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SECURITIES AND EXCHANGE COMMISSION
[Release No. 34-73396; File No. PCAOB-2014-01]

October 21, 2014.

Public Company Accounting Oversight Board; Order Granting Approval of Proposed Rules on Auditing Standard No. 18, Related Parties, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions, and Other Amendments to PCAOB Auditing Standards

I. Introduction

On July 10, 2014, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission"), pursuant to Section 107(b)[1] of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") and Section 19(b)[2] of the Securities Exchange Act of 1934 (the "Exchange Act"), proposed rules to adopt Auditing Standard No. 18, *Related Parties*, amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other amendments to PCAOB auditing standards, including required procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers (collectively, the "Proposed Rules").[3] The Proposed Rules were published for comment in the Federal Register on July 24, 2014.[4] At the time the notice was issued, the Commission designated a longer period to act on the Proposed Rules, until

[1] 15 U.S.C. 7217(b).

[2] 15 U.S.C. 78s(b).

[3] The Board originally proposed in February 2012 ("Original Proposal") and reproposed in May 2013 ("Reproposal") what became the Proposed Rules.

[4] See Release No. 34-72643 (July 18, 2014), 79 FR 43163 (July 24, 2014).

October 22, 2014.[5] The Commission received three comment letters in response to the notice.[6] This order approves the Proposed Rules.

II. Description of the Proposed Rules

Related party transactions, significant unusual transactions, and a company's financial relationships and transactions with its executive officers are included together in the Proposed Rules because the PCAOB believes the auditor's efforts in these areas are, in many ways, complementary. For example, the auditor's efforts to identify and evaluate a company's significant unusual transactions could identify information that indicates that a related party or relationship or transaction with a related party previously undisclosed to the auditor might exist. Likewise, obtaining an understanding of a company's financial relationships and transactions with its executive officers also could identify information that indicates that a related party or relationship or transaction with a related party previously undisclosed to the auditor might exist.

1. Related Parties

Auditing Standard No. 18 will supersede AU section 334, *Related Parties* ("AU sec. 334"), which primarily contains the existing requirements for auditing relationships and transactions with related parties. AU sec. 334 provides guidance and examples of procedures for the auditor's consideration in identifying and evaluating related party transactions. Auditing Standard No. 18 includes some auditing concepts and procedures from AU sec. 334, but is intended to strengthen auditor performance requirements for identifying, assessing, and

[5] Ibid.

[6] See letters to the Commission from Suzanne H. Shatto, dated July 23, 2014 ("Shatto Letter"); Tom Quaadman, Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, dated July 28, 2014 ("Chamber Letter"); and Deloitte & Touche LLP, dated August 11, 2014 ("Deloitte Letter").

responding to the risks of material misstatement associated with a company's relationships and transactions with its related parties by, among other things, requiring the auditor to:

- Perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties, including obtaining an understanding of the nature of the relationships between the company and its related parties and of the terms and business purposes (or the lack thereof) of transactions involving related parties. The new procedures are required to be performed in conjunction with the auditor's risk assessment procedures pursuant to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.
- Evaluate whether the company has properly identified its related parties and relationships and transactions with its related parties. In making that evaluation, the auditor performs procedures to test the accuracy and completeness of management's identification, taking into account information gathered during the audit. If the auditor identifies information that indicates that undisclosed relationships and transactions with a related party might exist, the auditor is required to perform procedures necessary to determine whether undisclosed relationships or transactions with related parties in fact exist.
- 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.[7]
- 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, and other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

2. Significant Unusual Transactions

Existing auditing requirements regarding significant unusual transactions are principally contained in AU section 316, *Consideration of Fraud in a Financial Statement Audit* ("AU sec. 316").[8] Specifically, AU sec. 316 requires the auditor, if he or she becomes aware of significant unusual transactions during the course of the audit, to gain an understanding of the business rationale of such transactions and consider whether that rationale suggests the transactions may have been entered into to engage in, or conceal, fraud. The amendments regarding significant unusual transactions are intended to improve AU sec. 316 and other PCAOB auditing standards by, among other things:

- Requiring the auditor to perform procedures to identify significant unusual transactions;

[7] Auditing Standard No. 12 defines a significant risk as a "risk of material misstatement that requires special audit consideration."

[8] See AU secs. 316.66–.67.

- Requiring 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
- Adding 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.

In addition to targeted enhancements to AU sec. 316, the amendments regarding significant unusual transactions would revise Auditing Standard No. 12 and Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*. These amendments include some changes intended to enhance the complementary linkages between the auditor's work relating to significant unusual transactions and related party transactions. The amendments regarding significant unusual transactions also include conforming changes to other PCAOB auditing standards to provide for consistency in the use of the term "significant unusual transactions" throughout the Board's standards.[9]

3. Other Amendments

Additional amendments are intended to provide for improved audit procedures in complementary areas, including requiring that the auditor perform procedures, as part of the auditor's risk assessment, to obtain an understanding of the company's financial relationships and transactions with its executive officers.[10] These new procedures are intended to heighten

[9] The Proposed Rules describe "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."

[10] The PCAOB notes that the other amendments do not change the existing requirement in its risk assessment standards for the auditor to consider obtaining an understanding of compensation arrangements with senior management as part of obtaining an understanding of the company. Rather, the Board states that the population for

the auditor's attention to incentives or pressures for the company to achieve a particular financial position or operating result, recognizing the key role that a company's executive officers may play in the company's accounting decisions or in a company's financial reporting.

In response to requests for clarification received by the PCAOB as part of its comment process, the Proposed Rules explicitly provide that the auditor's work relating to a company's financial relationships and transactions with its executive officers does not include an assessment of the appropriateness or reasonableness of executive compensation arrangements. The Commission believes the PCAOB's clarification is responsive and appropriate since such assessments would have resulted in a significant unintended change to the current objectives of the audit, which are focused on risks of material misstatement of the financial statements.

In addition to the amendments relating to financial relationships and transactions with executive officers, the Board adopted amendments to revise other auditing standards to conform them to the Proposed Rules and, where appropriate, include new requirements that complement the Proposed Rules. For example, the Board adopted amendments to AU section 333, *Management Representations* ("AU sec. 333"), to require a representation that management has made available to the auditor the names of all related parties and relationships and transactions with related parties. Additionally, among others, the Board adopted amendments to AU sec. 333 to require a written representation from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor. Other new requirements complement the requirements in the Proposed Rules through improvements to the auditor's: (i)

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the procedures required by the other amendments is the list of "executive officers," as defined in Rule 3b-7 of the Exchange Act or included on Schedule A of Form BD, as applicable, while the existing requirement continues to apply to what may be a larger population of a company's management. 17 CFR 240.3b-7 and 17 CFR 249.501.

communications with a predecessor auditor; (ii) procedures during the period subsequent to the balance-sheet date, but prior to the issuance of the financial statements; and (iii) procedures during reviews of interim financial information.

The PCAOB has proposed application of its Proposed Rules to audits of all issuers, including audits of emerging growth companies ("EGCs"),[11] as discussed in Section IV. below. The Proposed Rules also would apply to audits of SEC-registered brokers and dealers.[12] The Proposed Rules would be effective for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of interim financial information within these fiscal years.

III. Comment Letters

As noted above, the Commission received three comment letters concerning the Proposed Rules. Two commenters expressed support for the Proposed Rules.[13] One of these commenters also expressed a desire for an earlier effective date.[14] The final commenter raised concerns regarding the substance of the PCAOB's economic analysis and consideration of cost-benefit analysis upon EGCs.[15]

1. Effective Date

[11] The term "emerging growth company" is defined in Section 3(a)(80) of the Exchange Act. 15 U.S.C. 78c(a)(80).

[12] On July 30, 2013, the Commission adopted amendments to Rule 17a-5 under the Exchange Act to require, among other things, that audits of brokers' and dealers' financial statements be performed in accordance with the standards of the PCAOB for fiscal years ending on or after June 1, 2014. 17 CFR 240.17a-5. See *Broker–Dealer Reports*, Release No. 34–70073, (July 30, 2013), 78 FR 51910 (August 21, 2013), available at http://www.sec.gov/rules/final/2013/34-70073.pdf.

[13] See Shatto Letter and Deloitte Letter.

[14] See Shatto Letter, which also raised a number of other points with respect to brokers and dealers, but those points are outside the scope of the PCAOB's Proposed Rules.

[15] See Chamber Letter.

The PCAOB describes the rationale as to the effective date, which was established to allow for sufficient time for registered firms to incorporate the new requirements into methodologies, guidance, audit programs, and staff training. The Commission believes the Proposed Rules' effective date is not unreasonable in order to provide sufficient time for proper implementation by registered firms.

2. Economic Analysis

One commenter raised concerns regarding the substance of the PCAOB's economic analysis and its consideration of EGCs. The commenter stated that it expressed these concerns in previous comment letters to the PCAOB, and in its opinion, those concerns have not been considered or addressed by the PCAOB. This commenter's principal concerns are addressed below.

- In its comment letter on the Original Proposal, the commenter stated that the proposal did not contain a cost-benefit analysis.

The Board presented, and sought comment on, an economic analysis in the Reproposal. Further, in response to comments on the economic analysis provided in the Reproposal, the Board revised its analysis as presented in its release accompanying the Proposed Rules ("Final Rule Release").

- In its comment letter on the Reproposal, the commenter stated that the economic analysis was composed of a number of assertions that were generic and speculative in nature, and were not linked to the elements of the proposal.

In the economic analysis provided in the Final Rule Release, the Board refined the analysis included with the Reproposal, including by linking the elements of the analysis closer to the elements of the Proposed Rules. Specifically, the Board's refined analysis set forth: (1) a description of the need for the standard-setting, and how the Proposed Rules address the need;

(2) the baseline to consider the economic impacts of the Proposed Rules; (3) the Board's approach and consideration of alternatives; (4) the economic impacts of the Proposed Rules including benefits, costs, effects on different categories of audit firms and smaller companies, and responses to comments received on the economic analysis included with the Reproposal; and (5) economic considerations pertaining to audits of EGCs, including efficiency, competition and capital formation. The Board also acknowledged challenges in considering the economic impacts, such as the challenges of quantifying the economic impact of changes to audit standards, and explained how the Board addressed those challenges.

- In its comment letter on the Reproposal, the commenter stated that the economic analysis fails to explicitly articulate any appropriate economic baseline against which to measure the proposed requirements' likely economic impact.

The Board presented an economic baseline within Appendix 5 of the Final Rule Release, which the Board used in its economic analysis as a benchmark for comparing against the Proposed Rules. The Board's discussion of the baseline includes both existing requirements and current audit practices, where the latter is determined based on information from the Board's oversight activities, including its inspection findings. The Board's analysis of the baseline shows that audit practices associated with the areas addressed by the Proposed Rules are inconsistent across firms.

- In its comment letter on the Reproposal, the commenter stated that the Reproposal contains no substantive analysis of the economic impact of the proposed requirements on EGCs, EGCs vis-à-vis other companies, or companies generally.

The economic analysis presented in the Final Rule Release presents the Board's economic considerations of the Proposed Rules both for companies generally and specifically for EGCs. Broadly, the Board believes that the areas addressed by the Proposed Rules are

challenging areas warranting additional audit effort and focus. The Board notes that EGCs will incur some incremental costs because costs may be disproportionately higher for smaller companies, including EGCs.[16] However, the Board notes that EGCs may benefit more from the Proposed Rules because, as compared to non-EGCs, related party transactions are more common and there is a higher likelihood for control deficiencies, which may result in a higher risk of material misstatement associated with related party transactions.

The analysis includes the relevant views of those who commented on the Reproposal on the economic effects of the Proposed Rules on EGCs. Further, the Board notes that the Proposed Rules are designed to mitigate cost impacts by aligning the auditor's efforts with the risk assessment standards and providing opportunities for a scaled approach depending on the size and complexity of the company being audited. The Board states that this alignment with risk assessment allows auditors to integrate audit effort where appropriate and thereby avoid unnecessary audit effort. Finally, the Board's analysis takes into account the view from certain commenters on the Reproposal that it may be more costly not to apply the Proposed Rules to audits of EGCs because it would require firms to maintain two audit methodologies. The Commission believes that the Board's economic analysis reasonably addresses the comment raised, and as discussed further in Section IV, based on the analysis submitted, the Commission believes the information in the record is sufficient for the Commission to make the requested EGC determination in relation to the Proposed Rules.

- In its comment letter on the Reproposal, the commenter stated that the Reproposal does not adequately address potential alternatives.

[16] See Section IV below for further information regarding the PCAOB's EGC analysis.

The Final Rule Release discussed the Board's consideration of alternatives to the Proposed Rules. In response to the commenter's suggestion that the Reproposal did not discuss why PCAOB Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* ("Practice Alert"),[17] was inadequate, the Board stated that the Practice Alert was issued to remind auditors of the risks associated with significant unusual transactions and to compile selected, relevant requirements from existing PCAOB auditing standards into one document. Given that the Practice Alert only highlights circumstances for auditor consideration, it did not alter audit requirements with respect to significant unusual transactions. The Board concluded, based in part on the results of its oversight activities following the issuance of the Practice Alert, that it was appropriate to develop standards with more specific requirements to promote heightened scrutiny in the areas addressed by the Proposed Rules. Further, the Board stated that the need to improve the existing standards in these areas, including alignment with the Board's risk assessment standards, cannot be adequately addressed through staff interpretations of existing standards.

In response to the commenter's statement that the Board did not analyze why it chose not to converge the Proposed Rules with similar standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the American Institute of Certified Public Accountants ("ASB"), the Board states in its Final Rule Release that it considered the analogous standards of the IAASB and the ASB and incorporated a number of similar audit procedures and requirements that the Board believed were useful and appropriate.[18]

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[17] See http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf

[18] For examples of similar audit procedures and requirements, see footnote 86 on page A5-46 of the Final Rule Release. Additionally, Appendix 6 of the Final Rule Release compares certain significant differences between the objective and certain key requirements of the Proposed Rules and analogous standards of the IAASB and the ASB.

The Board, however, determined that the areas addressed by the Proposed Rules require heightened scrutiny, and, thus, the Proposed Rules contain auditing requirements that are not reflected in the analogous standards of the IAASB and the ASB. Further, the Commission notes that the Board has received similar comments in the past and has thus previously addressed its consideration of the work of other standard-setters generally.[19] The Commission also addressed similar comments in connection with its consideration of other rules proposed by the PCAOB.[20] As it relates to the Proposed Rules, the Commission notes the PCAOB's efforts to consider the analogous standards of the IAASB and the ASB. Thus, while the Commission continues to encourage the PCAOB to consider the work of other standard-setters, there remain a variety of reasons why the Board's standards may differ from the standards of the IAASB and ASB, and we believe the Board has provided a reasonable explanation for the differences here.

- Finally, in its comment letter to the Commission, the commenter recommended "that the SEC return the [Proposed Rules] to the PCAOB for a cost benefit analysis that complies with the [Jumpstart Our Business Startups] Act and allows stakeholders to understand the costs and benefits…" Further, the commenter stated that the Proposed Rules add to audit complexity and raise doubt that the proposed requirements would be cost-benefit effective.

The Commission notes that the Board provided a detailed qualitative analysis that took into account the views of commenters. As the Board explained, there was limited research and

[19] For example, in the Board's adopting release for its risk assessment standards it stated the following:

"[B]ecause the Board's standards must be consistent with the Board's statutory mandate, differences will continue to exist between the Board's standards and the standards of the IAASB and ASB, e.g., when the Board decides to retain an existing requirement in PCAOB standards that is not included in IAASB or ASB standards. Also, certain differences are often necessary for the Board's standards to be consistent with relevant provisions of the federal securities laws or other existing standards or rules of the Board. Also, the Board's standards-setting activities are informed by and developed to some degree, in response to observations from its oversight activities."

See PCAOB Release No. 2010-004, August 5, 2010, pp. A10–91 – A10-92 (internal footnotes omitted).

[20] See Release No. 34-63606 (December 23, 2010), 75 FR 82417 (December 30, 2010) and Release No. 34-68453 (December 17, 2012), 77 FR 75689 (December 21, 2012).

data available regarding economic costs and benefits of the Proposed Rules, making reliable quantification difficult. Further, as part of the Board's process through its issuance of the Original Proposal and the Reproposal, the Board requested empirical data regarding costs and benefits specific to the Proposed Rules, and commenters did not provide any. The Commission observes that Section 103(a)(3)(C) of the Sarbanes-Oxley Act, the relevant statutory provision added by the Jumpstart our Business Startups ("JOBS") Act, does not require a detailed, quantitative cost-benefit analysis.[21] Consistent with the responses to the commenter's specific concerns enumerated above, the Board states that it designed the Proposed Rules to minimize complexity by aligning the auditor's efforts with the risk assessment standards and providing opportunities for a scaled approach depending on the size and complexity of the company being audited.

IV. The PCAOB's EGC Request

Section 103(a)(3)(C) of the Sarbanes-Oxley Act provides that any additional rules adopted by the PCAOB subsequent to April 5, 2012 do not apply to the audits of EGCs, unless the Commission determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation.[22] Having considered those factors, and as explained further herein, the Commission finds that applying the Proposed Rules to audits of EGCs is necessary or appropriate in the public interest.

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[21] See National Association of Manufacturers v. SEC, 748 F.3d 359, 369 (D.C. Cir. 2014) (stating that "[a]n agency… need not conduct a 'rigorous, quantitative economic analysis' unless the statute explicitly directs it to do so"), partially overruled on other grounds by American Meat Institute v. U.S. Department of Agriculture, 760 F.3d 18 (D.C. Cir. 2014) (en banc).

[22] Section 103(a)(3)(C) of the Sarbanes-Oxley Act, as amended by Section 104 of the JOBS Act.

In proposing application of the Proposed Rules to audits of all issuers, including EGCs, the PCAOB requested that the Commission make the determination required by Section 103(a)(3)(C). To assist the Commission in making its determination, the PCAOB prepared and submitted to the Commission its own EGC analysis. The PCAOB's EGC analysis includes discussions of characteristics of self-identified EGCs and economic considerations pertaining to audits of EGCs, including efficiency, competition, and capital formation. In its analysis, the Board states, among other things, that applying the Proposed Rules to the audits of EGCs may be particularly pertinent because of the characteristics of EGCs (e.g., potential for higher rates of material weaknesses in internal control, use of related party transactions, and substantial doubt about the company's ability to continue as a going concern). In fact, the Board's oversight activities have identified a significant number of findings regarding related party transactions in audits of financial statements of smaller public companies, which have characteristics that are similar to EGCs.

The PCAOB's EGC analysis was included in the Commission's public notice soliciting comment on the Proposed Rules.[23] Based on the analysis submitted, we believe the information in the record is sufficient for the Commission to make the requested EGC determination in relation to the Proposed Rules. The Commission also takes note, in particular, of the PCAOB's approach to the Proposed Rules, which are intended to build upon existing requirements in the areas addressed by them; align with the auditor's efforts in complying with the risk assessment standards; and provide opportunities for scaling based on the facts, circumstances, and risks of the particular company under audit.

[23] One comment letter, as discussed above in Section III, was received relating to the PCAOB's EGC analysis. See Chamber Letter.

V. Conclusion

The Commission has carefully reviewed and considered the Proposed Rules and the information submitted therewith by the PCAOB, including the PCAOB's EGC analysis, and the comment letters received. In connection with the PCAOB's filing and the Commission's review,

A. The Commission finds that the Proposed Rules are consistent with the requirements of the Sarbanes-Oxley Act and the securities laws and are necessary or appropriate in the public interest or for the protection of investors; and

B. Separately, the Commission finds that the application of the Proposed Rules to EGC audits is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation.

IT IS THEREFORE ORDERED, pursuant to Section 107 of the Sarbanes-Oxley Act and Section 19(b)(2) of the Exchange Act, that the Proposed Rules (File No. PCAOB-2014-01) be and hereby are approved.

By the Commission.

Kevin M. O'Neill,
Deputy Secretary.

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