CAQ ALERT

December 2017

B/D Alert #6: Related Party Transactions

This alert is intended to provide certain auditing considerations that may be relevant for audit and attestation engagements for brokers and dealers registered with the US Securities and Exchange Commission (SEC). The alert discusses some of the more judgmental or complex areas of the audit and attestation engagements, including some of those identified by the Public Company Accounting Oversight Board (PCAOB). [1]

While the alert highlights certain areas and questions for consideration, it should not be relied upon as definitive or all-inclusive, and should be read in conjunction with applicable rules, standards, and guidance in their entirety. The questions posed in this alert are a mixture of (1) questions applicable to all audits of brokers and dealers and (2) questions that may require further action if certain circumstances are present at the broker or dealer.

Please see previously issued CAQ Alert #2017-05, *Select Auditing Considerations for the 2017 Audit Cycle for Brokers and Dealers* where additional areas of the audit and attestation engagements are highlighted for consideration.[2]

Developing and Performing Audit Procedures

AS 2410, *Related Parties* (AS 2410), establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. Related party transactions are common in broker and dealer entities. Brokers and dealers may enter into expense-sharing or revenue-sharing agreements with a parent company or other affiliates (at times with cost plus mark-up type of arrangements).

[1] See PCAOB Staff Inspection Brief: *Information about 2017 Inspection of Auditors of Brokers and Dealers* and PCAOB Staff Inspection Brief: *Preview of Observations from 2016 Inspections of Auditors of Brokers and Dealers*.
[2] CAQ Alert #2017-05 is available at http://www.thecaq.org/caq-alert-2017-05-select-auditing-considerations-2017-audit-cycle-brokers-and-dealers.

Questions to Consider

Consider the following questions when developing and performing audit procedures to test related party transactions:

- Did the auditor obtain a sufficient understanding of the broker's or dealer's related party transactions to perform procedures responsive to the risks of material misstatement?
  - What agreements are in place with the related party and what is the purpose of the agreements? How often are those agreements executed, evaluated, and updated? What is the approval process for related party transactions?
  - How are the revenues and expenses allocated and recorded? What are the inputs to the allocation? How often do those inputs change? Who is responsible for the revenue and/or expense allocation process? Who authorizes changes to the allocation process?
  - What are the relevant inputs in calculating allocated expenses or revenues? How are those inputs determined?
  - Have there been errors in the allocation process in the past?
  - How are the intercompany balances settled with the parent company or affiliate?
  - What are the processes and controls in place related to the completeness and accuracy of related party disclosure(s) in the financial statements?
  - How does the broker or dealer determine or document that its expense allocation is reasonable in the context of the Notice to Members NASD 03-63 (net capital)?
  - Have all unconsolidated related parties been considered?
  - Are there investment banking fees earned from the parent?
- Does the auditor's response to the risks of material misstatement in related party transactions contemplate testing inputs to the related party transaction calculation? For example, if expenses are allocated based upon expenses incurred at the parent level, what was the nature and extent of the procedures to test those parent level expenses?
- Has management's treatment of related party receivable or payable balances in the net capital computation been considered? Are any of the receivable or payable amounts netted between affiliates? Have procedures been designed or performed to test that the netting is in accordance with US GAAP?

Audit Deficiencies

The following are examples of audit deficiencies that have been identified in previous PCAOB inspections related to this area:[3]

- Auditors did not perform sufficient risk assessment procedures to obtain an understanding of relationships and transactions with related parties.
- Auditors did not perform sufficient procedures to test the related party transactions.
    - The auditor did not test the revenue or expense allocated to the broker or dealer, or test the basis for the allocation and the computation of the allocated amount.
    - The auditor's procedures to test allocated expenses from a parent company were limited to reading the intercompany agreement, and tracing the amounts disclosed in the financial statements to a list of intercompany payments.
    - The auditor did not evaluate the reasonableness of whether the allocated revenues or expenses were in accordance with the terms of the intercompany agreement.

[3] As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.