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PCAOB Amends Auditing Standards For Related-Party And Significant, Unusual Transactions

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

On October 21, 2014, the SEC approved amendments to certain auditing standards that impact small cap companies that maintain GAAP compliant audits and file reports with the SEC under the Securities Exchange Act of 1934 (“Exchange Act”). The SEC Order approved proposed rule changes that had been submitted to by the Public Company Accounting Oversight Board (the “PCAOB”) regarding the auditing standards for related party transactions and the standards regarding significant unusual transactions.

The amended rules apply to all SEC audits including those for broker-dealers and go into effect for the audits for fiscal year ends beginning on or after December 15, 2014.

Related Party Transactions

The SEC has approved new Auditing Standard No. 18 (AU No. 18) setting forth guidance and procedures for auditors to use in identifying and evaluating related party transactions. AU No. 18 is intended to strengthen requirements for identifying, assessing and responding to the risks of material misstatement associated with related party transactions. In particular, AU No. 18 requires an auditor to:

Perform procedures to obtain an understanding of the company’s relationships and transactions with its related parties including the nature of the relationships and business terms (or lack thereof);

Evaluate whether the company has properly identified its related parties and relationships and transactions with its related parties. AU No. 18 sets out specific procedures for the auditor to test the accuracy and completeness of its evaluation.

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

Perform specific procedures regarding each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk.

Communicate with the company's audit committee regarding the auditors' findings and the company's controls, procedures and accounting processes.

Significant Unusual Transactions

Auditing Standards Section 316 (Consideration of Fraud in a Financial Statement Audit) (AU Sec. 316) addresses significant unusual transactions. AU 316 requires that if the auditor becomes aware of significant unusual transactions, further inquiry must be made, including taking steps to gain an understanding of the business rationale for the transactions and consider whether the transactions may constitute or conceal a fraud. The amended AU 316 requires an auditor to:

Perform procedures to identify significant unusual transactions;

Perform procedures to obtain an understanding of, and evaluate the business purpose (or lack thereof) of, significant unusual transactions;

Consider certain factors in evaluating whether significant unusual transactions may be concealing fraudulent financial reporting or the misappropriation of assets;

Other Amendments

The PCAOB rule amendments also require that the auditor perform procedures in transactions and areas surrounding related parties or significant unusual transactions, including requiring the auditor to gain an understanding of the company's financial relationships and transactions with its executive officers. The PCAOB rules are designed to make sure an auditor pays attention to incentives offered to key executives for particular financial results and milestones and the concurrent incentive to engage manipulative practices to achieve these goals. The amendments specifically exclude the auditors' ability to opine on the appropriateness or reasonableness of executive compensation.

As part of the amendments, management must now provide a written representation to the auditor that there are no side agreements or other written or oral arrangements undisclosed to the auditor.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the Securities Law Network.

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