

Recent Regulatory and FASB Actions Impacting Auditors

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Contributing Partners

Michael Y. Scudder
Chicago

Contributing Counsel

Jeremy A. Berman
New York

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Four Times Square
New York, NY 10036
212.735.3000

skadden.com

In one of several recent actions impacting auditors, the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) have devoted heightened attention to related-party transactions, adopting a new auditing standard that requires an enhanced level of reporting detail for such transactions, significant transactions outside the normal course of business and transactions with executives. The PCAOB found the new standard necessary because of “continuing weaknesses in auditors’ scrutiny in these areas.”¹

Another development impacting auditors is that the Financial Accounting Standards Board (FASB) recently announced new revenue recognition rules for contracts with customers that become effective at the end of 2016. The FASB described the new rules as “converged guidance” with the International Accounting Standards Board, and the new guidance represents “a major achievement in the Boards’ joint efforts to improve this important area of financial reporting,” according to the FASB.²

In addition, as part of its statutory mandate under the Jumpstart Our Business Startups (JOBS) Act, the SEC is in the process of comprehensively reviewing its longstanding disclosure rules under Regulation S-K to determine, in part, whether these older rules remain pertinent and what information issuers should be required to disclose.³

Stricter Standards for Related-Party Transaction Audit Procedures May Signal Increased Enforcement

In October 2014, the SEC approved a PCAOB proposed rule adopting Auditing Standard No. 18, *Related Parties*, which amends various auditing standards concerning related-party transactions (including those with executives) and other unusual transactions.⁴ The new standard recognizes that related-party transactions increase the risk of material misstatement, lead to difficult measurement and recognition issues, and afford management opportunities to further its own self-interest. While the previous standards did not mandate specific auditing procedures for related-party transactions, Auditing Standard No. 18 will in certain instances require the auditor to perform new procedures and prepare additional documentation. Among other things, the auditor must now specifically inquire of management the names of related parties, their background and the company’s relationship to the related parties.⁵ Audit inquiries should be directed not only to management but, in appropriate circumstances, to other personnel who initiate or record related-party transactions, internal auditors, in-house counsel, chief compliance officers and human resources directors.⁶ The auditor must read documentation underlying the related-party transactions and gain an understanding of their business purpose.⁷ In addition, management must expand its written representations about related-party transactions, and the auditor must communicate directly with the board’s audit committee on this subject.⁸ Similar enhanced audit procedures apply to significant transactions — those transactions outside the normal course of business or that appear unusual due to their timing, size or nature. Given the new Auditing Standard No. 18 and the importance the SEC and PCAOB attach to the risks to the adequacy of financial disclosure arising from related-party transactions, these agencies may increase enforcement in this area.

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Companies Are Gearing Up for Changes in Revenue Recognition

In Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, adopted in May 2014, the FASB adopted a new, principles-based approach to revenue recognition that will become effective at the end of 2016. The new standard mandates that auditors acquire a much greater understanding of revenue-generating contracts than previously required of the auditor in order to determine when revenue is properly recognized. The standard requires the auditor to: (1) identify the contract with the customer, (2) understand the performance obligations under the contract, (3) determine the transaction price, (4) allocate the transaction price to the performance obligations, and (5) recognize revenue when (or as) the reporting organization satisfies a performance obligation.⁹ To adhere to this standard, the auditor must have a deep understanding of the contracts in order to identify pertinent performance obligations (particularly if the contracts contain multiple obligations, such as both supplying goods and providing services); determine how to allocate the transaction price among multiple obligations; and assess when a performance obligation has been satisfied, which may be especially difficult when that matter is disputed by the contracting parties. Although not explicit in the rule, the auditor may need legal opinions to make the determinations outlined in the new standard. Once the standard becomes effective, regulators are likely to scrutinize revenue recognition based on the new principles. Companies are now gearing up to meet this new standard, as they will have to change their methods of estimating revenues, establish controls for such estimation and install the necessary information technology to properly record revenue.

Competing Views Shape Dialog on Potential Changes to Disclosure Rules

The SEC is actively reviewing its disclosure rules for the purpose of determining if and how the rules should be modified. In certain areas, the same rules have been in place for decades, and the question is whether they remain pertinent. Different groups have presented competing views to the SEC. The Chamber of Commerce, for example, has urged the elimination of redundant disclosures as well as the removal of disclosure of information readily available on the Internet, such as stock prices. In contrast, an investor advocacy group has urged that more forward-looking information, such as forecasts and estimates, be outside the management discussion and analysis (MD&A) of financial condition and results of operations section, where it is protected by the safe harbor rule under the Private Securities Litigation Reform Act. Instead, they advocate for incorporating that information into the financial statements, which are outside the safe harbor. Where the SEC will come out in response to the competing suggestions is unknown, but there will be much focus on the new rules when and if they are promulgated. Ultimately, corporations, auditors and the investing public likely will take different views as to their meanings, and the courts will have to resolve these disputes.

¹ Auditing Standard No. 18, *Related Parties; Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions; and Other Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2014-002, at 2 (June 10, 2014) (Auditing Standard No. 18).

² Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers (Topic 606)*, FASB in Focus, at 1, 2014 [Accounting Standards Update].

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³ SEC, Report on Review of Disclosure Requirements in Regulation S-K, as Required by Section 108 of the Jumpstart Our Business Startups Act (Dec. 2013).

⁴ See *Order Granting Approval of Proposed Rules on Auditing Standard No. 18*, Exchange Act Release No. 73396, 2014 WL 5361456 (Oct. 21, 2014). The approved rule is effective for audits of financial statements for fiscal years beginning on or after December 15, 2014. *Id.* at *4.

⁵ Auditing Standard No. 18, at A1-3.

⁶ See *id.* at A1-4 n.5.

⁷ *Id.* at A1-7.

⁸ See *id.* at A1-12, A1-11 n.20.

⁹ See Accounting Standards Update, at 2-3.