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# Heads Up

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## PCAOB Proposes New Auditing Requirements on Related Parties, Significant Unusual Transactions, and Other Matters

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#### Introduction

On February 28, 2012, the PCAOB issued a proposed standard¹ on related parties as part of a release² that includes proposed amendments to PCAOB standards related to significant unusual transactions, executive compensation, and other matters. The proposed standard would supersede PCAOB AU Sections 334³ and 9334⁴ (the "current standard") and amend certain other PCAOB auditing standards. The guidance in the release would be effective for audits of fiscal years beginning on or after December 15, 2012. PCAOB Chairman James Doty commented on the need for the changes, stating that the "Board is considering this proposal because related party transactions and significant unusual transactions have played a recurring role in financial failures, from those that led to the Sarbanes-Oxley Act to those recently alleged in certain emerging market companies."

As discussed in the release, the proposed standard is intended to "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 [and] is designed to align with and build upon the foundational requirements in the Board's standards on risk assessment." Among other changes, the proposed amendments would require new procedures to be performed in connection with (1) financial transactions and arrangements with a company's executive officers and (2) significant unusual transactions entered into by a company. This *Heads Up* discusses proposed requirements that would most likely result in changes to current practice.

# **Audit Procedures Related to Company Transactions With Executive Officers**

Certain amendments to AS 12<sup>6</sup> in the release 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). The release indicates that "[u]nderstanding the financial relationships

- <sup>1</sup> PCAOB Proposed Auditing Standard, *Related Parties*.
- <sup>2</sup> PCAOB Release No. 2012-001, Proposed Auditing Standard Related Parties, Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Proposed Amendments to PCAOB Auditing Standards.
- <sup>3</sup> PCAOB AU Section 334, *Related Parties*.
- <sup>4</sup> PCAOB AU Section 9334, Related Parties: Auditing Interpretations of Section 334.
- <sup>5</sup> PCAOB Auditing Standards 8–15 are related to the auditor's assessment of, and response to, risk in a financial statement
- <sup>6</sup> PCAOB Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

and transactions that a company has with its executive officers . . . can assist the auditor in identifying conditions (including incentives and pressures) that could result in risks of material misstatement, including fraud risks."

The proposed procedures include requiring auditors to read (1) employment and compensation contracts of executive officers and (2) proxy statements and other relevant company filings with the SEC and other regulatory agencies related to the company's financial relationships and transactions with its executive officers. In addition, auditors would be required to (1) make inquires 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 (2) obtain an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements. Under the proposal, these procedures would be performed as part of the auditor's assessment of risks of material misstatement to the financial statements. "Executive officers" are defined in the proposed amendments as follows:

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).<sup>[7]</sup>

**Editor's Note:** The additional time an auditor would need to obtain and understand these employment and compensation contracts could be significant. Further, the auditor may need to engage specialists to understand these contracts and evaluate their impact on the auditor's fraud risk assessment. It is unclear from the proposal what the auditor would need to do if obtaining such information was impracticable (e.g., if it was sought in a foreign country in which privacy or confidentiality laws or regulations may prohibit disclosure of contract terms).

# **Audit Procedures Related to Significant Unusual Transactions**

Several of the PCAOB's proposed auditing requirements are intended to strengthen the auditor's evaluation of significant unusual transactions. The release states that "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." Significant unusual transactions are transactions outside the normal course of business for the company or that otherwise appear to be unusual because of their timing, size, or nature.

The proposed amendments would:

- Require the auditor to perform specific procedures to identify significant unusual transactions.
- 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.
- Require the auditor to evaluate whether significant unusual transactions have been appropriately accounted for and adequately disclosed.

Several of the PCAOB's new auditing requirements are intended to strengthen the auditor's evaluation of significant unusual transactions.

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.

As part of the enhanced evaluation of the underlying business purpose of significant unusual transactions, the proposed amendments would require the auditor to evaluate additional matters related to significant unusual transactions, 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;
- The company's accounting for the transaction enables the company to achieve certain financial targets.

The release states that these additional matters are intended to help the auditor evaluate "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 [sufficient] information regarding the significant unusual transaction essential for a fair presentation [of the financial statements] in conformity with the applicable financial reporting framework."

### **Audit Procedures Concerning Related Parties**

The auditor's objective when addressing related parties and relationships and transactions with related parties "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." The proposed standard contains requirements that are intended to fulfill this objective, many of which are consistent with those in the current standard.

The proposed standard is "financial reporting framework neutral" with respect to (1) the definition of related parties and (2) financial statement disclosure requirements (i.e., the proposal acknowledges that to prepare financial statements, issuers might use different financial reporting frameworks such as U.S. GAAP or IFRSs). The proposed standard directs auditors to consult the SEC's requirements for the company under audit to determine the accounting principles applicable to that company. This is a change from the current standard, which refers only to U.S. GAAP.

#### Identifying Related Parties and Obtaining an Understanding of Relationships and Transactions With Related Parties

The proposed standard states that 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. 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." The release highlights that these procedures are an extension of the risk assessment activities required by AS 12 and include a number of inquiries to be made by the auditor to understand the nature of related party relationships and transactions throughout the company.

The proposed standard requires the auditor to make inquiries of management, the audit committee, and "others within the company." The current standard only requires inquiries of management. Under the proposed standard, auditors' inquiries of management would include the following:

- 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);

The proposed standard requires the auditor to make inquiries of management, the audit committee, and "others within the company."

- 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.

Auditors would also be required to make inquiries 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
- 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.

In addition, the auditor is required by the proposed standard to make inquiries of "others within the company" that are similar to those it makes of management. The auditor is required to determine the individuals to whom such inquiries should be directed by considering whether the individuals are "likely to have additional knowledge" of the company's related parties and related-party relationships or transactions and the company's controls over related-party relationships or transactions. The proposed standard 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 release explains that these requirements are intended to help the auditor obtain "a sufficient understanding of the company's relationships and transactions with related parties to identify and assess risks of material misstatement."

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

Several required procedures in the proposed standard address the risks of material misstatement that are identified by the auditor and that are associated with related parties and related-party transactions. Specifically, 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 or is determined to be a significant risk, the auditor should:

- 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;
- 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; 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. [Footnote omitted]

Several required procedures in the proposed standard address the risks of material misstatement that are identified by the auditor and that are associated with related parties and related-party transactions.

These procedures are intended to help the auditor evaluate (1) the business purpose of an identified related-party transaction and (2) whether the transaction has been properly accounted for and adequately disclosed.

### **Opportunity for Public Comment**

We encourage all financial statement stakeholders, including audit committees, company management, investor groups, and others to study the proposals and submit comments to the PCAOB. Interested parties can send comments 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 or through the Board's Web site at 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.

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