
STANDING ADVISORY GROUP MEETING

RELATED PARTIES

OCTOBER 14-15, 2009

Introduction

The auditing standards of the Public Company Accounting Oversight Board ("PCAOB" or the "Board") require auditors to perform procedures to address the risk of material misstatement of financial statements arising from related party transactions.^{1/} The PCAOB is in the process of evaluating its auditing standard on related party transactions, AU sec. 334, *Related Parties* ("AU sec. 334"), to determine if the Board should amend AU sec. 334 or issue a new auditing standard on related party transactions that would supersede the Board's current standard.^{2/}

The staff believes that a standards-setting project to revise the related party guidance may be appropriate for a number of reasons. First, financial relationships with related parties have been a factor in recent corporate scandals. Second, information obtained from the Board's inspection reports and enforcement actions indicate that some auditors might not be exercising sufficient professional skepticism when evaluating financial relationships and transactions with related parties. Finally, a

^{1/} In addition, Section 10A of the Securities Exchange Act of 1934 requires each audit of an issuer to include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein." See Section 10A(a)(2) of the Exchange Act, 15 U.S.C. §78-j1(a)(2).

^{2/} References to AU sections ("AU secs.") throughout this paper are to the PCAOB's interim auditing standards, which consist of generally accepted auditing standards, as described in the American Institute of Certified Public Accountants ("AICPA") Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. These standards are available on the PCAOB's web site at www.pcaobus.org.

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| <p>This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.</p> |
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standards-setting project in this area could clarify and consolidate the related party guidance into a single standard, as well as consider both the work of other standards-setters and additional input from the SAG.

At the October 14-15, 2009 meeting of the PCAOB Standing Advisory Group ("SAG"), the SAG will be asked to discuss certain matters in connection with the development of the Board's standards-setting project on related parties. The Board has previously discussed improving its direction on the topic of related parties with the SAG at its September 9-10, 2004 and June 21, 2007 meetings.^{3/} The discussion topics at those meetings, among other things, included: the definition of a related party, the auditor's responsibility to identify undisclosed related parties, and the extent of testing for related party transactions. At those meetings, SAG members were supportive of the need to improve the direction in AU sec. 334.

Further discussion with the SAG regarding related parties will enhance our understanding of certain matters before the Board considers amending AU sec. 334 or proposing a new standard. Specifically, the SAG discussion will cover topics that a standards-setting project on related party transactions might address, including: assessing the risks associated with related party transactions, financial relationships with management, identifying undisclosed related party transactions, considering other relationships that might pose risks similar to related party transactions and management assertions regarding the equivalency of arm's-length terms. This briefing paper provides SAG members with background information about each discussion topic and the questions that will be presented during the meeting.

Background

Many related party transactions occur in the normal course of business. However, the influence of a related party might result in different transaction terms from those terms that would have occurred between independent parties or transactions that would not have otherwise occurred. Related party transactions also might be structured so as to achieve specific accounting results that are inconsistent with their substance. In addition, such financial relationships might create a significant incentive or pressure to perpetrate fraudulent financial reporting, or create an opportunity for self-dealing or

^{3/} The SAG briefing papers for previous meetings are available at: http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2004/09-08/Related_Party_Transactions.pdf and http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2007/06-21/Related_Parties.pdf.

unjust enrichment. The manner in which the risk of material misstatement associated with related party transactions might manifest itself in financial statements differs across industry sectors and geography.^{4/}

AU sec. 334 provides direction for the auditor regarding related party transactions and disclosures. Before its adoption as an interim standard by the Board in April 2003, AU sec. 334 was last updated in 1983.^{5/} Since then, financial relationships with related parties have been a contributing factor in corporate scandals that resulted in substantial shareholder losses.^{6/}

In 2006, the SEC strengthened its disclosure requirements regarding executive compensation and related persons through amendments to Items 402 and 404 of Regulation S-K.^{7/} In July 2008, the International Auditing and Assurance Standards

^{4/} For example, see *Cautionary Tales for Investors in Asia*, published by the Asia-Pacific Office of the CFA Institute Centre for Financial Market Integrity, available at: <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2009.n1.1>.

^{5/} When originally issued, AU sec. 334 included both accounting and auditing guidance. Financial Accounting Standards Board ("FASB") Statement No. 57, *Related Party Disclosures* ("FAS 57"), issued in 1982, carved out the accounting guidance for related party transactions. The AICPA subsequently amended AU sec. 334 to remove accounting guidance. FAS 57 is now referred to as FASB Accounting Standards Codification ("FASB Codification") Topic 850, *Related Party Disclosures*.

^{6/} For example, the study of SEC enforcement actions required by section 704 of the Sarbanes-Oxley Act notes that the failure to disclose related party transactions was associated with approximately 10% of SEC enforcement actions examined. See page 6 of the study, *Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002*, available at: <http://sec.gov/news/studies/sox704report.pdf>.

^{7/} Among other things, those amendments require that management disclose (1) a Compensation Discussion and Analysis addressing the objectives and implementation of executive compensation programs which focuses on the most important factors underlying the company's compensation practices; and (2) the company's policies and procedures for the review, approval or ratification of related person transactions. See SEC Release No. 33-8732A, *Executive Compensation and Related Person Disclosure* (August 29, 2006), available at: <http://www.sec.gov/rules/final/2006/33-8732a.pdf> and SEC Release No. 33-8765, *Executive Compensation Disclosure* (December 22, 2006) available at: <http://sec.gov/rules/final/2006/33-8765.pdf>.

Board ("IAASB") issued revised International Standard on Auditing No. 550, *Related Parties* ("ISA 550").^{8/} The Auditing Standards Board of the American Institute of Certified Public Accountants is currently considering revisions to its existing standard on auditing related parties. The Board is considering these developments, as well as input from the SAG and others, as part of its standards-setting efforts on related parties.

Discussion Topics

Assessing the Risks Associated with Related Party Transactions

In planning the audit, the auditor develops an overall strategy for the expected conduct and scope of the audit and should consider conditions that may require extension or modification of audit tests, such as the risk of material error or fraud or the existence of related party transactions.^{9/} Due professional care requires the exercise of professional skepticism when considering whether related party transactions have been properly accounted for and disclosed.^{10/}

Existing PCAOB standards highlight the importance of exercising professional skepticism when evaluating related party transactions. AU sec. 334.06 states that auditors should be aware of the possibility that transactions with related parties may have been motivated solely, or in large measure, by conditions similar to the following: lack of sufficient working capital or credit to continue the business; an urgent desire for a continued favorable earnings record in the hope of supporting the price of the company's stock; and overly optimistic earnings forecasts.

These conditions are similar to the examples of fraud risk factors contained in paragraph .85 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* ("AU sec. 316"). AU sec. 316.07 notes that three conditions generally are present when a fraud occurs. First, management or other employees have an incentive or are under pressure, which provides a reason to commit fraud. Second, circumstances exist that

^{8/} ISA 550 is effective for audits of financial statements for periods beginning on or after December 15, 2009.

^{9/} See paragraph 3(g) of AU sec. 311, *Planning and Supervision*.

^{10/} See AU sec. 230, *Due Professional Care*. Professional skepticism is an attitude that requires a questioning mind and a critical assessment of audit evidence. Professional skepticism requires that the auditor not be satisfied with less than persuasive evidence because of a belief that management is honest.

provide an opportunity for a fraud to be perpetrated. Third, those involved are able to rationalize committing a fraudulent act. AU sec. 316 contains the following examples of fraud risk factors that provide opportunities to engage in fraudulent financial reporting:

- significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
- ineffective monitoring of management as a result of domination of management by a single person or small group without compensating controls^{11/}

AU sec. 316.35 notes that the auditor should not assume that all three conditions must be observed before concluding there is a risk of material misstatement due to fraud ("fraud risk").

The staff is considering recommending that a proposed standard include a requirement that auditors presume, under certain conditions, related party transactions are fraud risks. Presuming that a related party transaction is a fraud risk could enhance the auditor's ability to identify the types of material misstatements that could occur due to fraud. For example, the presumption of a fraud risk could result in the auditor designing procedures to detect those types of misstatements.

Discussion Questions –

1. Should a proposed standard require the auditor to presume that the following are fraud risks:
 - A significant related party transaction that is outside the ordinary course of business

^{11/} AU sec. 316.08 notes that fraudulent financial reporting often involves management override of internal controls. AU sec. 316.85 also notes "...ineffective monitoring of management as a result of...domination of management by a single person or a small group could provide the opportunity for such override." Similar direction is contained in ISA 240, *The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements*. ISA 550 introduces the concept of "dominant influence" and provides examples of indicators to assist the auditor in identifying instances of dominant influence with regard to a related party. For example, paragraph A29 of ISA 550 notes that indicators of dominant influence exerted by a related party include: the related party has vetoed significant business decisions taken by management and referring significant transactions to the related party for final approval.

- A significant transaction with a related party that is not audited
 - The creation of a variable interest entity in which a company's economic interest (its obligation to absorb losses or its right to receive benefits) is disproportionately greater than the company's stated power^{12/}
 - The existence of a dominant influence exerted by a related party
2. Are there other relationships or related party transactions that should ordinarily be presumed to be a fraud risk?

Financial Relationships with Management

Management, which includes the CEO and CFO, is considered to be a related party. According to a March 1999 academic study that examined in detail 200 SEC accounting and auditing enforcement releases from 1987 to 1997, the CEO or CFO was involved in 83 percent of those cases of fraudulent financial reporting.^{13/} The financial relationships that a company has with its management can create significant incentives or pressures to commit fraud. For example, management might be motivated to focus on increasing the company's stock price in the short term rather than working toward achieving longer term business goals when there are stock options that vest in an upcoming period. Or, perhaps management has borrowed heavily against its shares

^{12/} Paragraph A35 of FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, states:

...[the FASB]...agreed that an increased level of skepticism is needed in situations in which an enterprise's economic interest in a variable interest entity, including its obligation to absorb losses or its right to receive benefits, is disproportionately greater than its stated power. In the...[FASB's]...view, the level of skepticism about an enterprise's lack of power should increase as the disparity between an enterprise's economic interest and its power increases.

^{13/} See M. Beasley, J. Carcello, D. Hermanson, "*Fraudulent Financial Reporting: 1987-1997 An Analysis of U.S. Public Companies*," available at: http://www.coso.org/publications/FFR_1987_1997.PDF.

and might be pressured to achieve aggressive earnings targets.^{14/} Obtaining an understanding of the company's financial relationships with management might assist the auditor in assessing the risk of material misstatement due to error or fraud and the ways in which management's incentives/pressures might impact the financial statements. Such an understanding could also inform the auditor's evaluation of misstatements.^{15/} That understanding could also impact the auditor's ability to identify inconsistencies between disclosures in the audited financial statements and the related person disclosures contained in other portions of SEC filings that include those statements.

AU sec. 316.85 includes examples of fraud risk factors that could result in incentives and pressures to commit fraud.^{16/} For example, information available indicates that management or the board of directors' personal financial situation is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results financial position, or cash flow
- Personal guarantees of debts of the entity

Paragraph 13 of proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, states that the auditor also should consider "[o]btaining an

^{14/} Item 403 of SEC regulation S-K now requires disclosure of the number of shares pledged as security by named executive officers, directors, and director nominees. However, no corresponding disclosure is required for foreign private issuers filing annual reports on Form 20-F.

^{15/} See paragraph .17(f) of AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312*, which notes that the relevant qualitative factors that the auditor may consider in assessing whether misstatements are material, include whether "[a] misstatement that has the effect of increasing management's compensation, for example, by satisfying the requirements for the award of bonuses or other forms of incentive compensation."

^{16/} Appendix 1 of ISA 240 contains similar examples of fraud risk factors.

understanding of compensation arrangements with senior management, including incentive compensation arrangements; changes or adjustments to those arrangements and special bonuses." The Board may consider whether to include procedures in a proposed standard to assist the auditor in determining whether or when the auditor should obtain such an understanding. A proposed standard might describe procedures that the auditor could perform to obtain that understanding of financial relationships with management and how those relationships could result in incentives and pressures for management to commit fraud. For example, the auditor could be required to obtain an understanding of the company's executive compensation arrangements by reviewing contracts and agreements.

U.S. generally accepted accounting principles ("U.S. GAAP") and International Financial Reporting Standards ("IFRS") differ in their approach to disclosure of executive compensation. These differences might result in different audit approaches. Financial Accounting Standards Board Accounting Standards Codification ("FASB Codification") Topic 850, *Related Party Disclosures*, does not require disclosure in the notes to the financial statements of "compensation arrangements, expense allowances, and other similar items in the ordinary course of business,"^{17/} while International Accounting Standard No. 24, *Related Party Disclosures* ("IAS 24"), on the other hand, does require disclosure in the notes to the financial statements of management compensation.^{18/} Although SEC regulations require supplemental disclosure of management compensation in filings that might include audited financial statements,^{19/}

^{17/} See FASB Codification Topic 850, paragraph 850-10-50-1.

^{18/} In paragraph BC6 of IAS 24, the International Accounting Standards Board ("IASB") noted that it decided management compensation should be disclosed in the notes to the financial statements, in part, because the "structure and amount of compensation are major drivers in the implementation of the business strategy." In paragraph BC7 of IAS 24, the IASB further noted that "disclosing key management personnel compensation would improve transparency and comparability, thereby enabling users of financial statements to make a better assessment of the impact of such compensation on the entity's financial position and profit or loss."

^{19/} Disclosure of executive compensation is required under Item 402 of Regulation S-K.

the auditor does not opine on these supplemental disclosures because they are outside the financial statements.^{20/}

Both FASB Codification Topic 850 and IAS 24 include management in their respective definitions of related parties and provide definitions of management.^{21/} Further, PCAOB Rule 3501 defines a "financial reporting oversight role" as:

...a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.^{22/}

Discussion Questions –

3. Should a proposed standard include a presumption that a financial relationship with management that creates a significant incentive for achievement of short-term performance goals is a fraud risk? Are there other ways in which a proposed standard could assist auditors in obtaining an understanding of financial relationships with management (e.g., management compensation)?
4. What types of procedures could auditors perform to obtain an understanding of the company's financial relationship with management? For example, should the Board consider a requirement for an auditor to

^{20/} AU sec 550, *Other Information in Documents Containing Audited Financial Statements*, provides guidance on the auditor's responsibility for other information contained in documents containing audited financial statements. AU sec. 550.04 notes that the auditor "should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements."

^{21/} See definition of "management" contained in the FASB Codification Master Glossary and definition of "key management personnel" contained in paragraph 9 of IAS 24.

^{22/} See PCAOB Rule 3501(f)(1) and 17 C.F.R Section 210.02-1(f)(3)(ii).

gain an understanding of executive compensation arrangements through a review of contracts and agreements?

5. When evaluating financial relationships with management, which individuals should be included in the auditor's scope? For example:
 - Persons in a financial reporting oversight role, (e.g., persons in a position to exercise influence over the financial statements)
 - Senior management
 - Management as defined by the applicable accounting framework

Identifying Undisclosed Related Party Transactions and Relationships

AU sec. 334 notes that the auditor should consider the risk of possible undisclosed related party transactions and relationships and outlines procedures that the auditor might consider performing to address those risks. AU sec. 334.05 allows the auditor's risk assessment to determine the extent of procedures performed to identify possible undisclosed related party transactions and relationships. However, an audit normally includes other procedures (e.g., reading minutes of board of directors and committee meetings and considering information obtained from legal and other confirmations obtained as part of the auditor's procedures) that might assist in identifying undisclosed related party transactions and relationships.^{23/} AU sec. 334.08 provides examples of procedures for identifying material transactions with known related parties and identifying transactions that may be indicative of the existence of previously undetermined relationships, including:

- Reviewing conflict-of-interests statements obtained by the company from its management
- Reviewing the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships

^{23/} See e.g., AU sec. 230, *Due Professional Care in the Performance of Work*, AU sec. 560, *Subsequent Events*, AU sec. 722, *Interim Financial Information*, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

- Considering whether transactions are occurring, but are not being given accounting recognition, such as receiving or providing accounting, management or other services at no charge or a major stockholder absorbing corporate expenses
- Reviewing accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period
- Reviewing invoices from law firms that have performed regular or special services for the company for indications of the existence of related parties or related party transactions

AU sec. 334.04 further notes that an audit performed in accordance with PCAOB auditing standards cannot be expected to provide assurance that all related party transactions will be discovered.

ISA 550.15 requires the auditor to remain "alert" for undisclosed related party transactions during the course of the audit and requires the auditor to inspect:

- Bank and legal confirmations obtained as part of the auditor's procedures
- Minutes of meetings of shareholders and of those charged with governance
- Such other records or documents as the auditor considers necessary in the circumstances of the entity

The application and other explanatory material of ISA 550 contains examples of procedures that may be used to identify undisclosed related party transactions. For example, inspecting records or documents such as: significant contracts or agreements not in the ordinary course of business, statements of conflicts of interest from management and those charged with governance, information supplied by the entity to regulatory authorities and shareholder registers to identify the entity's principal shareholders.

At previous SAG discussions, some SAG members noted that auditors should perform procedures to identify undisclosed related party transactions. Other SAG members, however, expressed concern that an auditing standard that requires auditors to identify undisclosed related party transactions might be too costly and burdensome.

Discussion Question –

6. Should a proposed standard require procedures that the auditor should perform to determine the existence of undisclosed related party transactions? If so, what procedures should be performed?

Considering Other Relationships That Might Pose Risks Similar to Related Party Transactions

SAG members previously noted some concerns over transactions, such as "round-trip" transactions, that might not meet the definition of a related party transaction, but that have similar risks. For example, AU sec. 316.85 includes "a strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions" as a fraud risk factor that provides an opportunity to engage in fraudulent financial reporting.

Those concerns could be addressed by not restricting the auditor's scope to entities that meet the definition of a related party. For example, the auditor could consider relationships that might be used to achieve a specific accounting result whose form differs from its substance or to achieve terms that would not be available to independent parties. Similar concerns were discussed in SEC Release No. 33-8056, *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations*, which notes that "investors may be unable to understand the registrant's reported results of operations without a clear explanation of...arrangements and relationships" which "may not meet the definition of a related party pursuant to FAS 57" but "may result in negotiation of terms that are more or less favorable than those available on an arm's-length basis from clearly independent third parties that are material to the registrant's financial position or results of operations."^{24/}

A proposed standard could require the auditor to consider whether transactions with entities that do not meet the definition of a related party pose similar risks to the financial statements. Examples of such relationships might include transactions or relationships with:

- entities managed by former officers
- significant customers and suppliers

^{24/} See <http://www.sec.gov/rules/other/33-8056.htm>.

- competitors^{25/}
- strategic alliances or partnerships

Discussion Question –

7. Should a proposed standard require auditors to consider relationships, that do not meet the definition of a related party, but that might pose similar risks (e.g., relationships with entities managed by former officers of the company, significant customers and suppliers, competitors, or strategic alliances)? What considerations are appropriate (e.g., concerns about substance over form or about obtaining terms that might not be available to a clearly independent party)? Are there other examples of such relationships that auditors should consider?

Management Assertions Regarding Equivalency with Arm's-Length Terms

Management might assert that a related party transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. For example, the following disclosure was contained in the accompanying notes to Enron's financial statements for the year ended December 31, 2000:

In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties.^{26/}

Both U.S. GAAP and IFRS allow management to assert that a related party transaction was consummated on terms equivalent to those that prevail in arm's-length transactions when there is support for that assertion.^{27/} However, neither framework

^{25/} See e.g., SEC Release 2004-148, available at <http://www.sec.gov/news/press/2004-148.htm>.

^{26/} See <http://www.sec.gov/Archives/edgar/data/1024401/000102440101500010/ene10-k.txt>.

^{27/} See FASB Codification Topic 850, paragraph 850-10-50-5. Paragraph 21 of IAS 24 also notes that disclosures "that related party transactions were made on

provides direction on how to determine whether the terms and conditions of a related party transaction are equivalent to those that prevail in an arm's-length exchange. AU sec. 334.12 provides direction to the auditor in such instances and notes that (*emphasis added*):

Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. If such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, he should express a qualified or adverse opinion because of a departure from generally accepted accounting principles, depending on materiality.

Paragraph .02 of AU sec. 150, *Generally Accepted Auditing Standards*, requires that "sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit." Paragraph .21 of AU sec. 326, *Evidential Matter*, notes that to be competent, evidence must be both valid and relevant and "when evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of independent audit than that secured solely from within the entity." AU sec. 326.25 further notes that "to the extent that the auditor remains in substantial doubt about any assertion of material significance, he or she must refrain from forming an opinion until he or she has obtained sufficient competent evidential matter to remove such substantial doubt, or the auditor must express a qualified opinion or a disclaimer of opinion."

Discussion Questions –

8. Should a proposed standard include a presumption that an assertion that a material related party transaction was consummated on terms equivalent to those that prevail in an arm's-length transaction is a significant risk?

terms equivalent to those that prevail in arm's length transactions are made only if such terms can be substantiated."

9. What type of evidence can an auditor obtain to support an assertion that a related party transaction was consummated on terms equivalent to those that prevail in an arm's-length transaction?

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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.