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STANDING ADVISORY GROUP MEETING

RELATED PARTIES

JUNE 21, 2007

Introduction

The Standing Advisory Group ("SAG") will discuss the interim auditing standard of the Public Company Accounting Oversight Board ("PCAOB" or the "Board") on related parties. The SAG first discussed related parties at its September 8-9, 2004 meeting.[1/] The discussion at the June meeting will focus principally on the auditor's role in assessing risks relevant to related party transactions and performing sufficient audit procedures in identifying related parties and auditing transactions with those parties.

Generally accepted accounting principles define related parties and require certain disclosures. Required disclosures include material related party transactions and the nature of control relationships that could result in operating results or financial positions significantly different from those that would have been achieved in the

1/ The Briefing Paper prepared on related parties for that meeting provides additional background information on related parties and issues relevant to the auditor's obligation for the identification and disclosure of related parties and related party transactions. It is located at http://www.pcaobus.org/News/Events/Documents/09082004_SAGMeeting/Related_Party_Transactions.pdf.

absence of such relationships, regardless of whether there were transactions between or among the related parties.[2/]

Recent Developments

In December 2005, the International Auditing and Assurance Standards Board ("IAASB") approved an exposure draft of the proposed International Standard on Auditing 550 (Revised), *Related Parties* ("Proposed ISA 550"). Based upon the volume and nature of comments received from the public, the IAASB made substantive revisions that warranted a second exposure. The IAASB exposed a redrafted version in February 2007[3/] and requested that interested parties provide comments by June 30, 2007.

In 2004 and 2005, the Executive Committee of the Auditing Section of the American Accounting Association formed research synthesis teams with the primary goal of providing PCAOB staff with a synthesis of existing research related to nine designated projects. The research synthesis paper prepared for one of those projects – related party transactions – concluded, among other things, that the existence of related party transactions is often cited as the principal reason for the auditor's failure to detect a financial fraud.[4/]

Related Parties and Fraud Risk

Transactions with related parties can provide opportunities for management to perpetrate fraudulent financial reporting. For example, it is possible for management to improperly inflate earnings by using undisclosed related parties to conceal the economic substance of transactions or otherwise distort the financial position and results of operations through inadequate disclosures. This failure to disclose related party

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[2/] See paragraphs .02 through .04 of FASB Statement of Financial Accounting Standard No. 57, *Related Party Disclosures*.

[3/] The exposure draft is located at www.ifac.org/Guidance/EXD-Download.php?EDFID=00215.

[4/] The authors of this synthesis paper later published this paper as E. A. Gordon, Henry, T. Louwers, and B. Reed, "Auditing Related Party Transactions: A Literature Overview and Research Synthesis," *Accounting Horizons* (vol. 21, no. 1, March 2007), pp. 81-102.

transactions has been cited in numerous enforcement actions conducted by the U.S. Securities and Exchange Commission.[5/]

The auditor's responsibilities with respect to related parties and related party transactions are discussed in the Board's interim standards, principally AU sec. 334, *Related Parties* and AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*[6/] AU sec. 316.07 notes that three conditions generally are present when fraud occurs:

- Management or other employees have an incentive or are under pressure, which provides a reason to commit fraud;
- Circumstances exist – for example, the absence of controls, ineffective controls, or the ability of management to override controls – that provide an opportunity for a fraud to be perpetrated; and
- Those involved are able to rationalize committing a fraudulent act.

Under these conditions, transactions with related parties and the ability to override controls provide opportunities for management to perpetrate fraudulent financial reporting.

AU sec. 316 makes specific mention of related party transactions in the context of the auditor's response to the risk of management override. Specifically, AU sec. 316.66 indicates that the auditor evaluates significant unusual transactions and considers whether the involvement of related parties suggests that the significant unusual transactions may have been entered into to perpetrate or to conceal fraud. However, neither AU sec. 316 nor AU sec. 334 contains significant detail about how transactions with related parties, whether disclosed or undisclosed, present opportunities for management to perpetrate fraud. Similarly, Proposed ISA 550 and ISA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*, do not contain any further direction.

[5/] See SEC "Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002" at www.sec.gov/news/studies/sox704report.pdf.

[6/] References to AU sections ("AU secs.") throughout this paper are to the Board's interim auditing standards, which are available on the PCAOB's website at http://www.pcaobus.org/Standards/Pages/default.aspx.

Auditors, therefore, could give consideration to how transactions with related parties might facilitate fraud. This consideration could then extend to the nature of the business, the organizational structure of the company, the relationship between the company and its customers or suppliers, and other matters that can affect the level of risk that transactions with related parties or other relationships are not properly reflected in the financial statements.

Aside from the potential fraud risk, AU sec. 334 states that in absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business. Proposed ISA 550 similarly states that many related party transactions are in the normal course of business and may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties.

Discussion Questions –

1. How does the market respond to related party transactions? Are related party transactions perceived as having a higher risk of fraud or error?

2. Absent evidence to the contrary, should transactions with related parties be considered to be in the normal course of business and carry no higher risk of material misstatement than transactions with unrelated parties?

Understanding the Company's Related Party Relationships

AU sec. 334 outlines audit procedures for understanding a company's related party relationships. Specifically, AU sec. 334 states that the auditor should perform the following:

- Obtain an understanding of management responsibilities and the relationship of each component to the total entity.

- Consider controls over management activities.

- Consider the business purpose served by the various components of the entity.

AU sec. 334 also provides an illustrative list of procedures the auditor might perform to identify material transactions with parties known to be related and to identify material transactions that may be indicative of the existence of previously undisclosed relationships. Some of the suggested procedures include: providing audit personnel with the names of known related parties; reviewing the minutes of meetings of the board of directors; and reviewing the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships.

Proposed ISA 550 provides more specific direction stating that the auditor shall perform the following:

- Include specific consideration of the susceptibility of the financial statements to material misstatements due to fraud or error that could result from the entity's related party relationships and transactions in the discussion among members of the engagement team.

- Share relevant information obtained about the entity's related parties with the other members of the engagement team.

- Obtain from management the names of the related parties that management has identified in accordance with the framework.

- Inquire of management regarding:

    - The nature of the relationships between the entity and these related parties; and

    - Whether the entity entered into any transactions with these related parties during the period, and if so, the general nature of the transactions.

- Obtain an understanding of the controls that management has established to:

    - Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;

    - Authorize and approve significant transactions and arrangements with related parties; and

- Authorize and approve significant transactions and arrangements outside the normal course of business.

- Inspect the following documents for information that may indicate the existence of related relationships or transactions:

  - Bank and legal confirmations obtained as part of the auditor's procedures; and

  - Minutes of meetings of shareholders and of those charged with governance.

Discussion Question –

3. Should the auditor perform procedures for understanding and identifying a company's related party relationships in every audit, regardless of the assessed level of risk? If so, what should those procedures be?

Known Related Party Relationships

AU sec. 334 states that an auditor should place emphasis on testing material transactions with parties known to be related to the reporting entity. However, the specific procedures to be performed are a matter of auditor judgment. AU sec. 334 outlines illustrative procedures the auditor may perform, including:

- Obtain an understanding of the business purpose of the transactions.

- Examine invoices, executed copies of agreements, contracts, and other pertinent documents, such as receiving reports and shipping documents.

- Determine whether the transaction has been approved by the board of directors or other appropriate officials.

- Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure.

- Arrange for the audits of intercompany account balances to be performed as of concurrent dates, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties.

- Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

Proposed ISA 550, in addition to the procedures for understanding the entity's related party relationships and transactions, requires the auditor to design and perform further procedures that are responsive to the assessed risks of material misstatement. In addition, Proposed ISA 550 states that the auditor shall treat the following as circumstances giving rise to significant risks and, thus, requiring further audit procedures:

- Identified significant related party transactions outside the normal course of business.

- Management has made an assertion in the financial statements stating that a related party transaction was conducted on terms equivalent or similar to those prevailing in an arm's length or market transaction.

Discussion Question –

4. Are there specific types of related party relationships or transactions that pose a higher risk? If so, should the auditor perform additional procedures?

Undisclosed Relationships

Members of the auditing profession generally regard the identification of undisclosed relationships as one of the most challenging aspects of an audit. This is especially challenging when relationships are deliberately concealed by management. This view is reflected in AU sec. 334.04, which states –

> An audit performed in accordance with [PCAOB standards] cannot be expected to provide assurance that all related party transactions will be discovered.

However, AU sec. 334 provides that auditors should be aware of the possibility that transactions with related parties may have been motivated solely, or in large measure, by lack of sufficient working capital, an overly optimistic earnings forecast, dependence on a single or relatively few products, a declining industry, excess capacity, etc.

With regard to undisclosed relationships, proposed ISA 550 states that during the audit the auditor shall be alert for arrangements or other information that may indicate the existence of related party transactions or transactions that management has not previously identified or disclosed to the auditor. Further, if the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions, the auditor shall perform appropriate procedures to determine whether the underlying circumstances reveal the existence of related parties that management has not previously identified or disclosed to the auditor.

Discussion Questions –

5. To what degree should the auditor be expected to search for and identify undisclosed related parties and related party transactions?

6. Are there certain procedures the auditor should perform in each audit, or should the auditor be expected to determine those procedures based on the assessed risk of undisclosed matters? If based on risk, how should the auditor be directed to assess the risk of undisclosed related parties and related party transactions?

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.