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Heads Up

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PCAOB Adopts New Requirements for Auditing Related Parties, Significant Unusual Transactions, and Other Matters

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On June 10, 2014, the PCAOB issued and approved AS 18,[1] a new auditing standard on related parties. AS 18 is part of a release[2] that also includes amendments to PCAOB auditing standards related to significant unusual transactions, executive compensation, and other matters (collectively referred to as the "new standard"). If approved by the SEC, the new standard would supersede PCAOB AU Sections 334[3] and 9334[4] (the "current standard") and would amend certain other PCAOB auditing standards. It would be effective for audits of fiscal years beginning on or after December 15, 2014, including reviews of interim financial information within these fiscal years.

The new standard is the result of modifications made by the PCAOB to a reproposed standard[5] (issued on May 7, 2013) on the basis of comment-letter feedback and a discussion at the May 15, 2013, Standing Advisory Group meeting.

Editor's Note: The new standard is substantially the same as the reproposed standard; however, the Board clarified and refined certain sections. The most significant clarifying changes are described in Appendix 4 of the release.

In a statement about the PCAOB's adoption of the new standard, James R. Doty, chairman of the PCAOB, noted that the "goal of this project is to improve the quality and consistency of the auditor's work to protect investors from the risk of being misled by poorly explained, or undisclosed, related party transactions and significant unusual transactions outside the normal course of business. . . . The new standard [is based on] ways to integrate the auditor's procedures related to related party and significant unusual transactions with the overall audit approach [and aligns with the] risk assessment standards."

Appendix 4 of the release contains detailed commentary about each aspect of the new standard, including (1) a discussion of its requirements, (2) a comparison with existing standards, (3) an overview of significant comments received and related Board responses, and (4) changes to the language in the reproposed standard.

[1] Auditing Standard No. 18, *Related Parties.*

[2] PCAOB Release No. 2014-002, *Auditing Standard No. 18 — Related Parties, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Amendments to PCAOB Auditing Standards.*

[3] PCAOB AU Section 334, *Related Parties.*

[4] PCAOB AU Section 9334, *Related Parties: Auditing Interpretations of Section 334.*

[5] PCAOB Release No. 2013-004, *Proposed Auditing Standard — Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Proposed Amendments to PCAOB Auditing Standards.*

This *Heads Up* gives an overview of the new standard. For a discussion of the reproposed standard and the original proposal, see Deloitte's June 21, 2013, *Heads Up* and April 10, 2012, *Heads Up*, respectively.

New Standard: Themes and Considerations

The Board expects the new standard to strengthen auditor performance regarding three critical areas that historically have been associated with increased risks of material misstatement in financial statements: (1) relationships and transactions with related parties, (2) significant unusual transactions, and (3) financial relationships and transactions with executive officers. The release points out that related-party transactions "have been contributing factors in numerous financial reporting frauds over the last several decades" and notes that such frauds have sometimes involved "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" and "a company's financial relationships and transactions with its executive officers."

The release also explains that the PCAOB's existing auditing requirements related to these areas needed to be updated "to address significant developments since their issuance." Such developments include prominent corporate scandals and reports and studies supporting the need for improved requirements to better address issues related to fraudulent financial reporting. In addition, the release notes that other standard setters have undertaken projects to improve their own requirements related to these issues. For example, the International Auditing and Assurance Standards Board and the AICPA's Auditing Standards Board updated their related-party auditing standards by issuing ISA 550[6] and AU-C Section 550[7] in 2008 and 2011, respectively.

The release explains that the PCAOB's existing auditing requirements related to these areas needed to be updated "to address significant developments since their issuance."

The purpose of the new standard is to enhance audit quality by making audit procedures more effective. The release notes that the new standard establishes "basic required procedures that are supplemented by more in-depth procedures" that would be performed on the basis of the auditor's judgment and would therefore allow the requirements to be scaled to the facts and circumstances of the audit.

The new standard carries forward much of the content from the reproposed standard. In certain circumstances, however, the Board made revisions to "clarify and refine various aspects" of the new standard. For example, the Board (1) included additional examples of others in the company to whom an auditor may direct inquiries about related parties and (2) refined the new standard to prominently emphasize that the auditor's responsibility for the identification of related parties includes testing the accuracy and completeness of the company's identification of its related parties and relationships and transactions with its related parties (taking into account information already gathered during the audit).

The new standard is discussed in greater detail below.

The appendix of this *Heads Up* lists audit procedures required under AS 18 for related parties as well as audit procedures for significant unusual transactions and company transactions with executive officers addressed by other PCAOB standards. It also identifies whether the audit procedures are new or expanded (relative to current procedures).

Editor's Note: In addition to the items discussed below, the release includes certain conforming amendments to other PCAOB standards, including management representations, subsequent events, and interim financial information.

[6] ISA 550, *Related Parties.*

[7] AICPA AU-C Section 550, *Related Parties.*

Audit Procedures Associated With Related Parties and Related-Party Transactions

The new standard adds and expands requirements intended to help auditors achieve the objective of obtaining "sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements." Many of the requirements are carried over from the original proposal and reproposed standard, and some are consistent with those in the current standard.

> **Editor's Note:** Unlike the current standard, the new standard specifies the objective of the auditor's work associated with a company's related-party relationships and transactions.
>
> The new standard uses a "framework neutral" approach regarding (1) the definition of related parties and (2) financial statement disclosure requirements (i.e., the release acknowledges that in preparing financial statements, issuers might use different financial reporting frameworks, such as U.S. GAAP or IFRSs). The new standard directs auditors to the SEC's requirements for the company under audit for the accounting principles applicable to that company, including the definition of the term "related parties," as well as the company's financial statement disclosure requirements with respect to related parties. In this regard, the new standard does not differ from the reproposed standard. However, it differs from the current standard, which refers auditors only to U.S. GAAP.

The new standard adds and expands requirements intended to help auditors achieve the objective of obtaining "sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements."

The new standard retains certain of the current standard's requirements related to procedures; however, it makes a number of key changes, including:

- *Adding basic required procedures* for auditors to respond to risks of material misstatements regarding a company's relationships and transactions with its related parties, particularly those that require disclosure in their financial statements or have been determined to be a significant risk. The current standard includes suggested procedures for the auditor's consideration and notes that not all procedures may be required in every audit.
- *Adding specific procedures* to help auditors understand the company's process; specifically, to help them understand the terms and business purposes (or the lack thereof) of related-party transactions and make inquiries of others in the company in addition to management. The current standard provides limited guidance on this.
- *Adding specific procedures* for auditors to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company. The current standard does not include this.
- *Aligning related-party procedures* with the PCAOB's risk assessment standards (issued in 2010) so that the new standard's required procedures are performed in conjunction with the auditor's overall risk assessment.
- *Improving the auditor's focus on accounting* by evaluating the adequacy of the accounting and disclosures of related-party transactions. The current standard primarily focuses on the adequacy of the disclosures.
- *Adding audit committee communications* to obtain an understanding of related-party transactions as well as to communicate the auditor's evaluation of the company's identification of, accounting for, and disclosure of related parties. The current standard does not describe communications to audit committees.
- *Emphasizing a complementary audit approach* in which auditors use information gathered throughout the audit when evaluating a company's identification of related-party transactions.

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

The new standard requires the auditor to "perform procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with [AS 12[8]]." Such procedures should include:

- "Obtaining an understanding of the company's process."
- "Performing inquiries."
- "Communicating with the audit engagement team and other auditors."

Obtaining an Understanding of the Company's Process

AS 18 requires the auditor, in conjunction with obtaining an understanding of internal control over financial reporting, to obtain an understanding of the controls that management has established to:

- "[I]dentify related parties and relationships and transactions with related parties."
- "[A]uthorize and approve transactions with related parties."
- "[A]ccount for and disclose relationships and transactions with related parties in the financial statements."

Editor's Note: These provisions differ from those in the current standard, which state that the auditor should obtain an understanding of management's responsibilities when determining the work to be performed for possible related-party transactions. Further, the current standard requires the auditor to consider controls over management activities, whereas the new standard requires the auditor to understand the controls in place specifically for the items noted above, which means that auditors will need to perform procedures to evaluate the design of such controls and determine that they have been implemented. If auditors are performing integrated audits, they will also be required to test the operating effectiveness of such controls.

This provision is unchanged from the reproposed standard.

The new standard requires the auditor to make inquiries of management about related parties and about the company's relationships and transactions with them, including the business purposes (or lack thereof) of such transactions and authorization in accordance with established policies and procedures.

Performing Inquiries

The new standard requires the auditor to make inquiries of management about related parties and about the company's relationships and transactions with them, including the business purposes (or lack thereof) of such transactions and authorization in accordance with established policies and procedures. The new standard also requires the auditor to identify others in the company to whom similar inquiries should be directed.

Finally, the auditor is required to make inquiries of the audit committee or its chair about:

- "The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company."
- "Whether any member of the audit committee has concerns regarding relationships or transactions with related parties, and, if so, the substance of those concerns."

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

Editor's Note: The new standard adds procedures the auditor is required to perform regarding inquiries of management and others. The current standard only describes audit procedures that the auditor should consider in determining the existence of related parties, including requesting from management the names of related parties and whether there were any transactions with these parties during the period under audit. In addition, the current standard does not specify any required communication with the audit committee.

In developing the new standard, the PCAOB modified the reproposed standard to clarify that auditor inquiries of management and others should address transactions with an entity's related parties that were changed during the period, whereas the reproposed standard only addressed transactions that were initiated or terminated. The new standard also includes examples of other individuals in the company to whom it is appropriate for the auditor to direct such inquiries (e.g., internal auditors, in-house legal counsel, human resources director).

Communicating With the Audit Engagement Team and Other Auditors

The new standard states that auditors "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." In addition, for audits in which other auditors participate, such as group audits, 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."

In developing the new standard, the PCAOB modified the reproposed standard to clarify that auditor inquiries of management and others should address transactions with an entity's related parties that were changed during the period.

Editor's Note: The new standard prescribes the procedures to be performed by the auditor, whereas the current standard describes various procedures that the auditor would consider performing when communicating with engagement team members and other auditors. The new standard's required procedures are similar to the suggested procedures under the current standard.

In the new standard, the PCAOB modified the reproposed standard's language to state that the required communication to engagement team members and other auditors "can be more effective when it occurs at an early stage of the audit."

Identifying and Assessing Risks of Material Misstatement Associated With Related Parties and Related-Party Transactions

In a manner consistent with the PCAOB's risk assessment standards, the new standard requires the auditor to identify and assess the risks of material misstatement associated with related parties and related-party transactions as the basis for planning and performing audit procedures to respond to such risks. The requirement directs the auditor to focus on whether the company has properly identified, accounted for, and disclosed its related parties and its relationships and transactions with them. The release indicates that this provision "is intended to highlight, among other things, that the auditor's assessment of risk includes a focus on risks related to the company's less than complete identification of its related parties or relationships or transactions with related parties."

Editor's Note: The new standard adds requirements for auditors regarding identifying and assessing risks of material misstatements associated with related parties and related-party transactions. These additions improve the current standard's requirements because they do not contain specific guidance for auditors on these matters. In addition, the current standard states that in the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business.

This provision is unchanged from the reproposed standard.

Responding to the Risks of Material Misstatement Associated With Related Parties and Related-Party Transactions

Relationships and transactions with related parties can pose increased risks of material misstatement in financial statements. The new standard prescribes specific auditing procedures for related-party transactions that either (1) are required to be disclosed in the financial statements or (2) are determined to be a significant risk. The procedures, which are intended to be scalable, include the following:

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

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

c. Determine whether any exceptions to the company's established policies or procedures were granted;

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

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

The release describes procedures (a)–(d) above as basic and procedure (e) as more in-depth, noting that the performance of procedure (e) would be "commensurate with the auditor's evaluation of the company's facts and circumstances."

The new standard also requires the auditor to "perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ."

> **Editor's Note:** Procedures (a)–(e) above strengthen the current standard and do not differ substantively from those in the reproposed standard.
>
> Further, in the new standard, the PCAOB modified the reproposed standard's language to clarify that the procedures performed should address the risks of material misstatement associated with the company's intercompany accounts.

The new standard requires the auditor "to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company."

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

The new standard requires the auditor to "evaluate whether the company has properly identified its related parties and relationships and transactions with related parties." In doing so, the auditor should take into account "the information gathered during the audit."

In addition, the new standard indicates that the auditor's evaluation "involves more than assessing the process used by the company" and that the auditor is also required "to perform procedures to test the accuracy and completeness of the related parties and relationships and transactions with related parties identified by the company."

The new standard emphasizes that the auditor may not rely solely on management's representations about the accuracy and completeness of the related-party information the company provided to the auditor.

According to the new standard, when the auditor identifies information indicating the possible existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor, the auditor should determine whether these undisclosed relationships or transactions do, in fact, exist. In a June 13, 2014, speech, Mr. Doty explained that "the auditor may not treat related party procedures as an isolated component of the audit. If other information from the audit suggests an undisclosed related party might exist, the standard requires the auditor to follow up." Further, the auditor's inquiries about these matters should extend to individuals beyond management.

If an auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor is required to perform additional procedures, including (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," and (3) evaluate the impact of management's nondisclosure and its consideration of the risk of fraud.

Editor's Note: The above provisions are in a separate section of the new standard that focuses on the auditor's evaluation of the company's identification of its related parties and on the relationships and transactions the company has with them. The current standard provides "limited direction" on these matters.

The provisions are substantively unchanged from the reproposed standard. Appendix A was revised to state that information "may be gathered during the audit," clarifying that auditors do not need to obtain and consider all the information in the Appendix's examples. The revisions also note that examples of sources of information have been expanded to include the "disclosures contained on the company's website." In addition, the Board modified the reproposal's language by adding text to the body of the new standard that gives prominence to the requirement that the auditor test the accuracy and completeness of the company's identification of related parties. Also, the Board added a new footnote that refers to AS 12 (regarding contradictory evidence and the need for an updated risk assessment and audit procedures responsive to the new risk assessment) to clarify the auditor's role with respect to other undisclosed related parties.

If an auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor is required to perform additional procedures.

Evaluating Financial Statement Accounting and Disclosures

Under the new standard, the auditor is required to evaluate the company's accounting for and disclosure of relationships and transactions with related parties, including whether the financial statements contain the information necessary to achieve fair presentation in accordance with the applicable accounting framework. The auditor is specifically directed to determine whether the audit evidence supports or contradicts any management assertion that transactions with related parties were conducted as arm's-length transactions. If the auditor is unable to obtain sufficient appropriate audit evidence to corroborate management's assertion, or if management does not agree to modify the disclosure, the auditor is required to modify his or her report and express a qualified or adverse opinion.

The new standard indicates that "it may be difficult for the auditor to obtain sufficient appropriate audit evidence to substantiate management's assertion that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. A preface to a statement such as 'management believes that' or 'it is the company's belief that' does not change the auditor's responsibilities."

Editor's Note: The new standard broadens the requirements in the current standard regarding the scope of the auditor's responsibility and focuses on evaluating the accounting for, and the disclosures about, relationships and transactions with related parties.

These provisions are substantively unchanged from the reproposed standard.

Communications With the Audit Committee

The new standard requires the auditor to "communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties." It further states that the "auditor also should communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties."

The release indicates that requiring the auditor to engage in meaningful dialogue with the audit committee will (1) benefit both the auditor and the audit committee by providing "information regarding significant risks of material misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports, including matters arising from a company's relationships and transactions with related parties" and, in turn, (2) strengthen financial reporting.

> **Editor's Note:** Unlike the new standard, the current standard does not state that the auditor is required to communicate matters concerning related parties and related-party transactions to the audit committee.
>
> This provision is unchanged from the reproposed standard.

Audit Procedures Related to Significant Unusual Transactions

The release notes that significant unusual transactions, in addition to related-party transactions and those with executive officers, "have been contributing factors in numerous financial reporting frauds over the last several decades [and that] the Board believes its existing requirements need to be strengthened to heighten the auditor's attention to areas that have been associated with risks of fraudulent financial reporting and that also may pose increased risks of error." The new standard defines significant unusual transactions as "significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature." The new standard contains amendments that make the use of this term and definition consistent throughout the Board's standards.

The new standard will help the auditor identify related parties that were "previously undisclosed to the auditor because it focuses the auditor on the substance of the relationship or transaction."

In addition, the new standard strengthens existing PCAOB requirements related to the auditor's identification and evaluation of significant unusual transactions by:

- Requir[ing] the auditor to perform procedures to identify significant unusual transactions;[9]
- Requir[ing] the auditor to perform procedures to obtain an understanding of, and evaluate, the business purpose (or the lack thereof) of identified significant unusual transactions; and
- Add[ing] factors for the auditor to consider in evaluating whether significant unusual transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

Moreover, the new standard requires the auditor to evaluate the company's accounting for, and disclosure of, significant unusual transactions in the financial statements, including whether the financial statements contain the information necessary to achieve fair presentation in accordance with the applicable financial reporting framework. The new standard will help the auditor identify related parties that were "previously undisclosed to the auditor because it focuses the auditor on the substance of the relationship or transaction."

[9] Procedures the auditor would perform to identify significant unusual transactions include "(i) inquiring of management and others; (ii) understanding controls relating to significant unusual transactions; and (iii) taking into account other information obtained during the audit."

Editor's Note: The new standard enhances audit procedures under the current standard in several ways and builds on the PCAOB's risk assessment standards. For example, the new standard makes the meaning of the term "significant unusual transactions" consistent throughout the Board's standards. Also, auditors will be required to perform specific audit procedures (e.g., required management inquiries) for significant unusual transactions, and the procedures are scalable (i.e., more in-depth procedures can be used depending on the specific facts and circumstances of the audit). Furthermore, auditors will be required to evaluate the business purpose of such transactions to determine whether they were fraudulent. The new standard emphasizes a "complementary audit approach" that takes account of the information already gathered during the audit. As a result of the new standard, the auditor is required to determine whether the financial statements contain "a fair presentation in conformity with the applicable financial reporting framework."

This provision of the new standard does not differ substantively from that in the reproposed standard, although certain minor revisions were made to clarify that (1) "the 'occurrence of infrequent transactions' and the 'occurrence of significant unusual transactions' are separate examples" and (2) when assessing the business purpose of a significant unusual transaction, the auditor should determine whether the transaction involves other parties that do not appear to be financially capable of supporting the transaction without the aid of the entity or its related parties.

The release states that a "company's financial relationships and transactions with its executive officers can create risks of material misstatement that relate pervasively to the financial statements."

Audit Procedures Related to Company Transactions With Executive Officers

The release states that 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 PCAOB notes that executive officers are "a group that, because of their position in the company, can exert influence over the company's accounting and financial statement presentation." The release includes amendments to the PCAOB's risk assessment standards and is intended to strengthen existing risk assessment procedures by requiring the auditor to "perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers," such as "executive compensation, including perquisites, and any other arrangements." Such procedures include "(1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the [SEC] and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers."

In addition, the auditor will be required to consider:

- Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and
- Obtaining an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

The new standard defines "executive officers" as follows:

> [T]he 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 policymaking functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policymaking 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.[10])

[10] Form BD is the SEC's "Uniform Application for Broker-Dealer Registration." Schedule A of that Form is the source of this definition (in the context of a broker-dealer).

Editor's Note: The above provisions of the new standard contain new requirements, but they do not differ substantively from those in the reproposed standard. The PCAOB made certain minor clarifications, including (1) stating that the auditor should make inquiries regarding any changes to or significant new related parties and (2) revising illustrative management representation letters to state that management has made available to the auditor "all financial records and related data, including the names of all related parties and all relationships and transactions with related parties."

As explained in the release, the provisions' purpose is "to require the auditor to perform specific procedures, as part of the auditor's risk assessment process, to obtain an understanding of the company's financial relationships and transactions with its executive officers. However, these amendments do not require the auditor to make any determination regarding the reasonableness of compensation arrangements or recommendations regarding compensation arrangements." [Footnote omitted]

The additional time an auditor may need to read and understand the employment and compensation contracts could prove significant, especially when there are many executive officers and the arrangements are complex. Further, the auditor may need assistance from individuals with the specialized skills and knowledge to understand the contracts and evaluate their impact on the auditor's identification and assessment of risks of material misstatement, including fraud risks.

Economic Analysis: Including Considerations Related to Audits of Emerging Growth Companies and Audits of Brokers and Dealers

The release includes feedback on the economic considerations for emerging growth companies.

Performing an economic analysis of the expected benefits of a new standard relative to its expected costs is an important aspect of the Board's rulemaking activities. The PCAOB believes that the benefits of the new standard will outweigh its costs. It noted, however, that "costs considered by the Board are difficult to quantify reliably" and that "the Board's economic discussion is qualitative in nature" since it has not obtained empirical data on potential costs from commenters. Also, the Board acknowledged that it understands that "the new requirements will result in some additional audit effort and costs." However, it believes that the "heightened scrutiny" required under the new standard should improve audit quality and audit committee oversight.

The JOBS[11] Act requires the SEC to perform a separate economic analysis when considering whether PCAOB rules, including auditing standards, should apply to audits of emerging growth companies (EGCs).[12] (For more information, see Deloitte's April 2, 2012 (updated May 8, 2012), *Heads Up*.) Accordingly, the release includes feedback on the economic considerations for EGCs. Economic evidence suggests that because of the smaller size of EGCs, they will bear a greater share of the cost of increased audit work for related-party relationships and transactions than non-EGCs; however, evidence from the PCAOB's Office of Research and Analysis shows that related-party disclosures by EGCs are prevalent and that an EGC's internal controls regarding related parties are more likely to be ineffective than those of non-EGCs. The release also notes that all respondents that commented on the applicability of the new standard to EGCs agreed that it should apply to them.

Likewise, respondents indicated that related-party financial reporting risks are frequently observed in audits of broker-dealers (e.g., the risk of transferring customer assets to custodians that are not approved) and noted that PCAOB oversight of audits of broker-dealers have identified such risks as deficiencies.

Accordingly, the PCAOB decided that the new standards, if approved by the SEC, will apply to all audits performed pursuant to PCAOB standards, including those of EGCs and broker-dealers.

[11] Jumpstart Our Business Startups.

[12] As defined in Section 3(a)(80) of the Securities Exchange Act of 1934.

Next Steps

PCAOB standards are not effective until they are approved by the SEC. As part of its approval process, the SEC will issue AS 18 for additional public comments. We encourage audit committees to study AS 18 and to submit comments to the SEC if they believe there are concerns the SEC should address during its review of the standard.

Appendix — Required Audit Procedures

The following table lists the audit procedures required by AS 18 and indicates whether they are new or expanded requirements:

New or Expanded Audit Procedures Required by AS 18	New or Expanded Requirement
Performing risk assessment procedures to obtain an understanding of the company's relationships and transactions with its related parties:	Expanded
• Obtaining an understanding of the company's process	Expanded
• Performing inquiries of:	
o Management	Expanded
o Others within the company	New
o Audit committee or its chair	New
Communicating with the audit engagement team and other auditors	Expanded
Identifying and assessing risks of material misstatement	Expanded
Responding to the risks of material misstatement	Expanded
Evaluating whether the company has properly identified its related parties and relationships and transactions with related parties	Expanded
Evaluating financial statement accounting and disclosures	Expanded
Communications with the audit committee	New

The following table lists amendments to other auditing standards related to significant unusual transactions:

New or Expanded Audit Procedures Required by PCAOB Standards	New or Expanded Requirement
AS 12:	
• Required procedures to help auditors *identify significant unusual transactions* (e.g., make inquiries of management and others).	New
AU Section 316:[13]	
• Requirement that when *identifying significant unusual transactions*, auditors *take into account* other *work performed during the audit* (e.g., information gathered with respect to related-party transactions).	New
• Basic required procedures for obtaining information for *evaluating significant unusual transactions* and more in-depth procedures designed to be scalable and commensurate with the facts and circumstances of the audit.	New
• *Evaluating the business purpose* or lack thereof for significant unusual transactions, including whether it indicates that transactions may have been entered into to engage in fraud.	Expanded
• *Evaluating accounting matters* relative to significant usual transactions in addition to evaluating disclosure requirements.	New

The following table notes amendments to other auditing standards related to a company's financial relationships and transactions with its executive officers:

New or Expanded Audit Procedures Required by PCAOB Standards	New or Expanded Requirement
AS 12:	
• Required audit procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers.	New

[13] PCAOB AU Section 316, *Consideration of Fraud in a Financial Statement Audit.*

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