

Auditing Related Party Transactions of Brokers and Dealers pursuant to AS 2410

June 6, 2017

Introduction

Caveat

The views we express today are our own and do not necessarily reflect the views of the Board, individual Board members, or other members of the Board's staff.

Learning Objectives

The PCAOB Webcast for Auditors of Brokers and Dealers on Auditing Related Party Transactions of Brokers and Dealers, pursuant to AS 2410 is intended to assist auditors in further understanding the audit considerations related to the related parties and related party transactions of brokers and dealers through discussion of inspection observations and the use of illustrative examples.

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Agenda

- Opening Remarks
- Relevance to Brokers and Dealers
- Inspection Results
- Performing Risk Assessment and Other Procedures
- Responding to Identified and Assessed Risk
- Actions for Auditors
- Questions

Opening Remarks

Polling Question #1

In the Annual Report on the Interim Inspection Program related to Audits of Brokers and Dealers, issued in August 2016, which audit area saw a percentage increase in applicable audits with deficiencies?

- A. Fair value measurements
- B. Net capital computation
- C. Revenue
- D. Related party transactions

Relevance to Brokers and Dealers

Related Parties

Examples include:

- Principal owner(s)
- Parent or subsidiary
- Subsidiaries of common parents
- Affiliates

Related Party Transactions

Examples include:

- Sales, purchases, and transfers of real or personal property
- Services received or furnished
- Use of property and equipment by lease or otherwise
- Borrowing, lending, and guarantees

Audit and Attest Considerations

□ AS 2410: *Related Parties*

- AS 2110: *Identifying and Assessing the Risks of Material Misstatement*
- Staff Audit Practice Alert No. 12
- Staff Guidance for Auditors of SEC-Registered Brokers and Dealers

□ Attestation Standards

- Attestation Standard No.1
- Attestation Standard No. 2

FINRA Notice to Members 03-63, Expense-Sharing Agreements

- Books and records of brokers and dealers should accurately reflect operating performance and financial condition
- Artificial inflation of profitability
- Guidance with respect to use of expense sharing agreements

Polling Question #2

As described in Staff Audit Practice Alert No. 12, gaining an understanding of a company, its environment and internal controls over financial reporting includes understanding the company's key products and services and the contractual terms by which sales are made, such as the key provisions of contractual arrangements and the extent to which contractual terms are standardized across the company and includes understanding sales to related parties.

Yes = True

No = False

Inspection Results

2015 Inspection Results

- Identification of related party transactions
- Examining identified related party transactions

Identification of Related Party Transactions

- Evaluate the broker or dealer's identification of related party transactions
- Evaluate the completeness of management's disclosure

Examining Identified Related Party Transactions

- ❑ Perform procedures to test identified related party transactions
- ❑ Test revenue or expense amounts allocated to the broker or dealer

2016 Inspection Results

- Risk assessment and other procedures
- Procedures to test transactions identified as related party transactions

Polling Question #3

According to PCAOB release 2014-02, what was one of the key improvements that differentiate AS 2410 from the previous standard, AU 334?

- A. Aligning with the risk assessment standards
- B. Enhancing procedures to obtain an understanding of the Company's relationships and transactions with its related parties
- C. Adding audit committee communications
- D. All of these and more were identified as key improvements.

AS No. 2410, *Related Parties*

- ❑ Performing risk assessment procedures to obtain an understanding of the company's relationships and transactions with related parties
- ❑ Identifying and assessing risk of material misstatement ("RoMM")
- ❑ Responding to RoMM
- ❑ Evaluating whether the company has identified related parties (RPs) and related party transactions (RPTs)
- ❑ Evaluating accounting and disclosure
- ❑ Communications with the Audit Committee, or the equivalent

Performing Risk Assessment and Other Procedures

Risk Assessment and Other Procedures

Required Procedures (AS 2410):

- ❑ Obtain an understanding of the company's process (paragraph 4);
- ❑ Perform inquiries (paragraphs 5-7); and
- ❑ Communicate with the audit engagement team and other auditors (paragraphs 8-9).

Understanding the Company's Process

- ❑ Identifying related parties and relationships and transactions with related parties
- ❑ Authorizing and approving transactions with related parties
- ❑ Accounting for and disclosing relationships with related parties in the financial statements

Polling Question #4

What procedures should auditors perform to determine whether relevant related party and related party transaction controls are implemented?

- A. Inquiry of appropriate personnel
- B. Observation of the company's operations
- C. Inspection of relevant documentation
- D. A, and B or C

Performing Inquiries

- Management
- Others within the company
- Audit Committee, or the equivalent

Identifying and Assessing RoMM

Identify and assess the risks of material misstatement

- ❑ Financial statement level
- ❑ Assertion level

Polling Question #5

Risks of material misstatement associated with related parties and relationships and transactions with related parties are presumed to be significant risks or fraud risks.

Yes or No

Fraud Risk Assessment

□ Types of fraud:

- Fraudulent financial reporting, and
- Misappropriation of assets

□ Conditions present:

- Incentives/pressures,
- Opportunities, and
- Attitudes/rationalizations

5 Minute Break

Case Study – Part 1

Part 1 - Background

- ❑ Distributor, LLC (Distributor) is an introducing broker-dealer
- ❑ Distributes investment company products and limited partnership interests
- ❑ Wholly-owned subsidiary of Parent Funds, LLC (Parent)
- ❑ The FinOp for Distributor also maintains the books and records for affiliated entities

Part 1 - Background

❑ Financial statements disclosure:

“The Company is allocated expenses, including compensation and other amounts on the Income Statement, in accordance with a written expense sharing agreement with Parent, based on a percentage of time, space, and equipment used by Parent in conducting activities of the Company. The Company and Parent review the agreement annually to ensure such expense sharing percentages and estimates remain reasonable.”

❑ Balance sheet includes a receivable from Parent

Polling Question #6

Which procedure should the auditor perform related to the disclosed allocated expenses to comply with AS 2410 requirements?

- A. Design and implement audit responses that address the identified and assessed RoMMs
- B. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other evidence about the business purpose (or the lack thereof) of the transactions
- C. Determine whether and exceptions to the company's established policies or procedures were granted
- D. All of the above

Responding to Identified and Assessed Risk

Responding to RoMM

- ❑ The auditor must design and implement audit responses that address the identified and assessed risks of material misstatement.
- ❑ For each RPT that is either required to be disclosed in the financial statements or determined to be a significant risk, the auditor should.....

Responding to RoMM

- ❑ Read the underlying documentation
- ❑ Evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

Responding to RoMM

- ❑ Determine whether the transaction has been authorized and approved in accordance with the company's established policies and procedures regarding the authorization and approval of transactions with related parties;
- ❑ Determine whether any exceptions to the company's established policies or procedures were granted

Responding to RoMM

- ❑ Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
- ❑ Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Case Study – Part 2

Part 2

The auditor tested allocated expenses:

- Inquired of management
- Obtained and read the expense allocation agreement
- For a sample of months during the audit period, obtained the expense allocation spreadsheet and recalculated the allocation using percentages in the agreement

Polling Question #7

Which auditing standard provides guidance for designing and implementing audit procedures to respond to assessed risks of material misstatement for allocated expenses?

- A. AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*
- B. AS 1105, *Audit Evidence*
- C. Both AS 2301 and AS 1105
- D. AS 2510, *Auditing Inventories*

Polling Question #8

Which is an example of information that may be relevant to the auditor's evaluation of the Parent's financial capability, pursuant to AS 2410, paragraph 12, with respect to the receivable carried on Distributor's balance sheet?

- A. Audited financial statements of the Parent
- B. Reports issued by regulatory agencies
- C. Income tax returns of the Parent
- D. Any one of the above or more

Evaluating Proper Identification

- ❑ Evaluate whether the company has properly identified its related parties and relationships and transactions with related parties
- ❑ Perform procedures to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist
- ❑ If an undisclosed related party, relationship, or transaction exists, additional procedures are required (paragraph 16 of AS 2410)

AS 2410 Paragraph 16

- Inquire of management
- Evaluate why
- Promptly communicate
- Assess need to perform additional procedures
- Perform procedures required by Paragraph 12, as applicable
- Evaluate implications and reassess risk

Polling Question #9

Appendix A of AS 2410 includes examples of information that may be gathered during an audit that could help auditors identify previously undisclosed related parties, relationships, or transactions. These include:

- A. Relevant internal auditors' reports
- B. Contracts or agreements with parents or affiliates
- C. Regulatory communications
- D. All of the above

Case Study – Part 3

Part 3

- ❑ Requested Board of Directors meetings minutes for the year
- ❑ Obtained and read minutes from the first three meetings of the year and a summary of the actions of the last meeting during the audit period, as minutes were not yet available
- ❑ Auditor observed significant loans approved during these meetings for certain members of management, which were not identified by Distributor as related party transactions

Polling Question #10

Which procedure should the auditor perform with respect to the previously undisclosed related party transactions, if they are required to be disclosed?

- A. Read the underlying documentation and evaluate the terms and other information
- B. Determine whether any of the loans are exceptions to Distributor's established policies and procedures
- C. Evaluate the financial capability of the members of management to repay the loans
- D. All of the above

Evaluating Financial Statement Accounting and Disclosures

- ❑ Evaluate whether related party transactions have been properly accounted for and disclosed
- ❑ Evaluate whether financial statements contain essential information regarding relationships and transactions with related parties

Other Requirements

Significant Unusual Transactions

- ❑ AS 2401: *Consideration of Fraud in a Financial Statement Audit*
- ❑ AS 2110: *Identifying and Assessing Risks of Material Misstatement*

Polling Question #11

While the auditor is required to make certain inquiries of management, the auditor is not specifically required to inquire about significant unusual transactions.

Yes or No

Financial Relationships and Transactions with Executive Officers

AS 2110, Identifying and Assessing Risks of Material Misstatement

- ❑ Paragraph 10A—obtain an understanding of the company's financial relationships and transactions with its executive officers
- ❑ Paragraph 11—consider understanding compensation arrangements with senior management and inquiries with the chair of the compensation committee

Case Study – Part 4

Part 4

- ❑ Audit request list prepared by the auditor and sent to Distributor in advance of fieldwork
- ❑ One new request was to obtain copies of employment and compensation contracts for Distributor's executive officers
- ❑ CFO is pushing back on this new request

Polling Question #12

When discussing this new request with the CFO, what audit standard could the auditor refer to in order to help the CFO understand the nature of the request?

- A. AS 2410, paragraph 4
- B. AS 2110, paragraph 10A
- C. AS 2401, paragraph 5

Actions for Auditors

Actions for Auditors

- ❑ Apply the guidance in AS 2410
 - Risk assessment
 - Audit response, including required procedures
 - Audit Committee (or the equivalent) communications
- ❑ Consider other amendments made to certain PCAOB standards
- ❑ Maintain appropriate:
 - Professional skepticism
 - Integration of audit and attestation procedures
 - Risk-based assessment of audit evidence

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Questions?