audit procedures.

<sup>27/</sup> See paragraph .19 of AU sec. 9334.

<sup>28/</sup> *Id.*

financial statements should recognize the substance of particular transactions rather than merely their legal form.<sup>29/</sup>

Paragraph 15.d. of the proposed standard would require auditors perform other procedures as appropriate to meet the objective of the proposed standard. 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 parent may be motivated to obscure the substance of the transaction.

The economic substance of a related party transaction also may differ materially from its form. As described in Section I.F. of Appendix 4, paragraph .06 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, 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. The procedures performed pursuant to paragraph 15.d. should be designed to address 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, 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;

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<sup>29/</sup> See AU sec. 334.02.

- 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;
- Confirming whether there are any side agreements or other arrangements (either written or oral) with the related party;
- Evaluating the transferability and value of collateral provided by the related party, if any; and
- Performing procedures at the related party, if possible.

Questions:

9. Is paragraph 13 of the proposed standard appropriately aligned with the existing requirements regarding responding to the risks of material misstatement?
10. Are the procedures regarding related party transactions required to be disclosed in the financial statements, or that are a significant risk appropriate? Are there other specific procedures that should be required?

*Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor (paragraphs 16-17 and Appendix A of Appendix 1)*

Existing standards describe procedures that could assist the auditor to identify undisclosed related parties or relationships and transactions with related parties. For example, AU sec. 334.07 lists the following procedures for determining the existence of related parties:

- Reviewing filings by the reporting entity with the SEC and other regulatory agencies for the names of related parties and for other businesses in which officers and directors occupy directorship or management positions.
- Determining the names of all pension and other trusts established for the benefit of employees and the names of their officers and trustees.

- Reviewing stockholder listings of closely held companies to identify principal stockholders.

Further, AU sec. 334.08 provides the following examples of procedures 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:

- Reviewing the minutes of meetings of the board of directors and executive or operating committees for information about material transactions authorized or discussed at their meetings.
- Reviewing proxy and other material filed with the SEC and comparable data filed with other regulatory agencies for information about material transactions with related parties.
- Reviewing conflict-of-interests statements obtained by the company from its management.
- Reviewing confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.
- Reviewing confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.
- Reviewing invoices from law firms that have performed regular or special services for the company for indications of the existence of related parties or related party transactions.

As described in paragraph 13 of the proposed standard, the auditor should perform procedures to respond to identified and assessed risks of related parties or relationships or transactions with related parties previously undisclosed to the auditor. Information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist might be found in evidence that is normally obtained during the course of an audit. As described earlier, to assist auditors in identifying information that could indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor, examples of information and sources contained in the existing standard have been included in Appendix A to the proposed standard. For example, Appendix A lists the following sources of information that could indicate that related parties or

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

- Minutes of meetings of the board of directors.
- Periodic and current reports, proxy statements and other relevant company filings with the SEC and other regulatory agencies.
- Conflicts-of-interests statements from management and others.
- Confirmation responses and responses to inquiries of the company's lawyers.
- Invoices and correspondence received from the company's professional advisors, for example, attorneys and consulting firms.
- 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.
- Shareholder registers that identify the company's principal shareholders.

Existing standards require that the auditor respond to the assessed risks of material misstatement due to related parties or relationships or transactions with related parties previously undisclosed to the auditor, including significant risks.<sup>30/</sup> Existing standards also describe procedures that could identify undisclosed related parties or relationships and transactions with related parties.<sup>31/</sup>

Paragraph 3 of the proposed standard requires the auditor to identify likely sources of material misstatement in the financial statements that may arise from the company's relationships and transactions with related parties, including related parties or relationships or transactions with related parties previously undisclosed to the auditor. Consistent with the requirements of Auditing Standard No. 13, the extent of the auditor's response should be commensurate with the risks of material misstatement. Based upon the auditor's assessment, the auditor should design and perform

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<sup>30/</sup> See paragraph 3 of Auditing Standard No. 13.

<sup>31/</sup> See, for example, AU secs. 334.07-.08.

procedures to identify information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist.

The determination that either related parties or relationships or transactions with related parties previously undisclosed to the auditor exist may have a significant impact on other areas of the audit, including the auditor's evaluation of the integrity of management and the company's internal control over financial reporting.

Paragraph 16 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 procedures to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Paragraph 16 also requires that these procedures should extend beyond inquiry of management. A footnote to paragraph 16 refers the auditor to paragraph 29 of Auditing Standard No. 15, *Audit Evidence*, 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.

If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, paragraph 17 of the proposed standard would require the auditor to, among other things: (1) inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor, including regarding the possible existence of other transactions with the related party previously undisclosed to the auditor; (2) determine why the related party or relationship or transaction with the related party was not previously disclosed to the auditor; (3) promptly communicate to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationships or transactions with the related party; (4) assess the need to perform additional procedures to identify additional relationships or transactions with the related party previously undisclosed to the auditor; and (5) perform the procedures required by paragraph 15 of the proposed standard, treating the related party transaction as a significant risk.

Additionally, paragraph 17 of the proposed standard requires the auditor to: (1) evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable; (2) reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and (3) 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. Paragraph 17 further states that if the auditor determines that it is likely that an illegal act has or may have occurred, the auditor should perform the procedures required by AU sec. 316, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934 ("Exchange Act").<sup>32/</sup>

Questions:

11. Are the requirements in paragraph 16 of the proposed standard appropriate concerning the auditor's responsibilities regarding information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist?
12. Are the requirements in paragraph 17 appropriate regarding the identification of related parties or relationships or transactions with related parties previously undisclosed to the auditor?

**F. Evaluating Financial Statement Accounting and Disclosures (paragraphs 18-19 of Appendix 1)**

AU sec. 334.11 requires the auditor to consider whether sufficient appropriate evidence has been obtained to understand each related party relationship, as well as the effect on the financial statements of each material related party transaction. 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." The existing standard further states that the auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure.<sup>33/</sup>

Paragraph 18 of the proposed standard states that 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. This includes evaluating whether the financial statements contain the information regarding related party transactions essential for a fair presentation in conformity with the applicable financial reporting framework. A footnote to paragraph 18 states that

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<sup>32/</sup> See 15 U.S.C. §78j-1(b).

<sup>33/</sup> See AU sec. 334.02.



there is an existing requirement in Auditing Standard No. 14 regarding the auditor's evaluation of the company's financial statement accounting and disclosures regarding related parties and relationships and transactions with related parties. The auditor's evaluation under paragraph 18 would apply to each related party transaction that requires disclosure. In addition, the auditor would evaluate the results of audit procedures performed on intercompany account balances pursuant to paragraph 14 of the proposed standard.

Transactions with related parties, like all transactions, are subject to the requirements contained in paragraph .06 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. That standard requires that the auditor consider whether the substance of the transaction differs materially from its form when evaluating whether the financial statements have been presented fairly in accordance with the applicable financial reporting framework. The proposed 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.

Question:

13. Are the requirements in the proposed standard regarding the auditor's evaluation of the company's financial statement accounting and disclosure of related party transactions appropriate?

*Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions (paragraph 19 of Appendix 1)*

Financial reporting frameworks allow management to assert that a related party transaction was consummated on terms equivalent to those prevailing in arm's-length transactions only when management can substantiate that assertion.<sup>34/</sup> However, those financial reporting frameworks do not discuss what information is required to substantiate such an assertion or how management is to determine the terms and

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<sup>34/</sup> See FASB ASC paragraph 850-10-50-5. Paragraph 23 of IAS 24 also states that disclosures "that related party transactions were made on terms equivalent to those that prevail in arm's length transactions are made only if such terms can be substantiated."

conditions that would prevail in an arm's-length exchange, including for example, whether there would be a guarantee or an extension of credit.

Paragraph 19 of the proposed standard requires that the auditor determine whether the evidence obtained supports or contradicts management's assertion. Paragraph 19 also states that 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>35/</sup>

A note to paragraph 19 informs auditors that, 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 assertions that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. The note to paragraph 19 also retains the discussion contained in AU secs. 9334.22-.23 that a preface to an assertion such as "management believes that" or "it is the company's belief that" does not change the auditor's responsibilities to substantiate representations that the transaction terms are equivalent to terms in arms-length transactions.

Appendix 3 of this release contains proposed amendments to AU sec. 333, *Management Representations*, which also would 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.

Question:

14. Are the proposed requirements for substantiating management assertions that a related party transaction was consummated on terms equivalent to those prevailing in arm's-length transactions appropriate? If not, what other requirements are appropriate?

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<sup>35/</sup> 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 impact the auditor's assessment of internal control over financial reporting.

**G. Communications with the Audit Committee (paragraph 20 of Appendix 1)**

Paragraph 20 of the proposed standard would require that the auditor communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. Paragraph 20 also would require the auditor to 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 (i) that have not been authorized or approved in accordance with the company's established policies or procedures and (ii) for which exceptions to the company's established policies or procedures were granted;
- c. 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 such assertions; and
- d. The identification of significant related party transactions that appear to the auditor to lack a business purpose.

A note to paragraph 20 states that an auditor may communicate significant matters to only the audit committee chair if done in order to communicate these matters in a timely manner during the audit. It also states that the auditor, however, should communicate significant matters to the full audit committee prior to the issuance of the auditor's report.<sup>36/</sup>

Paragraph 8 of the proposed standard would require 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 that are significant to the company and (b) whether any member of the audit committee has particular concerns regarding relationships and transactions with related parties, and, if so, the substance of those

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<sup>36/</sup> This is consistent with paragraph 25 of proposed auditing standard, *Communications with Audit Committees*, see PCAOB Release 2011-008 (December 20, 2011).

concerns. The communication required by paragraph 20 of the proposed standard would provide an opportunity for the auditor to communicate information obtained during the audit relevant to those matters. 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>37/</sup>

Question:

15. Are the requirements in the proposed standard for the auditor to communicate to the audit committee regarding relationships and transactions with related parties appropriate?

**H. Other Considerations**

Paragraph .19 of AU sec. 508, *Reports on Audited Financial Statements*, describes situations in which the auditor may emphasize a matter regarding the financial statements in a separate paragraph of the auditor's report. AU sec. 508.19 provides the example "[t]hat the entity has had significant transactions with related parties" as a matter that an auditor might wish to emphasize.<sup>38/</sup> The proposed standard would not change the auditor's responsibilities regarding the auditor's report.

Question:

16. Should the proposed standard change the auditor's responsibilities for the auditor's report regarding related party transactions? If so, how?

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<sup>37/</sup> See AU sec. 722.34.

<sup>38/</sup> Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, requires the auditor to consider the need to disclose changes in the reporting entity in the auditor's report.

**II. Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions**

As discussed in Section III.A. of the release, significant financial reporting frauds have demonstrated that companies may use significant unusual transactions such as transactions in which 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 transactions), to materially misstate their financial statements. Existing auditing standards require the auditor to consider significant unusual transactions as part of the auditor's overall consideration of fraud in an audit of financial statements.<sup>39/</sup>

The proposed amendments regarding significant unusual transactions to AU sec. 316.66 would describe significant unusual transactions as significant transactions outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature. The proposed amendments regarding significant unusual transactions would align the description contained in AU sec. 316.66 with the factor listed in paragraph 71.g. of Auditing Standard No. 12 for the auditor's evaluation in identifying whether an assessed risk of material misstatement is a significant risk. A significant unusual transaction does not necessarily need to occur infrequently. For example, a significant unusual transaction could occur quarterly or more frequently. Whether a transaction constitutes a significant unusual transaction should be based upon the specific facts and circumstances.

This section highlights the proposed amendments regarding significant unusual transactions included in Appendix 2 of this release. Both Appendix 2 and this section

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<sup>39/</sup> See AU secs. 316.66-.67. These requirements were responsive to recommendations contained in *The Panel on Audit Effectiveness Report and Recommendations* (the "PAE Report") (August 31, 2000). The PAE Report noted that "a number of cases of fraudulent financial reporting have involved...[disclosure of significant accounting policies], and the disclosed accounting policies inaccurately portrayed the entity's actual accounting policies. Accounting policy disclosures often related to industry practices or matters unique to the specific entity." See Chapter 3, "Earnings Management and Fraud" of the PAE Report, and *Public Oversight Board Staff Status Report: The Recommendations of the Panel on Audit Effectiveness, as of February 15, 2002*, available at: <http://www.pobauditpanel.org/downloads/chapter3.pdf>, and <http://www.publicoversightboard.org/StatusReport.pdf>, respectively.

have been organized as follows: (a) identifying significant unusual transactions and (b) evaluating significant unusual transactions.

**A. Identifying Significant Unusual Transactions (Section A of Appendix 2)**

The proposed amendments regarding significant unusual transactions would 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: (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).

*Inquiring of Management and Others (paragraph 56 of Auditing Standard No. 12)*<sup>40/</sup>

Existing standards require that the auditor make inquiries of management, the audit committee, and internal auditor regarding fraud risks.<sup>41/</sup> Existing standards also note examples of other individuals to whom the auditor can direct inquiries regarding fraud risks.<sup>42/</sup> The proposed amendments regarding significant unusual transactions to paragraph 56.a. of Auditing Standard No. 12 would require that the auditor inquire 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 related parties are involved. The proposed amendments regarding significant unusual transactions to paragraphs 56.b. and 56.c. of Auditing Standard No. 12 also would require the auditor to inquire of the audit committee and internal audit personnel (if applicable), respectively, regarding their knowledge of whether the company has entered into any significant unusual transactions.

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<sup>40/</sup> The paragraph references in this section relate to the provisions of the proposed amendments contained in Appendix 2.

<sup>41/</sup> See paragraph 56 of Auditing Standard No. 12.

<sup>42/</sup> See paragraph 57 of Auditing Standard No. 12.

*Obtaining an Understanding of the Methods Used to Account for Significant Unusual Transactions (paragraph 13 of Auditing Standard No. 12)*

Existing standards also require the auditor to obtain an understanding of the company and its environment, including the company's selection and application of accounting principles, including related disclosures.<sup>43/</sup> Existing standards note that the methods the company uses to account for significant and unusual transactions are relevant to the necessary understanding of the company's selection and application of accounting principles, including related disclosures.<sup>44/</sup> The proposed amendments regarding significant unusual transactions to paragraph 13 of Auditing Standard No. 12 would replace the reference to "significant and unusual transactions" with a reference to "significant unusual transactions" as used in AU secs. 316.66-.67A.

*Obtaining an Understanding of Internal Control over Financial Reporting (paragraph 73A of Auditing Standard No. 12)*

Existing standards require that the auditor obtain a sufficient 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.<sup>45/</sup>

The proposed amendments regarding significant unusual transactions would add paragraph 73A to Auditing Standard No. 12 and would require the auditor to obtain an understanding of the controls that management has established to identify, authorize and approve, and account for and disclose, significant unusual transactions. Obtaining an understanding of internal control over financial reporting includes evaluating the design of controls relevant to the audit and determining whether those controls have been implemented.<sup>46/</sup>

In addition, the proposed amendments regarding significant unusual transactions to Auditing Standard No. 5, *An Audit of Internal Control That Is Integrated with An Audit*

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<sup>43/</sup> See paragraph 7.c. of Auditing Standard No. 12.

<sup>44/</sup> See paragraph 13 of Auditing Standard No. 12.

<sup>45/</sup> See paragraph 18 of Auditing Standard No. 12.

<sup>46/</sup> See paragraph 20 of Auditing Standard No. 12.

of *Financial Statements*, would replace the reference to "significant, unusual transactions" with a reference to "significant unusual transactions" as used in AU secs. 316.66-.67A.

*Other Information Obtained During the Audit*

As described above, the proposed amendments regarding significant unusual transactions would add a note to AU sec. 316.66 which states that the auditor's identification of significant unusual transactions should take into account information obtained through risk assessment and other procedures performed during an audit. Examples of those procedures include:

- a. Reading minutes of meetings of the board of directors and its committees;<sup>47/</sup>
- b. Reading periodic and current reports, including Forms 8-K, and other relevant company filings with the SEC and other regulatory agencies;<sup>48/</sup>
- c. Inspecting confirmation responses and responses to inquiries of the company's lawyers;<sup>49/</sup>
- d. 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>50/</sup>
- e. Performing analytical procedures during the audit;<sup>51/</sup> and

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<sup>47/</sup> See AU sec. 560.12.c and AU sec. 722.18.a.

<sup>48/</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>49/</sup> See paragraph .06 of AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

<sup>50/</sup> See paragraph 7.c. of Auditing Standard No. 12.

<sup>51/</sup> See paragraphs 46-48 of Auditing Standard No. 12.



- f. 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>52/</sup>

Also, the auditor might identify significant unusual transactions when performing other audit procedures. 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 the unusually high concentration of transactions during a given time period.

As described in section I.C. of this Appendix, Appendix A to the proposed standard includes examples of information 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.

In addition, the proposed amendments regarding significant unusual transactions would amend certain examples of fraud risk factors contained in AU sec. 316 that are relevant to significant unusual transactions. For example, AU sec. 316 notes that the nature of the industry or the company's operations provides opportunities to engage in fraudulent financial reporting that can arise from significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm. The proposed amendments to AU sec. 316.85 regarding significant unusual transactions would amend that example to consist of two separate examples: (1) related party transactions that are also significant unusual transactions (e.g., a significant related party transaction outside the normal course of business) and (2) significant transactions with related parties whose financial statements are not audited or are audited by another firm.

As discussed in Section III.A. of this Appendix, the Board also has proposed an amendment to AU sec. 315, *Communications Between Predecessor and Successor Auditors*, that would require inquiry of the predecessor auditor regarding significant unusual transactions and indicate that the successor auditor's review of documentation includes documentation regarding significant unusual transactions.

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<sup>52/</sup> See AU secs. 316.58-.62.

Question:

17. Are the proposed amendments regarding the auditor's identification of significant unusual transactions appropriate? If not, why not?

**B. Evaluating Significant Unusual Transactions (Section B of Appendix 2)**

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

- The form of such transactions is overly complex;
- Management has discussed the nature of and recording of such transactions with the audit committee or board of directors;
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction;
- Transactions that involve unconsolidated related parties, including special purpose entities, have been properly reviewed and approved by the audit committee or board of directors; and
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

The proposed amendments regarding significant unusual transactions would build on the existing requirements of AU secs. 316.66-.67 to enhance the auditor's evaluation of significant unusual transactions. The proposed amendments regarding significant unusual transactions are designed to address the unique nature of such transactions. The proposed amendments regarding significant unusual transactions include a new paragraph .66A to AU sec. 316 that would require the auditor to design and perform procedures that are specifically responsive to and address the assessed

risks of material misstatement associated with significant unusual transactions.<sup>53/</sup> This amendment would require that the auditor design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction by performing the following procedures:

- a. Reading the underlying documentation and determining whether the terms and business purpose (or the lack thereof) of the transaction are consistent with explanations from inquiries and other audit evidence;
- 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, guarantees, and other obligations, if any; and
- d. Performing other procedures as appropriate, depending on the nature of the transaction and the risks of material misstatement, to obtain an understanding of the business purpose (or the lack thereof) of the significant unusual transaction.

As described in Section I.E. of this Appendix, 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>54/</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 proposed AU sec. 316.66A are designed to work in conjunction with the procedures that the auditor performs during the audit to address the relevant assertions associated with each significant unusual transaction.

The proposed amendments regarding significant unusual transactions also would require auditors to design and perform any additional procedures that are appropriate to obtain an understanding of the business purpose (or the lack thereof) of the significant unusual transaction. Those procedures would be based on the facts and circumstances regarding the significant unusual transaction. These additional procedures should: (1)

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<sup>53/</sup> See paragraph 3 of Auditing Standard No. 13.

<sup>54/</sup> See paragraph 8 of Auditing Standard No. 13.

address the assessed risks of material misstatement; (2) 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 (3) 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 proposed amendments regarding significant unusual transactions to AU sec. 316.67 require the auditor to evaluate certain matters when determining 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 conceal misappropriations of assets. The proposed amendments to AU sec 316.67, however, include additional matters that the auditor should evaluate, including whether:

- 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.<sup>55/</sup>
- The company's accounting for the transaction enables the company to achieve certain financial targets.

These additional matters have been added to assist in the auditor's evaluation of whether the business purpose (or the lack thereof) indicates that the transaction may have been entered into to commit fraudulent financial reporting or misappropriate 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

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<sup>55/</sup> In December 2001, certain member firms of the accounting profession petitioned the SEC for rulemaking and requested required disclosure in the Management's Discussion and Analysis ("MD&A") section of SEC filings of relationships that fall outside the definition of a related party but represent non-arm's-length transactions. See *Petition to U.S. Securities and Exchange Commission for Issuance of Interpretive Release* (December 31, 2001) available at: <http://www.sec.gov/rules/petitions/petndiscl-12312001.htm>. The petition noted the "lack of transparent disclosure about transactions with unconsolidated entities and other parties where that information appeared necessary to understand how significant aspects of the business were conducted." In response, the SEC issued *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations*, which generally requires companies to consider the need for disclosure in the MD&A of arrangements and relationships that fall outside of the definition of "related parties," but with whom the company has a relationship that enables either party to negotiate terms of material transactions that may not be available for other, more clearly independent, parties on an arm's-length basis. See Securities Act Release No. 33-8056 (January 22, 2002), available at: <http://www.sec.gov/rules/other/33-8056.htm>.

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.

Paragraph .67A of the proposed amendments regarding significant unusual transactions to AU sec. 316 states that according to paragraph 30 of Auditing Standard No. 14 the auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. 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.

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 misstatements that could result from significant unusual transactions in designing and performing the procedures, including procedures performed pursuant to the proposed amendments to AU secs. 316.66-67A. The proposed amendments regarding significant unusual transactions would also amend Auditing Standard No. 13 by adding paragraph 11A to remind auditors of this when responding to risks associated with significant unusual transactions.

The Board has proposed an auditing standard, *Communications with Audit Committees*, that would supersede the existing standard AU sec. 380, *Communication with Audit Committees*.<sup>56/</sup> If adopted by the Board and approved by the Commission, that proposed standard would include a requirement for the auditor to communicate to the audit committee significant transactions, of which the auditor is aware, 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, including the auditor's understanding of the business rationale for such transactions. This proposed communication addresses the auditor's existing requirements in AU secs. 316.66-.67. The proposed amendments regarding significant unusual transactions would amend AU secs. 316.66-.67. The Board anticipates that if, at the conclusion of rulemaking regarding significant unusual

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<sup>56/</sup> See PCAOB Release No. 2011-008 (December 20, 2011).

transactions, the Board adopts, and the Commission approves, the proposed amendments regarding significant unusual transactions, those amendments would include any corresponding changes to the proposed standard, *Communications with Audit Committees*, that may be appropriate to match the communication requirements with the underlying procedures.

Question:

18. Are the proposed amendments regarding the auditor's evaluation of significant unusual transactions appropriate? If not, why not?

**III. Other Proposed Amendments to PCAOB Auditing Standards**

The following sections describe certain of the other proposed amendments to PCAOB Auditing Standards included in Appendix 3. The headings in this section correspond to the headings in Appendix 3.

**A. *Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Appendix 3)***

Understanding the financial relationships and transactions that a company has with its executive officers, including executive compensation, perquisites, and other arrangements, can assist the auditor in identifying conditions (including incentives and pressures) that could result in risks of material misstatement, including fraud risks.<sup>57/</sup> Further, obtaining an understanding of a company's financial relationships and transactions with its executive officers can assist in the identification of information that indicates the existence of related party relationships or transactions previously undisclosed to the auditor.

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<sup>57/</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 (a) significant financial interests in the entity or (b) 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 (c) personal guarantees of debts of the entity.

Existing standards require the auditor to consider risks of material misstatement associated with a company's financial relationship with its senior management. Paragraph 11 of Auditing Standard No. 12 states that as part of obtaining an understanding of the company the auditor should consider obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements and special bonuses. The proposed amendments would enhance existing requirements by requiring the auditor to perform certain procedures necessary to obtain an understanding of the company's financial relationships and transactions with its executive officers.

Paragraph 10A of the proposed amendments to Auditing Standard No. 12 would require the auditor to obtain an understanding of the company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements). Paragraph 10A would require the auditor to perform procedures designed to identify risks of material misstatement related to the company's financial relationships and transactions with its executive officers. Those procedures should be sufficient to identify whether these financial relationships and transactions could create conditions (e.g., incentives and pressures) that result in risks of material misstatement, including fraud risks. The auditor should perform procedures that include, but are not limited to:

- Reading employment and compensation contracts; and
- Reading 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.<sup>58/</sup>

The proposed amendments would define the term "executive officer" in Appendix A to Auditing Standard No. 12. The proposed definition is based on the SEC definition of an executive officer in Rule 3b-7 under the Exchange Act and a list in Schedule A of Form BD. The proposed amendments to Auditing Standard No. 12 would define an executive officer as:

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<sup>58/</sup> The auditor also might read the company's proxy statements and other relevant SEC company filings in meeting the requirements of paragraph 11 of Auditing Standard No. 12, which requires that the auditor consider reading public information regarding the company.



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.)

The proposed amendments would not change the existing requirement to consider obtaining an understanding of compensation arrangements with senior management. The population for the proposed procedures required by paragraph 10A is the list of executive officers disclosed in the securities filing or the executive officers included on Schedule A of Form BD.<sup>59/</sup> The existing requirement in paragraph 11 of Auditing Standard No. 12 applies to a larger population than just a company's executive officers.

Understanding how a company has structured its compensation for executive officers can assist the auditor in understanding whether such compensation arrangements affect the assessment of the risks of material misstatement.<sup>60/</sup> For example, the auditor could consider whether the company's internal control over financial reporting is designed and operating to address risks that management might seek accounting results that boost its compensation. This understanding could also assist the auditor in determining areas where management bias might occur (e.g., certain accounting estimates, including fair value measurements.) The auditor could inquire of the audit committee, or its chair, regarding its views on executive officer

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<sup>59/</sup> See Item 401(b) of Regulation S-K and Schedule A of Form BD.

<sup>60/</sup> According to a May 2010 academic study that examined in detail SEC accounting and auditing enforcement releases from 1997 to 2008, the chief executive officer or chief financial officer was named in 89 percent of the enforcement actions involving fraudulent financial reporting. See M. Beasley, J. Carcello, D. Hermanson, and T. Neal, "*Fraudulent Financial Reporting 1998-2007 An Analysis of U.S. Public Companies*," available at [http://www.coso.org/documents/COSOFRAUDSTUDY2010\\_001.pdf](http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf).

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.

Obtaining an understanding of how the company has structured its compensation for its executive officers can assist the auditor in identifying fraud risks. Paragraph 7 of the proposed standard directs the auditor to identify others within the company to whom inquiries could be made regarding related parties. Paragraph 7.e. of the proposed standard states that the human resource director or person in an equivalent position, is an example of an individual likely to have knowledge of the company's related parties or relationships and transactions with related parties or the company's controls over relationships or transactions with related parties. This inquiry also could provide an opportunity for the auditor to obtain an understanding of the company's financial relationship and transactions with its executive officers and how that relationship could create conditions that could result in risks of material misstatement, including fraud risks.

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 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), 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.

Obtaining an understanding of a company's financial relationships and transactions with its executive officers also would complement the requirement in paragraph 52 of Auditing Standard No. 12 that key engagement team members discuss the potential for material misstatement due to fraud, including consideration of the known external and internal factors affecting the company that might create incentives or pressures for management and others to commit fraud.

The proposed amendment also would amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider inquiring of the chair of the compensation committee, or its 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. An auditor performing this inquiry could take into

account other available audit evidence, such as disclosures in SEC filings that (1) describe the company's compensation policies and practices that present material risks to the company<sup>61/</sup> and (2) disclose fees paid to compensation consultants, in certain circumstances.<sup>62/</sup>

The proposed amendments also would amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider obtaining an understanding of controls over the authorization and approval of executive officer expense reimbursements, and its effect on the risk of material misstatement of the financial statements. 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 for the auditor to inspect executive officer expense reimbursement documentation for unusual items.

These proposed audit procedures are not intended to call into question the policies and procedures of the company, but rather to assist the auditor in identifying and assessing risks associated with a company's financial relationships and transactions with its executive officers, including unrecognized compensation, illegal acts, or other matters (e.g., self-dealing or other conflicts of interest). If present, these conditions may call into question the integrity of the management 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.

**B. AU sec. 315, *Communications Between Predecessor and Successor Auditors* (Appendix 3)**

Existing standards note that determining the existence of relationships with related parties requires the application of audit procedures which may include inquiring of predecessor, principal, or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in

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<sup>61/</sup> 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>.

<sup>62/</sup> See Item 407(e)(3)(iii) of Regulation S-K.

material transactions.<sup>63/</sup> The proposed standard would amend paragraph .09 of AU sec. 315 to require inquiry of the predecessor auditor's understanding of the company's regarding relationships and transactions with related parties and significant unusual transactions. The proposed standard also would amend paragraph .11 to include in the successor auditor's review of the predecessor auditor's working papers documentation regarding relationships and transactions with related parties and significant unusual transactions.

**C. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (Appendix 3)**

Emphasizing 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. The proposed amendments would amend AU sec. 316 by expanding the discussion in the standard regarding certain requirements contained in Section 10A of the Exchange Act. The proposed amendments would 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.

**D. AU sec. 333, *Management Representations* (Appendix 3)**

AU sec. 333, *Management Representations*, 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. AU sec. 333 requires the auditor to obtain a representation regarding the recognition, measurement, and disclosure of related party transactions.

The proposed standard would amend AU sec. 333.06 to 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 proposed standard also would amend AU sec. 333.06 to require the 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.

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<sup>63/</sup> See AU sec. 334.07.g. and AU secs. 9334.12-.13.

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 proposed standard also would amend AU sec. 333 to 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 proposed requirement would complement the auditor's evaluation, required by paragraph 19 of the proposed 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.

**E. AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543* (Appendix 3)**

Existing standards note that determining the existence of relationships with related parties requires the application of audit procedures which may include inquiring of predecessor, principal, or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions.<sup>64/</sup> The other proposed amendments to PCAOB auditing standards would amend paragraph .05 of AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543*, to remove the reference to AU sec. 334 and require that, before issuing his or her report, the other auditor inquire of the principal auditor as to matters significant to the audit. Those matters include 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. This proposed amendment would align the requirements in AU sec. 9543 with similar requirements for a principal auditor included in paragraph 11 of the proposed standard.

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<sup>64/</sup> *Id.*

**F. AU sec. 722, *Interim Financial Information* (Appendix 3)**

AU sec. 722, *Interim Financial Information*, 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. The proposed amendments would amend AU sec. 722 to be consistent with the proposed amendments to AU sec. 333 and would require the auditor to obtain written representations each interim period (i) that management has disclosed to the auditor the names of the company's related parties and all relationships and transactions with related parties and (ii) that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. In addition, the proposed amendments would require the auditor to obtain written representations for any assertion by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction.

Questions:

19. Are the proposed amendments to Auditing Standard No. 12 regarding a company's financial relationships and transactions with its executive officers appropriate? If not, why not?
20. Are the other proposed amendments to PCAOB auditing standards appropriate? If not, why not?

**IV. Audits of Brokers and Dealers**

As described in section IV of the release, the Dodd-Frank Wall Street Reform and Consumer Protection Act gave the Board oversight of the audits of brokers and dealers registered with the SEC. The proposed standard and the proposed amendments would be applicable for all audits performed in accordance with PCAOB standards. The Board requests comments from auditors of brokers and dealers and others on the proposed standard and the proposed amendments.

Questions:

21. Are the proposed standard and proposed amendments appropriate for audits of brokers and dealers? If not, why not?
22. Are there additional procedures specific to audits of brokers and dealers that should be included in the proposed standard and proposed amendments?

23. Should the auditor's communications to audit committees included in the proposed standard be applicable to audits of brokers and dealers? If not, provide examples and explanations for why the communication requirement should not be applicable for audits of brokers and dealers.

**V. Effective Date**

The proposed standard and proposed amendments are intended to improve the conduct of audits in areas of increased risk in order to provide greater investor protection. Given the importance of the proposed standard and proposed amendments to improved audits and greater investor protection, the Board anticipates that the proposed standard and proposed amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2012. The Board requests comments on the feasibility of this date.

**Questions:**

24. Is the Board's anticipated effective date appropriate?
25. Does the proposed effective date allow sufficient time for firms to incorporate the new requirements into their methodology, guidance and audit programs, and training for staff?

**Appendix 5 – Comparison of the Objectives and Requirements of the Proposed Standard and Proposed Amendments 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**

This appendix compares the objectives and certain key requirements of the proposed standard and proposed amendments with the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA").

The analogous standards of the IAASB discussed in this comparison include:

- International Standard on Auditing 550, *Related Parties* ("ISA 550");
- 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 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 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 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>1/</sup>

This comparison is organized in the following sections: (1) the proposed standard, (2) the proposed amendments regarding significant unusual transactions, and (3) the other proposed amendments to PCAOB auditing standards.<sup>2/</sup> This comparison does not cover the application and explanatory material in the analogous standards of the IAASB or ASB.<sup>3/</sup>

This appendix is provided for informational purposes only. It is not a summary of or substitute for the proposed standard in Appendix 1 or the proposed amendments in

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<sup>1/</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. See <http://www.aicpa.org/InterestAreas/FRC/AuditAttest/Pages/DescriptionofClarifiedSASs.aspx>.

<sup>2/</sup> This comparison does not cover the foundational requirements contained in the Board's risk assessment standards. Appendix 11 of PCAOB Release 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 those standards with the analogous standards of the IAASB and the ASB.

<sup>3/</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."

Appendices 2 and 3 of this release. This comparison may not represent the views of the IAASB or the ASB regarding the interpretations of their standards.

**I. Proposed Auditing Standard, Related Parties (Appendix 1)**

**A. Introduction (paragraph 1 of Appendix 1)**

PCAOB

The proposed standard refers auditors to the requirements of the U.S Securities and Exchange Commission ("SEC") for the company under audit with respect to the accounting principles applicable to that company, including the definition of related parties, and the financial statement disclosure requirements with respect to related parties. The proposed standard does not include definitions that might represent accounting guidance, including 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.

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 a related party as 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.

**B. Objective (paragraph 2 of Appendix 1)**

PCAOB

Paragraph 2 of the proposed 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

AU-C Section 550 contains a similar objective to the objective in ISA 550 for fair presentation frameworks.

**C. Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions with Related Parties (paragraphs 3 – 11 of Appendix 1)**

PCAOB

Paragraph 3 of the proposed standard would require the auditor 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 (or the lack thereof) of the types of transactions involving related parties. Paragraph 3 includes a requirement that the procedures performed should be designed to identify likely sources of potential material misstatements in the financial statements that may arise from the company's relationships and transactions with related parties, including related parties or relationships or transactions with related parties previously undisclosed to the auditor.

Paragraph 4 of the proposed standard states that, in identifying related parties and obtaining an understanding of relationships and transactions with related parties, the auditor should take into account information obtained from the performance of risk assessment procedures (e.g., obtaining an understanding of the company and its environment, performing analytical procedures, and conducting a discussion among engagement team members regarding the risks of material misstatement) required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

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.

*Performing Inquiries (paragraphs 6 – 8 of Appendix 1)*

PCAOB

Paragraph 6 of the proposed standard would require 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 (e.g., physical location, industry, number of employees);
- c. The nature of any relationships, including ownership structure, between the company and each related party;
- d. The types of transactions entered into with each related party during the period under audit and the terms and business purposes (or the lack thereof) of each type of transaction;
- e. The business reasons for entering into a transaction with a related party versus an unrelated party; and
- f. Any significant related party transactions (i) 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 (ii) for which exceptions to the company's established policies or procedures were granted.

Paragraph 7 of the proposed standard would require the auditor to identify others within the company to whom inquiries regarding related parties should be directed and determine the extent of such inquiries by considering whether such individuals are likely to have additional knowledge regarding (i) the company's related parties or relationships or transactions with related parties and (ii) the company's controls over relationships and transactions with related parties. Paragraph 7 would also require the auditor to consider whether such individuals are likely to have knowledge of related parties, or relationships or transactions with related parties previously undisclosed to the auditor.

Paragraph 8 of the proposed standard would require 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 members of the audit committee has particular 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

AU-C Section 550 contains similar requirements to those in ISA 550.

*Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor (paragraph 11 and Appendix A of Appendix 1)*

#### PCAOB

Paragraph 11 of the proposed standard requires the auditor to evaluate whether information that comes to the auditor's attention during the audit indicates that related parties or relationships or transactions with related parties previously undisclosed to the

auditor might exist. Appendix A of the proposed standard describes examples of information and sources of information that could indicate that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist. As described in section I.C. of Appendix 4, other PCAOB auditing standards might impose requirements relating to the sources of information included in Appendix A (e.g., reading bank and legal confirmations and minutes of meetings of the board of directors of the company).

IAASB

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 existences 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.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

**D. Identifying and Assessing Risks of Material Misstatement (paragraph 12 of Appendix 1)**

PCAOB

Paragraph 12 of the proposed 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 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 should be evaluated by the auditor in determining which risks are significant risks. Those factors include: (1) whether the risk involves significant transactions with related parties, (2) whether the risk involves

significant transactions that are outside the normal course of business and (3) whether the risk is a fraud risk. The proposed amendments to AU sec. 316.85.A2. 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.

IAASB and ASB

ISA 550 and 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.

**E. Responding to the Risks of Material Misstatement (paragraphs 13-17 of Appendix 1)**

PCAOB

Paragraph 13 of the proposed standard aligns with existing requirements that the auditor must design and implement audit responses that address the assessed risks of material misstatement. Paragraph 13 states that 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.

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

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 That Are a Significant Risk (Paragraph 15 of Appendix 1)*

PCAOB

Paragraph 15 of the proposed standard requires that for each related party transaction, or type of 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 determine whether the terms and business purpose (or the lack thereof) of the transaction are consistent with explanations from inquiries and from other audit evidence;
- b. Determine (i) 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 and (ii) whether any exceptions to those established policies or procedures were granted;
- c. Evaluate the financial capability of the other parties with respect to significant uncollected balances, guarantees, and other obligations, if any; and
- d. Perform other procedures as appropriate, depending on the nature of the related party transaction and related risks of material misstatement, to meet the objective of this standard.

IAASB

Paragraph 23 of ISA 550 requires that for identified significant related party transactions outside the entity's normal course of business, the auditor should:

- 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

AU-C Section 550 contains similar requirements to those in ISA 550.

*Related Parties or Relationships or Transactions with Related Parties Previously Undisclosed to the Auditor (paragraphs 16 – 17 of Appendix 1)*

PCAOB

Paragraph 16 of the proposed 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 procedures to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. Paragraph 16 states that those procedures should extend beyond inquiry of management.

Paragraph 17 of the proposed standard describes the required procedures that the auditor should perform if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists:

- 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. Determine 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 relationships or transactions with the related party;

- d. Assess the need to perform procedures to identify additional relationships or transactions with the related parties previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph 15 of this standard, treating the related party transaction as a significant risk;
- f. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
- g. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk; and
- h. 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 determines that it is likely that an illegal act has or may have occurred, the auditor should perform the appropriate procedures, including those required by AU sec. 316, AU sec. 317, *Illegal Acts by Clients*, and Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(b).

IAASB

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 should:

- 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 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.
- e. Evaluate the implications for the audit if the nondisclosure by management appears intentional (and, therefore, indicative of a risk of material misstatement due to fraud).

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

**F. Evaluating Financial Statement Accounting and Disclosure (paragraphs 18—19 of Appendix 1)**

PCAOB

Paragraph 18 of the proposed standard aligns with the existing requirement that the auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. Paragraph 18 states that this includes evaluating whether the financial statements contain the information regarding related party transactions 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

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 19 of Appendix 1)*

PCAOB

Paragraph 19 of the proposed 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 19 of the proposed 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

AU-C Section 550 contains similar requirements to those in ISA 550.

**G. Communications with the Audit Committee (paragraph 20 of Appendix 1)**

PCAOB

Paragraph 20 of the proposed standard requires that the auditor communicate to the audit committee, in a timely manner and prior to the issuance of the auditor's report, the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. Paragraph 20 also requires that the auditor communicate to the audit committee 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 (i) that have not been authorized or approved in accordance with the company's established policies or procedures and (ii) for which exceptions to the company's established policies or procedures were granted;
- c. 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 such assertions; and
- d. 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. ISA 550 states that an example of a significant related party matter includes difficulties in identifying the party that ultimately controls the entity.

ASB

AU-C Section 550 contains similar requirements to those in ISA 550.

**II. Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions (Appendix 2)**

**A. Identifying Significant Unusual Transactions (Section A of Appendix 2)**

PCAOB

The proposed 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 proposed amendments to paragraph 56.b. of Auditing Standard No. 12 would 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 proposed amendments to paragraph 56.c. of Auditing Standard No. 12 would require similar inquiries of internal audit.

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 proposed amendments.

**B. Evaluating Significant Unusual Transactions (Section B of Appendix 2)**

PCAOB

The proposed amendments to paragraph .66A of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* would require the auditor to design and perform procedures to obtain an understanding of the business purpose (or the lack thereof) of each significant unusual transaction. AU sec. 316.66A would require that those procedures include the following:

- a. Reading the underlying documentation and determining whether the terms and business purpose (or the lack thereof) of the transaction are consistent with explanations from inquiries and other audit evidence;
- 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, guarantees, and other obligations, if any; and
- d. Performing other procedures as appropriate, depending on the nature of the transaction and the risks of material misstatement, to obtain an understanding of the business purpose (or the lack thereof) of the significant unusual transaction.

The proposed amendments to AU sec. 316.67 would 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 to conceal misappropriation of assets. The amendments to AU sec. 316.67 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 resources to support the transaction without assistance from 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 company's accounting for 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 and accounting for the transaction with the audit committee or another committee of the board of directors or the entire board.

Further, the proposed amendments to paragraph 11A of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, would require 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 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.

#### 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. As discussed in Section I.E. of this Appendix, 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.

**III. Other Proposed Amendments to PCAOB Auditing Standards (Appendix 3)**

**A. *Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Appendix 3)***

PCAOB

The proposed amendments to paragraph 10A of Auditing Standard No. 12 would require the auditor to perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements). The procedures should be designed to identify risks of material misstatement and should include, but are not limited to (a) reading employment and compensation contracts and (b) reading 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 proposed amendments to Auditing Standard No. 12 would also include a definition of executive officer that aligns with definitions used in SEC filings.

In addition, the other proposed amendments to PCAOB auditing standards would amend paragraph 11 of Auditing Standard No. 12 to require the auditor to consider: (1) inquiring of the chair of the compensation committee, or its equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structure of the company's compensation for executive officers, and (2) 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 proposed amendments.

**B. *AU sec. 315, Communications Between Predecessor and Successor Auditors (Appendix 3)***

PCAOB

The proposed amendments to other PCAOB Auditing Standards would amend AU sec. 315, *Communications Between Predecessor and Successor Auditors*, to require the auditor to inquire of the predecessor auditor regarding the company's relationships and transactions with related parties and significant unusual transactions. The proposed amendments would also require the successor auditor to review

documentation regarding relationships and transactions with related parties and significant unusual transactions.

IAASB and ASB

ISA 510 and AU-C Section 510 do not contain similar requirements to those in the PCAOB's proposed amendments.

**C. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (Appendix 3)**

PCAOB

The proposed amendments to AU sec. 316.81A describe the auditor's 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 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. These requirements also include reports that may be required pursuant to Section 10A(b)(3) of the Securities Exchange Act of 1934 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 Securities Exchange Act of 1934, which is applicable to auditors of U.S. public companies registered with the PCAOB.

**D. AU sec. 333, *Management Representations* (Appendix 3)**

PCAOB

The proposed amendments to AU sec. 333, *Management Representations*, would 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 proposed amendments to AU sec. 333 also would 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

ISA 580, ISRE 2410, AU-C Section 580, and AU-C Section 930 do not contain similar requirements to those in the PCAOB's proposed amendments.

**E. AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543* (Appendix 3)**

PCAOB

The proposed amendments to AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543*, would provide that before issuing his or her report, the other auditor should inquire of the principal auditor as to matters significant to the audit. Those matters include 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.

Paragraph 10 of the proposed standard requires that, when the auditor serves as a principal auditor, the auditor should inquire 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. Paragraph 17.c. of the proposed standard further requires that if the auditor determines that related parties or relationships or transactions with related parties previously undisclosed to the auditor exist, the auditor 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 transactions with the related party.

IAASB

Paragraph 40 of ISA 600 provides that the group engagement team shall request the component auditor to communicate on a timely basis related parties not previously identified by group management or the group engagement team. The group engagement team shall determine whether to identify such additional related parties to other component auditors.

ASB

ISA 600 states that the two-way communication between the group auditor and the component auditor may be initiated by the component auditor regarding matters that may be significant to the component audit.

Paragraph 40 of AU-C Section 600 states that the group engagement team should request the component auditor to communicate on a timely basis related parties not previously identified by group management or the group engagement team. The group engagement team should identify such additional related parties to other component auditors.

**F. AU sec. 722, *Interim Financial Information* (Appendix 3)**

PCAOB

The proposed amendments to AU sec. 722, *Interim Financial Information*, would 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 proposed amendments to AU sec. 722 also would 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, ISA 580, and ISRE 2410 do not contain similar requirements to those in the PCAOB's proposed amendments.

ASB

AU-C Section 550, AU-C Section 580, and AU-C Section 930 do not contain similar requirements to those in the PCAOB's proposed amendments.