

Accounting and Auditing for Related Parties and Related Party Transactions

A Toolkit for Accountants and Auditors

**Prepared by the staff of the
American Institute of Certified Public Accountants**

Notice To Readers and Acknowledgments

This electronic document was developed by staff of the American Institute of Certified Public Accountants. While this toolkit is not intended to break any new ground, it is intended to provide accountants and auditors with an overview of selected authoritative accounting and auditing literature, SEC requirements and nonauthoritative best practice guidance concerning related parties and related party transactions. Additionally, this toolkit contains illustrative checklists and other tools that CPAs may find useful in helping to comply with authoritative related party accounting and auditing standards. This publication has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA or the Financial Accounting Standards Board and has no official or authoritative status.

The auditing portion of this publication is an *Other Auditing Publication* as defined in SAS 95, *Generally Accepted Auditing Standards*. Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply Statements on Auditing Standards (SASs).

If an auditor applies the auditing guidance included in an *Other Auditing Publication*, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA, and is presumed to be appropriate.

I would particularly like to acknowledge and thank the AICPA Related Party Toolkit Team for their exemplary efforts in researching, writing and producing this timely document. The members of that team include:

Kim Gibson – Technical Manager, Audit and Attest Standards
Fred Gill – Senior Technical Manager, Accounting Standards
Jeanne Parsons – Technical Manager, SEC Practice Section

Appreciation is also expressed to the following AICPA staff for their support and contributions to this guide:

Al Anderson, Senior Vice President, Technical Standards
Susan Coffey, Vice President, Self-Regulation and SEC Practice Section
Jennifer Roddy, Director, SEC Practice Section

The AICPA is extremely grateful to the following accounting and auditing firms that have supported this effort by sharing with us their related party practice guidance and for providing helpful review comments.

Andersen LLP
BDO Seidman LLP
Deloitte & Touche LLP
Ernst & Young LLP
Grant Thornton LLP
KPMG LLP
McGladrey & Pullen LLP
PricewaterhouseCoopers LLP

Finally, we wish to acknowledge that this publication draws heavily from the AICPA publication, Practice Alert No. 95-3, ***Auditing Related Parties and Related Party Transactions***.

Charles E. Landes
Director, Audit & Attest Standards

December 2001

CONTENTS

INTRODUCTION	5
SUMMARY OF ACCOUNTING LITERATURE.....	7
<i>DISCLOSURE OF TRANSACTIONS WITH RELATED PARTIES.....</i>	7
<i>SEC NON-FINANCIAL STATEMENT DISCLOSURE REQUIREMENTS</i>	9
<i>ACCOUNTING FOR INVESTMENTS IN OTHER ENTITIES</i>	14
<i>ACCOUNTING FOR SPECIAL-PURPOSE ENTITIES</i>	19
<i>OTHER FINANCIAL REPORTING MATTERS.....</i>	22
SUMMARY OF AUDITING LITERATURE.....	23
<i>PLANNING AND SUPERVISION.....</i>	23
<i>AUDITING RELATED PARTIES.....</i>	24
<i>Related Party Indicators</i>	24
<i>Determining the Existence of Related Parties</i>	25
<i>Identifying Transactions With Related Parties.....</i>	26
<i>Examining Identified Related Party Transactions.....</i>	26
<i>Auditing Disclosures.....</i>	27
<i>Audit Documentation.....</i>	28
<i>AUDITING OFF BALANCE SHEET ARRANGEMENTS THAT MAY INVOLVE RELATED PARTIES</i>	28
<i>RELATED PARTY TRANSACTIONS AND FRAUD</i>	29
<i>MANAGEMENT REPRESENTATIONS</i>	31
<i>ENGAGEMENT STAFFING AND OTHER Q.C. CONSIDERATIONS</i>	31
<i>DISCLOSURE UPDATE AND CONSIDERATIONS.....</i>	31
POTENTIAL RELATED PARTY INDICATORS	33
APPENDIX I - ILLUSTRATIVE AUDIT PROGRAM FOR RELATED PARTIES	35
APPENDIX II - ILLUSTRATIVE DISCLOSURE CHECKLIST FOR RELATED PARTIES ..	41
APPENDIX III - ILLUSTRATIVE RELATED PARTY LETTERS.....	45
<i>ILLUSTRATIVE RELATED PARTY CONFIRMATION LETTER</i>	45
<i>ILLUSTRATIVE LETTER TO OTHER AUDITORS REGARDING RELATED PARTIES</i>	48

INTRODUCTION

One of the more important and yet more difficult aspects of a financial statement audit is the identification of related parties and transactions with related parties. This aspect of the audit is important because of (1) the requirement under generally accepted accounting principles to disclose material related party transactions and certain control relationships, (2) the potential for distorted or misleading financial statements in the absence of adequate disclosure, and (3) the instances of fraudulent financial reporting and misappropriation of assets that have been facilitated by the use of an undisclosed related party. An undisclosed related party is a powerful tool in the hands of an unscrupulous person. Related parties, such as controlled entities, principal stockholders or management can execute transactions that improperly inflate earnings by masking their economic substance or distort reported results through lack of disclosure, or can even defraud the company by transferring funds to conduit related parties and ultimately to the perpetrators.

Related parties and related party transactions are difficult to audit for several reasons. First, transactions with related parties are not always easily identifiable. For example, a series of sales in the normal course of business, individually insignificant, could be executed with an undisclosed related party that in total could be material. Second, although other procedures are ordinarily performed, the auditor relies primarily upon management and principal owners to identify all related parties and related party transactions. Third, such transactions may not be easily tracked by a company's internal control.

Due to this complexity, the proper accounting and auditing of related party transactions requires a sound understanding and extremely careful analysis. We believe that this toolkit will assist accountants and auditors in better understanding some of the current issues pertaining to related parties and related party transactions. Additionally, we believe that this toolkit will serve as a valuable reference guide when dealing with this complex topic.

Generally accepted accounting principles define related parties and requires certain disclosures regarding material related party transactions, as well as 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 absence of such relationships, regardless of whether there were transactions between or among the related parties. In the [“Summary of Accounting Literature”](#) you will find an overview of accounting guidance applicable to related parties; and, because some unconsolidated, non-independent, limited purpose entities, often referred to as structured finance or special purpose entities may be related parties, we have also included in this [summary](#) certain accounting guidance we believe you may find useful in better understanding accounting for such entities.

Generally accepted auditing standards provide guidance on procedures that should be considered by the auditor to identify related party relationships and transactions, and to satisfy him or herself that such relationships and material transactions are properly accounted for and adequately disclosed in the financial statements. In the section titled [“Summary of Auditing Literature,”](#) we have provided summaries of authoritative auditing guidance as well as nonauthoritative guidance applicable to auditing related parties including nonauthoritative guidance on auditing off-balance sheet arrangements that may involve related parties.

An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related parties have been identified. However, during the auditor's assessment of risk, one of the factors that should be considered is the existence of related parties and

the extent and nature of transactions with those parties, particularly if one of the related parties is either unaudited or audited under questionable circumstances, such as significant scope limitations or questions as to the professional reputation and independence of the other auditors. When there are significant transactions between related parties and the scope of the audit does not cover the records of the other significant parties to the transactions (for example, an entity owned by the president of the company that provides management services to the company, but is not subject to audit), there is increased audit risk¹. This issue may be particularly troublesome when material transactions involve individuals such as stockholders or officers, because individuals are rarely subject to audit.

The existence of related parties and transactions with such parties alone is not necessarily an indication of increased audit risk. However, the auditor should consider the possibility that related party transactions might have been motivated by a desire to improve reported earnings or financial position or by fraud. Specific examples of related party relationships and related issues have been compiled based on input from the participating accounting and auditing firms as well as the AICPA SEC Practice Section and are included in the section entitled [“Potential Related Party Indicators”](#).

This toolkit also includes an [Illustrative Audit Program for Related Parties](#), an [Illustrative Disclosure Checklist for Related Parties](#) and [Illustrative Related Party Letters](#). These tools are based on the best practices guidance received from the participating accounting and auditing firms and should be appropriately tailored to the specific client.

As announced in our December 4, 2001 [press release](#), the AICPA is working cooperatively with the five largest U.S. auditing firms on several other related projects. One task force will provide specific recommendations to the SEC. Those recommendations include asking the SEC to provide interpretive disclosure guidance for 2001 public company annual reports in three critical areas where greater transparency could provide investors with information important to an understanding of the financial statements. Another task force is preparing a document that will provide an assessment of risk factors that may be important for financial statement preparers, auditors, and audit committees to consider during the current reporting cycle and suggestions as to how each of these major constituencies can contribute to promoting better financial reporting for the benefit of investors.

Because of these and other events and current circumstances, we encourage accountants and auditors to continue to monitor the [AICPA’s website](#) for these and other new developments. We will occasionally update this electronic toolkit as new standards or guidance applicable to related parties become available.

¹ Audit risk consists of (a) the risk (consisting of inherent risk and control risk) that the balance or class and related assertions contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other balances or classes and (b) the risk (detection risk) that the auditor will not detect such misstatements. See SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, (AICPA, *Professional Standards*, vol. 1, AU sec.312.27) for further discussion of inherent risk, control risk and detection risk.

SUMMARY OF ACCOUNTING LITERATURE

This section provides an overview of selected authoritative accounting literature and Securities and Exchange Commission (SEC) requirements concerning accounting for related entities and disclosure of transactions with related parties. It also includes an overview of selected authoritative accounting literature and SEC requirements concerning special-purpose entities. Accounting for related entities and disclosure of transactions with related parties are pervasive financial reporting issues, and this section is not intended to identify or address all possible matters concerning those issues. Furthermore, this publication should not be used as a substitute for the original authoritative accounting literature and SEC literature; readers should consult the original authoritative accounting literature and SEC literature in identifying and resolving accounting and disclosure issues affecting a particular reporting entity. Moreover, SEC registrants are encouraged to discuss unusual transactions with the SEC staff on a pre-filing basis.

Disclosure of Transactions with Related Parties

FASB Statement No. 57, *Related Party Disclosures*, provides guidance on the disclosure of transactions with related parties. Examples of related parties transactions include transactions between:

- A parent company and its subsidiaries;
- Subsidiaries of a common parent;
- An enterprise and trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of the enterprise's management;
- An enterprise and its principal owners, management, or members of their immediate families, and
- Affiliates.

Transactions between related parties commonly occur in the normal course of business. Some examples of common types of transactions with related parties are: sales, purchases, and transfers of realty and personal property; services received or furnished, for example, accounting, management, engineering, and legal services; use of property and equipment by lease or otherwise; borrowings and lendings; guarantees; maintenance of bank balances as compensating balances for the benefit of another; intercompany billings based on allocations of common costs; and filings of consolidated tax returns. Transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition. For example, an enterprise may receive services from a related party without charge and not record receipt of the services.

FASB Statement No. 57 defines related parties as the following:

- Affiliates of the enterprise. An affiliate is a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise. *Control* for purpose of FASB Statement No. 57 means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise.
- Entities for which investments are accounted for by the equity method by the enterprise.
- Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management.
- Principal owners of the enterprise. Principal owners are owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise.

- Management of the enterprise. Management includes persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policymaking functions. Persons without formal titles also may be members of management.
- Members of the immediate families of principal owners of the enterprise and its management. Immediate family includes family members whom a principal owner or a member of management might control or influence or by whom they might be controlled or influenced because of the family relationship.
- Other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.
- Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Financial statements must include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements.² The disclosures must include:³

- a. The nature of the relationship(s) involved.
- b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements.
- c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.
- d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.

Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, may not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless those representations can be substantiated.

² The requirements of FASB Statement No. 57 are applicable to separate financial statements of each or combined groups of each of the following: a parent company, a subsidiary, a corporate joint venture, or a 50-percent-or-less owned investee. However, it is not necessary to duplicate disclosures in a set of separate financial statements that is presented in the financial report of another enterprise (the primary reporting enterprise) if those separate financial statements also are consolidated or combined in a complete set of financial statements and both sets of financial statements are presented in the same financial report.

³ In some cases, aggregation of similar transactions by type of related party may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed.

If the reporting enterprise and one or more other enterprises are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting enterprise significantly different from those that would have been obtained if the enterprises were autonomous, the nature of the control relationship must be disclosed even though there are no transactions between the enterprises.

For SEC registrants, SEC regulation S-X, rules 4-08(k)(1) and (2) set forth the following additional requirements:

(k) *Related party transactions, which affect the financial statements.* (1) Related party transactions should be identified and the amounts stated on the face of the balance sheet, income statement, or statement of cash flows.

(2) In cases where separate financial statements are presented for the registrant, certain investees, or subsidiaries, separate disclosure shall be made in such statements of the amounts in the related consolidated financial statements which are (i) eliminated and (ii) not eliminated. Also, any intercompany profits or losses resulting from transactions with related parties and not eliminated and the effects thereof shall be disclosed.

SEC Non-Financial Statement Disclosure Requirements

SEC Regulation S-K (Reg. § 229.404. Item 404) requires disclosure of certain relationships and related transactions in the nonfinancial-statement portions of registration statements filed under the 1933 securities act and registration statements, annual reports, proxy statements, and any other documents required to be filed under the 1934 securities act, as follows:

(a) *Transactions with management and others.* Describe briefly any transaction, or series of similar transactions, since the beginning of the registrant's last fiscal year, or any currently proposed transaction, or series of similar transactions, to which the registrant or any of its subsidiaries was or is to be a party, in which the amount involved exceeds \$60,000 and in which any of the following persons had, or will have, a direct or indirect material interest, naming such person and indicating the person's relationship to the registrant, the nature of such person's interest in the transaction(s), the amount of such transaction(s) and, where practicable, the amount of such person's interest in the transaction(s):

- (1) Any director or executive officer of the registrant;
- (2) Any nominee for election as a director;
- (3) Any security holder who is known to the registrant to own of record beneficially more than five percent of any class of the registrant's voting securities; and
- (4) Any member of the immediate family of any of the foregoing persons.

Instructions to Paragraph (a) of Item 404.

1. The materiality of any interest is to be determined on the basis of the significance of the information to investors in light of all the circumstances of the particular case. The importance of the interest to the person having the interest, the relationship of the parties to the transaction with each other and the amount involved in the transactions are among the factors to be considered in determining the significance of the information to investors.

2. For purposes of paragraph (a), a person's immediate family shall include such person's spouse; parents; children; siblings; mothers and fathers-in-law; sons and daughters-in-law; and brothers and sisters-in-law.

3. In computing the amount involved in the transaction or series of similar transactions, include all periodic installments in the case of any lease or other agreement providing for periodic payments or installments.

4. The amount of the interest of any person specified in paragraphs (a)(1) through (4) shall be computed without regard to the amount of the profit or loss involved in the transaction(s).

5. In describing any transaction involving the purchase or sale of assets by or to the registrant or any of its subsidiaries, otherwise than in the ordinary course of business, state the cost of the assets to the purchaser and, if acquired by the seller within two years prior to the transaction, the cost thereof to the seller. Indicate the principle followed in determining the registrant's purchase or sale price and the name of the person making such determination.

6. Information shall be furnished in answer to paragraph (a) with respect to transactions that involve remuneration from, the registrant or its subsidiaries, directly or indirectly, to any of the persons specified in paragraphs (a)(1) through (4) for services in any capacity unless the interest of such person arises solely from the ownership individually and in the aggregate of less than ten percent of any class of equity securities of another corporation furnishing the services to the registrant or its subsidiaries.

7. No information need be given in answer to paragraph (a) as to any transactions where:

A. The rates or charges involved in the transaction are determined by competitive bids, or the transaction involves the rendering of services as a common or contract carrier, or public utility, at rates or charges fixed in conformity with law or governmental authority;

B. The transaction involves services as a bank depository of funds, transfer agent, registrar, trustee under a trust indenture, or similar services; or

C. The interest of the person specified in paragraphs (a)(1) through (4) arises solely from the ownership of securities of the registrant and such person receives no extra or special benefit not shared on a pro rata basis.

8. Paragraph (a) requires disclosure of indirect, as well as direct, material interests in transactions. A person who has a position or relationship with a firm, corporation, or other entity that engages in a transaction with the registrant or its subsidiaries may have an indirect interest in such transaction by reason of such position or relationship. Such an interest, however, shall not be deemed "material" within the meaning of paragraph (a) where:

A. The interest arises only (i) from such person's position as a director of another corporation or organization which is a party to the transaction; or (ii) from the direct or indirect ownership by such person and all other persons specified in paragraphs (a)(1) through (4), in the aggregate, of less than a ten percent equity interest in another person (other than a partnership) which is a party to the transaction; or (iii) from both such position and ownership;

B. The interest arises only from such person's position as a limited partner in a partnership in which the person and all other persons specified

in paragraphs (a)(1) through (4) have an interest of less than ten percent;
or

C. The interest of such person arises solely from the holding of an equity interest (including a limited partnership interest, but excluding a general partnership interest) or a creditor interest in another person that is a party to the transaction with the registrant or any of its subsidiaries, and the transaction is not material to such other person.

9. There may be situations where, although these instructions do not expressly authorize nondisclosure, the interest of a person specified in paragraphs (a)(1) through (4) in a particular transaction or series of transactions is not a direct or indirect material interest. In that case, information regarding such interest and transaction is not required to be disclosed in response to this paragraph.

(b) *Certain business relationships.* Describe any of the following relationships regarding directors or nominees for director that exist, or have existed during the registrant's last fiscal year, indicating the identity of the entity with which the registrant has such a relationship, the name of the nominee or director affiliated with such entity and the nature of such nominee's or director's affiliation, the relationship between such entity and the registrant and the amount of the business done between the registrant and the entity during the registrant's last full fiscal year or proposed to be done during the registrant's current fiscal year:

(1) If the nominee or director is, or during the last fiscal year has been, an executive officer of, or owns, or during the last fiscal year has owned, of record or beneficially in excess of ten percent equity interest in, any business or professional entity that has made during the registrant's last full fiscal year, or proposes to make during the registrant's current fiscal year, payments to the registrant or its subsidiaries for property or services in excess of five percent of (i) the registrant's consolidated gross revenues for its last full fiscal year, or (ii) the other entity's consolidated gross revenues for its last full fiscal year;

(2) If the nominee or director is, or during the last fiscal year has been, an executive officer of, or owns, or during the last fiscal year has owned, of record or beneficially in excess of ten percent equity interest in, any business or professional entity to which the registrant or its subsidiaries has made during the registrant's last full fiscal year, or proposes to make during the registrant's current fiscal year, payments for property or services in excess of five percent of (i) the registrant's consolidated gross revenues for its last full fiscal year, or (ii) the other entity's consolidated gross revenues for its last full fiscal year;

(3) If the nominee or director is, or during the last fiscal year has been, an executive officer of, or owns, or during the last fiscal year has owned, of record or beneficially in excess of ten percent equity interest in, any business or professional entity to which the registrant or its subsidiaries was indebted at the end of the registrant's last full fiscal year in an aggregate amount in excess of five percent of the registrant's total consolidated assets at the end of such fiscal year;

(4) If the nominee or director is, or during the last fiscal year has been, a member of, or of counsel to, a law firm that the issuer has retained during the last fiscal year or to retain during the current fiscal year; *Provided, however,* that the dollar amount of fees paid to a law firm by the registrant need not be disclosed if such amount does not exceed five percent of the law firm's gross revenues for that firm's last full fiscal year;

(5) If the nominee or director is, or during the last fiscal year has been, a partner or executive officer of any investment banking firm that has performed services for the

registrant, other than as a participating underwriter in a syndicate, during the last fiscal year or that the registrant proposes to have perform services during the current year; *Provided, however,* that the dollar amount of compensation received by an investment banking firm need not be disclosed if such amount does not exceed five percent of the investment banking firm's consolidated gross revenues for that firm's last full fiscal year; or

(6) Any other relationships that the registrant is aware of between the nominee or director and the registrant that are substantially similar in nature and scope to those relationships listed in paragraphs (b)(1) through (5).

Instructions to Paragraph (b) of Item 404.

1. In order to determine whether payments or indebtedness exceed five percent of the consolidated gross revenues of any entity, other than the registrant, it is appropriate to rely on information provided by the nominee or director.

2. In calculating payments for property and services the following may be excluded:

A. Payments where the rates or charges involved in the transaction are determined by competitive bids, or the transaction involves the rendering of services as a common contract carrier, or public utility, at rates or charges fixed in conformity with law or governmental authority;

B. Payments that arise solely from the ownership of securities of the registrant and no extra or special benefit not shared on a pro rata basis by all holders of the class of securities is received; or

C. Payments made or received by subsidiaries other than significant subsidiaries as defined in Rule 1-02(w) of Regulation S-X [§ 210.1-02(w)], provided that all such subsidiaries making or receiving payments, when considered in the aggregate as a single subsidiary, would not constitute a significant subsidiary as defined in Rule 1-02(w).

3. In calculating indebtedness the following may be excluded:

A. Debt securities that have been publicly offered, admitted to trading on a national securities exchange, or quoted on the automated quotation system of a registered securities association;

B. Amounts due for purchases subject to the usual trade terms; or

C. Indebtedness incurred by subsidiaries other than significant subsidiaries as defined in Rule 1-02(w) of Regulation S-X [§ 210.1-02(w)], provided that all such subsidiaries incurring indebtedness, when considered in the aggregate as a single subsidiary, would not constitute a significant subsidiary as defined in Rule 1-02(w).

4. No information called for by paragraph (b) need be given respecting any director who is no longer a director at the time of filing the registration statement or report containing such disclosure. If such information is being presented in a proxy or information statement, no information need be given respecting any director whose term of office as a director will not continue after the meeting to which the statement relates.

(c) *Indebtedness of management.* If any of the following persons has been indebted to the registrant or its subsidiaries at any time since the beginning of the registrant's last fiscal year in an amount in excess of \$60,000, indicate the name of such person, the nature of the person's relationship by reason of which such person's indebtedness is required to be described, the largest aggregate amount of indebtedness outstanding at

any time during such period, the nature of the indebtedness and of the transaction in which it was incurred, the amount thereof outstanding as of the latest practicable date and the rate of interest paid or charged thereon:

- (1) Any director or executive officer of the registrant;
- (2) Any nominee for election as a director;
- (3) Any member of the immediate family of the persons specified in paragraph (c)(1) or (2);
- (4) Any corporation or organization (other than the registrant or a majority-owned subsidiary of the registrant) of which any of the persons specified in paragraphs (c)(1) or (2) is an executive officer or partner or is, directly or indirectly, the beneficial owner of ten percent or more of any class of equity securities; and
- (5) Any trust or other estate in which any of the persons specified in paragraph (c)(1) or (2) has a substantial beneficial interest or as to which such person serves as a trustee or in a similar capacity.

Instructions to Paragraph (c) of Item 404.

1. For purposes of paragraph (c), the members of a person's immediate family are those persons specified in Instruction 2 to Item 404(a).

2. Exclude from the determination of the amount of indebtedness all amounts due from the particular person for purchases subject to usual trade terms, for ordinary travel and expense payments and for other transactions in the ordinary course of business.

3. If the lender is a bank, savings and loan association, or broker-dealer extending credit under Federal Reserve Regulation T [12 CFR Part 2201 and the loans are not disclosed as nonaccrual, past due, restructured or potential problems (see Item.III.C.1. and 2. of Industry Guide 3, Statistical Disclosure by Bank Holding Companies), disclosure may consist of a statement, if such is the case, that the loans to such persons (A) were made in the ordinary course of business,(B) were made on substantially the same terms, including interest rates and collateral as those prevailing at the time for comparable transactions with other persons, and (C) did not involve more than the normal risk of collectibility or present other unfavorable features.

4. If any indebtedness required to be described arose under Section 16(b) of the Exchange Act and has not been discharged by payment, state the amount of any profit realized, that such profit will inure to the benefit of the registrant or its subsidiaries and whether suit will be brought or other steps taken to recover such profit. If, in the opinion of counsel, a question reasonably exists as to the recoverability of such profit, it will suffice to state all facts necessary to describe the transactions, including the prices and number of shares involved.

(d) *Transactions with promoters.* Registrants that have been organized within the past five years and that are filing a registration statement on Form S-1 under the Securities Act [§239.11] or on Form 10 and Form 10-SE under the Exchange Act [§249.210 and § 249.210b] shall:

(1) State the names of the promoters, the nature and amount of anything of value (including money, property, contracts, options or rights of any kind) received or to be received by each promoter, directly or indirectly, from the registrant and the nature and amount of any assets, services or other consideration therefor received or to be received by the registrant; and

(2) As to any assets acquired or to be acquired by the registrant from a promoter, state the amount at which the assets were acquired or are to be acquired and the principle followed or to be followed in determining such amount and identify the persons making the determination and their relationship, if any, with the registrant or any promoter. If the assets were acquired by the promoter within two years prior to their transfer to the registrant, also state the cost thereof to the promoter.

Instructions to Item 404.

1. No information need be given in response to any paragraph of Item 404 as to any compensation or other transaction reported in response to any other paragraph of Item 404 or to Item 402 of Regulation S-K [§229.402] or as to any compensation or transaction with respect to which information may be omitted pursuant to Item 402.

2. If the information called for by Item 404 is being presented in a registration statement filed pursuant to the Securities Act or the Exchange Act, information shall be given for the periods specified in this Item and, in addition, for the two fiscal years preceding the registrant's last fiscal year.

3. A foreign private issuer may respond to Item 404 only to the extent that the registrant discloses to its security holders or otherwise makes public the information specified in that Item.

[As last amended in Release No. FR-44, December 13, 1994, 59 F.R. 65632.1]

Accounting for Investments in Other Entities

Consolidation. Accounting Research Bulletin (ARB) 51, *Consolidated Financial Statements*, as amended by Financial Accounting Standards Board (FASB) Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, requires the consolidation of all majority-owned subsidiaries unless control is temporary or does not rest with the majority owner. ARB 51 also provides guidance on the preparation of combined financial statements where a controlling financial interest does not rest directly or indirectly with one of the companies included in the consolidation, for example, where one individual owns a controlling interest in several corporations that are related in their operations.

FASB Statement No. 94 prohibits the issuance of parent-company financial statements as general-purpose financial statements of an enterprise that has one or more subsidiaries.

EITF Issue No. 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights," provides that substantive minority rights (whether granted by contract or by law) to effectively participate in significant decisions that would be expected to be made "in the ordinary course of business" would overcome the presumption that the investor with a majority voting interest should consolidate its investee, while rights that are only "protective" of the minority shareholder's investment would not overcome that presumption. EITF Issue No. 96-16 also provides guidance on determining whether minority rights are substantive participating rights or protective rights. EITF Issue No. 96-16 applies only to investments in which the investor has a majority voting interest in investees that are corporations or analogous entities (such as limited liability companies that have governing provisions that are the functional equivalent of regular corporations).

EITF Issue No. 97-2, “Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements,” addresses situations in which physician practice management entities establish a controlling financial interest in a physician practice through a contractual management agreement without having ownership of a majority of the outstanding voting equity instruments of the physician practice. There may be industries other than the health care industry in which a contractual management arrangement is established under circumstances similar to those addressed in EITF Issue 97-2; the use of the guidance in EITF Issue 97-2 should be considered when the circumstances are similar.

For SEC registrants, further guidance is provided in SEC Regulation S-X, Rule3A-02, which states in part:

In deciding upon consolidation policy, the registrant must consider what financial presentation is most meaningful in the circumstances and should follow in the consolidated financial statements principles of inclusion or exclusion which will clearly exhibit the financial position and results of operations of the registrant. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one entity directly or indirectly has a controlling financial interest in another entity. Other particular facts and circumstances may require combined financial statements, an equity method of accounting, or valuation allowances in order to achieve a fair presentation. In any case, the disclosures required by § 210.3A-03 should clearly explain the accounting policies followed by the registrant in this area, including the circumstances involved in any departure from the normal practice of consolidating majority owned subsidiaries and not consolidating entities that are less than majority owned. Among the factors that the registrant should consider in determining the most meaningful presentation are the following:

(a) *Majority ownership*: Generally, registrants shall consolidate entities that are majority owned and shall not consolidate entities that are not majority owned. The determination of "majority ownership" requires a careful analysis of the facts and circumstances of a particular relationship among entities. In rare situations, consolidation of a majority owned subsidiary may not result in a fair presentation, because the registrant, in substance, does not have a controlling financial interest (for example, when the subsidiary is in legal reorganization or in bankruptcy, or when control is likely to be temporary). In other situations, consolidation of an entity, notwithstanding the lack of technical majority ownership, is necessary to present fairly the financial position and results of operations of the registrant, because of the existence of a parent-subsidiary relationship by means other than of voting stock.

(b) *Different fiscal periods*: Generally, registrants shall not consolidate any entity whose financial statements are as of a date of for periods substantially different from those of the registrant. Rather, the earnings or losses of such entities should be reflected in the registrant’s financial statements on the equity method of accounting. However:

(1) A difference in fiscal periods does not of itself justify the exclusion of an entity from consolidation. It ordinarily is feasible for such entity

to prepare, for consolidation purposes, statements for a period which corresponds with or closely approaches the fiscal year of the registrant. Where the difference is not more than 93 days, it is usually acceptable to use, for consolidation purposes, such entity's statements for its fiscal period. Such difference, when it exists, should be disclosed as follows: the closing date of the entity should be expressly indicated, and the necessity for the use of different closing dates should be briefly explained. Furthermore, recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position or results of operations. . . .

(c) *Foreign subsidiaries*: Due consideration shall be given to the propriety of consolidating with domestic corporations foreign subsidiaries which are operated under political, economic or currency restrictions. If consolidated, disclosure should be made as to the effect, insofar as this can reasonably be determined, of foreign exchange restrictions upon the consolidated financial position and operating results of the registrant and its subsidiaries.

The equity method. Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, as amended, requires enterprises to use the equity method of accounting for an investment in common stock if the investment gives the investor the ability to exercise significant influence over operating and financial policies of an investee even if the investor holds 50 percent or less of the voting stock. Ability to exercise a significant influence may be indicated in several ways, such as representation on the board of directors, participation in policymaking processes, material intercompany transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by an investor in relation to the concentration of other shareholdings, but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor. Determining the ability of an investor to exercise significant influence is not always clear and applying judgment is necessary to assess the status of each investment. However, an investment (direct or indirect) of 20 percent or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee.⁴ Conversely, an investment of less than 20 percent of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless that ability can be demonstrated.

The significance of an investment to the investor's financial position and results of operations should be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. If the investor has more than one investment in common stock, disclosures wholly or partly on a combined basis may be appropriate. The following disclosures are generally applicable to the equity method of accounting for investments in common stock:

- a. Financial statements of an investor should disclose parenthetically, in notes to financial statements, or in separate statements or schedules (1) the name of each investee and percentage of ownership of common stock, (2) the accounting policies of the investor with respect to

⁴ An investor's voting stock interest in an investee should be based on those currently outstanding securities whose holders have present voting privileges. Potential voting privileges that may become available to holders of securities of an investee should be disregarded.

investments in common stock,⁵ and (3) the difference, if any, between the amount at which an investment is carried and the amount of underlying equity in net assets and the accounting treatment of the difference.

- b. For those investments in common stock for which a quoted market price is available, the aggregate value of each identified investment based on the quoted market price usually should be disclosed. This disclosure is not required for investments in common stock of subsidiaries.
- c. If investments in common stock of corporate joint ventures or other investments accounted for under the equity method are, in the aggregate, material in relation to the financial position or results of operations of an investor, it may be necessary for summarized information as to assets, liabilities, and results of operations of the investees to be presented in the notes or in separate statements, either individually or in groups, as appropriate.
- d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants and other contingent issuances of an investee may have a significant effect on an investor's share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises, or contingent issuances should be disclosed in notes to the financial statements of an investor.

APB Opinion No. 18 applies to investments in common stock; it therefore does not specifically apply to investments in unincorporated entities. However, AICPA Interpretation No. 2 of APB Opinion No. 18 states that many of the provisions of APB Opinion No. 18 would be appropriate in accounting for investments in unincorporated entities such as partnerships and unincorporated joint ventures.

For SEC registrants, Rules 3-09, 4-08(g), 10-01(b)(1), and 1-02(bb) of Regulation S-X set forth further requirements for the presentation of summarized financial information of subsidiaries not consolidated and 50 percent or less owned persons.

AICPA Statement of Position (SOP) 78-9, *Accounting for Investments in Real Estate Ventures*, provides guidance on consolidation of real estate ventures, including those organized as a general or limited partnership or undivided interest. In practice, the guidance in SOP 78-9 also is applied by analogy in accounting for non-real estate ventures outside the scope of APB Opinion No. 18. Among other things, SOP 78-9 provides that—

- Investments in noncontrolled real estate general partnerships should be accounted for and reported under the equity method.
- A general partnership that is controlled, directly or indirectly, by an investor is, in substance, a subsidiary of the investor. If partnership voting interests are not clearly indicated, a condition that would usually indicate control is ownership of a majority (over 50 percent) of the financial interests in profit or losses. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other partners, or by court decree. On the other hand, majority ownership may not constitute control if major decisions such as the acquisition, sale, or refinancing of principal partnership assets must be approved by one or more of the other partners.

⁵ Disclosure should include the names of any significant investee corporations in which the investor holds 20 percent or more of the voting stock, but the common stock is not accounted for on the equity method, together with the reasons why the equity method is not considered appropriate, and the names of any significant investee corporations in which the investor holds less than 20 percent of the voting stock and the common stock is accounted for on the equity method, together with the reasons why the equity method is considered appropriate.

- General partners in a limited partnership are in control and should account for the limited partnership as a subsidiary only if the substance of the partnership or other agreements provides for control by the general partners.
- If the general partner in a limited partnership is not in control of the major operating and financial policies of the partnership, a limited partner may be in control. An example could be a limited partner holding over 50 percent of the total partnership interest. A controlling limited partner should be guided in accounting for its investment by the principles for investments in subsidiaries.
- Investors should record their share of the real estate venture's losses, determined in conformity with generally accepted accounting principles, without regard to unrealized increases in the estimated fair value of the venture's assets.
- An investor that is liable for the obligations of the venture or is otherwise committed to provide additional financial support to the venture should record its equity in real estate venture losses in excess of its investment, including loans and advances. The following are examples of such circumstances:
 - The investor has a legal obligation as a guarantor or general partner.
 - The investor has indicated a commitment, based on considerations such as business reputation, intercompany relationships, or credit standing, to provide additional financial support. Such a commitment might be indicated by previous support provided by the investor or statements by the investor to other investors or third parties of the investor's intention to provide support.
- An investor in a real estate venture should report its recorded share of losses in excess of its investment, including loans and advances, as a liability in its financial statements.
- If it is probable that one or more investors cannot bear their share of losses, the remaining investors should record their proportionate shares of venture losses otherwise allocable to investors considered unable to bear their share of losses. An investor who is deemed by other investors to be unable to bear its share of losses should continue to record its contractual share of losses unless it is relieved from the obligation to make payment by agreement or operation of law.
- The accounting by an investor for losses otherwise allocable to other investors should be governed by the provisions of FASB Statement No. 5 relating to loss contingencies. Accordingly, the investor should record a proportionate share of the losses otherwise allocable to other investors if it is probable that they will not bear their share.
- An investor that contributes real estate to the capital of a real estate venture generally should record its investment in the venture at the investor's cost (less related depreciation and valuation allowances) of the real estate contributed, regardless of whether the other investors contribute cash, property, or services. Unless the investor that contributes real estate to the venture withdraws cash (or other hard assets) and has no commitment to reinvest, such a transaction is not the culmination of the earnings process.
- An investor contributing property to a venture may obtain a disproportionately small interest in the venture based on a comparison of the carrying amount of the property with the cash contributed by the other investors. That situation might indicate that the investor contributing the property has suffered a loss that should be recognized.
- The considerations that apply to real property contributed to a partnership or joint venture also apply to contributions of services or intangibles.
- Interest on loans and advances that are in substance capital contributions (for example, if all the investors are required to make loans and advances proportionate to their equity interests) should be accounted for as distributions rather than as interest income by the investors.

- An investor-lender that does not capitalize interest on its own real estate construction and development projects should account for interest on loans and advances that are not in substance capital contributions as follows:
 - a. All interest income on the investor's loans or advances to the venture should be deferred if either of the following conditions is present.
 - (i) Collectibility of the principal or interest is in doubt. This condition may exist if adequate collateral and other terms normally required by an independent lender are not present.
 - (ii) There is a reasonable expectation that the other investors will not bear their shares of losses, resulting in uncertainty as to the lender's share of the venture's related interest expense.
 - b. If neither of the conditions in (a) is present and either the venture has recorded interest as an expense or the venture has capitalized the interest but in order to conform to the investor's accounting policies, the investor has recorded its equity in the income or loss of the venture as if the venture had charged the interest to expense, the entire interest income accrued on loans or advances to a venture should be recorded as earned.
 - c. If the conditions in (a) or (b) are not present, a portion of interest income from loans and advances to a venture should be deferred based on the investor's percentage interest in the profits and losses of the venture. However, an evaluation similar to that discussed above for recording the investor's share of losses should be made to avoid recording as interest income amounts that may ultimately be borne as losses by the investor making the loan.
- If services are performed for a venture by an investor and their cost is capitalized by the venture, profit may be recognized by the investor to the extent attributable to the outside interests in the venture if the following conditions are met:
 - a. The substance of the transaction does not significantly differ from its form.
 - b. There are no substantial uncertainties about the ability of the investor to complete performance (as may be the case if the investor lacks experience in the business of the venture) or the total cost of services to be rendered.
 - c. There is a reasonable expectation that the other investors will bear their share of losses, if any.

The method of recognizing income from services rendered should be consistent with the method followed for services performed for unrelated parties.

- An investor should not record as income its equity in the venture's profit from a sale of real estate to that investor; the investor's share of such profit should be recorded as a reduction in the carrying amount of the purchased real estate and recognized as income on a pro rata basis as the real estate is depreciated or when it is sold to a third party. Similarly, if a venture performs services for an investor and the cost of those services is capitalized by the investor, the investor's share of the venture's profit in the transaction should be recorded as a reduction in the carrying amount of the capitalized cost.
- Investors in real estate ventures should be guided by the provisions of paragraph 20 of APB Opinion No. 18 in determining the disclosures to be made in their financial statements.

Accounting for Special-Purpose Entities

Some business entities make use of off-balance sheet arrangements to conduct financing or other business activities. These may involve unconsolidated, non-independent, limited purpose entities, often referred to as structured finance or special purpose entities (hereinafter referred to as "SPEs"). These entities may be in the form of corporations, partnerships, limited liability companies, trusts, structured finance entities or other types of agreements, relationships or understandings. These

entities may be used to provide financing, liquidity, market risk or credit support, or involve leasing, hedging, and/or research and development services. Although ARB 51, Statement 94 and Opinion 18 are generally applicable to SPEs, the SEC staff expressed the following views concerning the accounting for SPEs at the February and May 1990 Emerging Issues Task Force (EITF) meetings (EITF Topic D-14):

The SEC Observer announced that the SEC staff is becoming increasingly concerned about certain receivables, leasing, and other transactions involving special-purpose entities (SPEs). Certain characteristics of those transactions raise questions about whether SPEs should be consolidated (notwithstanding the lack of majority ownership) and whether transfers of assets to the SPE should be recognized as sales. Generally, the SEC staff believes that for nonconsolidation and sales recognition by the sponsor or transferor to be appropriate, the majority owner (or owners) of the SPE must be an independent third party who has made a substantive capital investment in the SPE, has control of the SPE, and has substantive risks and rewards of ownership of the assets of the SPE (including residuals). Conversely, the SEC staff believes that nonconsolidation and sales recognition are not appropriate by the sponsor or transferor when the majority owner of the SPE makes only a nominal capital investment, the activities of the SPE are virtually all on the sponsor's or transferor's behalf, and the substantive risks and rewards of the assets or the debt of the SPE rest directly or indirectly with the sponsor or transferor.

Also, the SEC staff has objected to a proposal in which the accounting for a transaction would change only because an SPE was placed between the two parties to the transaction. The SEC staff believes that insertion of a nominally capitalized SPE does not change the accounting for the transaction.

The SEC staff is considering the issuance of a Staff Accounting Bulletin setting forth guidelines on the accounting for transactions involving SPEs and until such time would consider transactions on a case-by-case basis. The SEC Observer emphasized that the SEC staff views the issue of SPEs to be primarily a consolidation issue.

The SEC Observer reminded the Task Force of previous SEC Observer comments regarding the SEC staff's position on the proper accounting for certain lease transactions, including build-to-order lease transactions and those involving SPEs. The SEC staff has reviewed many variations of such transactions and generally objected to sales or operating lease treatment. The transactions involve a lessor that may be a SPE who holds title to the asset, but performs little, if any, substantive functions, while it is clear that the lessee assumes substantially all the risks and rewards of ownership. The SEC staff is not attempting to change generally accepted accounting principles in this area but believes that the application of such principles should result in an accounting treatment that is not misleading and pointed out that literature in addition to FASB Statement No. 13, *Accounting for Leases*, including that related to consolidation, should be considered. While the SEC staff encourages the Task Force to clarify this area, the SEC staff will continue its review of such transactions on a case-by-case approach based on its previously stated position. The Task Force agreed to add the issue to the agenda.

EITF Topic D-14 relates to developments subsequent to the issuance of those staff views as follows:

In July 1990, Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions," was added to the agenda. This Issue deals with the subject of leasing transactions involving SPEs. In January 1991, a consensus was reached on this Issue. The Task Force indicated that if certain conditions exist, as described in Issue 90-15, then the assets, liabilities, results of operations, and cash flows of the SPE should be consolidated in the lessee's financial statements.

FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, was issued in June 1996. Statement 125 was replaced by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, in September 2000.

Statement 140 provides guidance for determining whether transfers of financial assets (including financing lease receivables) qualify as sales or secured borrowings based upon the notion of control set forth in paragraph 9. Lease accounting issues (other than transfers of financial assets that arise from sales-type and direct financing leases) are outside the scope of Statement 140.

Statement 140 also provides that a qualifying SPE shall not be consolidated by the transferor or its affiliates. As a result, this announcement is partially resolved by Statement 140. Consolidation of qualifying SPEs by other parties, and consolidation of entities that are not considered qualifying SPEs, are outside the scope of Statement 140. Those parties should apply existing consolidation policy guidance including AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, Topic D- 14, and Issue 90-15.

Related issues were discussed in Issues No. 96-20, "Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities," and No. 97-6, "Application of Issue No. 96-20 to Qualifying Special-Purpose Entities Receiving Transferred Financial Assets Prior to the Effective Date of FASB Statement No. 125." Statement 140 nullified both Issues 96-20 and 97-6.

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, prohibits the consolidation of *qualifying* SPEs and sets forth specific conditions that a SPE must meet to be a qualifying SPE. The description of qualifying SPEs in Statement No. 140 is restrictive, and the accounting for qualifying SPEs and transfers of financial assets to them should not be extended to any entity that does not currently satisfy all of the conditions set forth in the Statement.

EITF Issue 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions," provides that a lessee is required to consolidate an SPE lessor if all of the following conditions exist:

1. Substantially all of the activities of the SPE involve assets that are to be leased to a single lessee
2. The expected substantive residual risks and substantially all the residual rewards of the leased asset(s) and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the lessee through such means as

- a. The lease agreement
 - b. A residual value guaranteed through, for example, the assumption of first dollar of loss provisions
 - c. A guarantee of the SPE's debt
 - d. An option granting the lessee a right to (1) purchase the leased asset at a fixed price or at a defined price other than fair value determined at the date of exercise or (2) receive any of the lessor's sales proceeds in excess of a stipulated amount
3. The owner(s) of record of the SPE has not made an initial substantive residual equity capital investment that is at risk during the entire term of the lease.

EITF Issue 90-15 also contains SEC staff positions on a number of implementation questions related to this issue.

EITF Issue 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities," and EITF Issue 97-1, "Implementation Issues in Accounting for Lease Transactions, including Those Involving Special-Purpose Entities" provide further guidance on related issues.

Other Financial Reporting Matters

Receivables from the sale of stock. EITF Issue 85-1, "Classifying Notes Receivable Received for Capital Stock," provides that it is generally not appropriate to report as an asset a note received as a contribution to an enterprise's equity, except in very limited circumstances where there is substantial evidence of ability and intent to pay within a reasonably short period of time. The SEC requires in Regulation S-X, Rule 5-02.30 that public companies report notes received in payment for the enterprise's stock as a deduction from shareholders' equity.

Payment of expenses on behalf of a related party. SEC Staff Accounting Bulletins Topic 1B, "Allocation of expenses and related disclosure in financial statements of subsidiaries, divisions or lesser business components of another entity," provides guidance on the reporting in the financial statements of a subsidiary of expenses incurred by the parent company on behalf of the subsidiary and not charged to the subsidiary. SEC Staff Accounting Bulletins Topic 5T, "Accounting for Expenses or Liabilities Paid by Principal Shareholder(s)," provides guidance on the reporting in a company's financial statements of expenses of the company paid by a principal stockholder.

Transfers of nonmonetary assets by promoters or shareholders. SEC Staff Accounting Bulletins Topic 5G, "Transfers of Nonmonetary Assets by Promoters or Shareholders," provides that transfers of nonmonetary assets to a company by its promoters or shareholders in exchange for stock prior to or at the time of the company's initial public offering normally should be recorded at the transferor's historical cost basis determined under generally accepted accounting principles.

Divestiture to former employees. SEC Staff Accounting Bulletins Topic 5E, "Accounting for divestiture of a subsidiary or other business enterprise," sets forth accounting and disclosure guidance concerning the divestiture of a subsidiary or other business operation to former employees.

SUMMARY OF AUDITING LITERATURE

The following section provides a summary of Statements on Auditing Standards (SAS), interpretations and other auditing literature applicable to related parties, related party transactions and auditing off-balance sheet arrangements, some of which may involve related parties. An auditor conducting an audit of financial statements in accordance with generally accepted auditing standards should consider the referenced auditing standards and the related interpretations in their entirety.

Planning and Supervision

SAS No. 22, *Planning and Supervision*, (AICPA, *Professional Standards*, vol. 1, AU sec. 311.03) states:

Audit planning involves developing an overall strategy for the expected conduct and scope of the audit. The nature, extent, and timing of planning vary with the size and complexity of the entity, experience with the entity, and knowledge of the entity's business. In planning the audit, the auditor should consider among other matters: [Bold type added for emphasis only.]

- a. Matters relating to the entity's business and the industry in which it operates.
- b. The entity's accounting policies and procedures.
- c. The methods used by the entity to process significant accounting information, including the use of service organizations, such as outside service centers.
- d. Planned assessed level of control risk.
- e. Preliminary judgment about materiality levels for audit purposes.
- f. Financial statement items likely to require adjustment.
- g. ***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.***
- h. The nature of reports expected to be rendered (for example, a report on consolidated or consolidating financial statements, reports on financial statements filed with the SEC, or special reports such as those on compliance with contractual provisions).

The auditor's understanding of the client's business, its organization and its operating characteristics is critical for planning and performing an effective audit.

AU Sec. 311 also discusses supervision of personnel assigned to the audit. Paragraph 11 states in part: "The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualification of persons performing the work." SAS No. 47, *Audit Risk and Materiality in Conducting and Audit*, (AICPA, *Professional Standards*, vol. 1, AU sec. 312.17) adds to the discussion of supervision with the following:

The knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the level of risk for the engagement. Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement.

The existence of related parties and related party transactions especially in a complex corporate structure may indicate the need for more experienced personnel to be assigned and more extensive

supervision to be provided during the planning phase of the engagement and also during the conduct of the audit.

Auditing Related Parties

SAS No. 45, *Related Parties*, (AICPA, *Professional Standards*, vol. 1, AU sec. 334) provides guidance on procedures that should be considered with respect to related parties when performing an audit of financial statements. In particular, this standard is intended to help auditors identify related party relationships and transactions and to satisfy the auditor concerning the financial statement accounting and disclosures pertaining to related party transactions. The auditor should also plan to perform extended audit procedures if unusual related party transactions exist or there is an indication of a material misstatement to the financial statements as a result of a related party transaction.

Related Party Indicators

An audit cannot be expected to provide assurance that all related parties have been identified. AU Sec. 334 lists the following as transactions that because of their nature may indicate of the existence of related parties. They are:

- Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction.
- Selling real estate at a price that differs significantly from its appraised value.
- Exchanging property for similar property in a nonmonetary transaction.
- Making loans with no scheduled terms for when or how the funds will be repaid.

In addition, Practice Alert No. 95-3, *Auditing Related Parties and Related Party Transactions*, includes the following examples of events that may be indicative of transactions with undisclosed related parties:

- Sales without substance, including funding the other party to the transaction so that the sales price is fully remitted.
- Sales with a commitment to repurchase that, if known, would preclude recognition of all or part of the revenue.
- Accruing interest at above market rates on loans.
- Loans to parties that do not possess the ability to repay.
- Advancing company funds that are subsequently transferred to a debtor and used to repay what would otherwise be an uncollectible loan or receivable.
- Services or goods purchased from a party at little or no cost to the entity.
- Loans advanced ostensibly for a valid business purpose and later written off as uncollectible.
- Payments for services never rendered or at inflated prices.

- Sales at below market rates to an unnecessary "middle man" related party, who in turn sells to the ultimate customer at a higher price with the related party (and ultimately its principals) retaining the difference.
- Purchases of assets at prices in excess of fair market value.

[For additional examples of related party indicators, see the section entitled *Potential Related Party Indicators*]

When determining the scope of the audit work to be performed with respect to related parties, the auditor should:

- 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 states that the auditor should not assume that all transactions with related parties are outside the normal course of business. However the auditor should consider the possibility that the transactions may have been motivated solely, or in large measure, by conditions similar to the following:

- a. Lack of sufficient working capital or credit to continue the business
- b. An urgent desire for a continued favorable earnings record in the hope of supporting the price of the company's stock
- c. An overly optimistic earnings forecast
- d. Dependence on a single or relatively few products, customers, or transactions for the continuing success of the venture
- e. A declining industry characterized by a large number of business failures
- f. Excess capacity
- g. Significant litigation, especially litigation between stockholders and management
- h. Significant obsolescence dangers because the company is in a high-technology industry

Determining the Existence of Related Parties

Although certain relationships may be clearly evident, such as parent-subsidiary or investor-investee, others may not be so apparent. AU Sec. 334 includes the following specific audit procedures to help determine the existence of other related parties:

- a. Evaluate the company's procedures for identifying and properly accounting for related party transactions.
- b. Request from appropriate management personnel the names of all related parties and inquire whether there were any transactions with these parties during the period.
- c. Review filings by the reporting entity with the Securities and Exchange Commission and other regulatory agencies for the names of related parties and for other businesses in which officers and directors occupy directorship or management positions.
- d. Determine the names of all pensions and other trusts established for the benefit of employees and the names of their officers and trustees.
- e. Review stockholder listings of closely held companies to identify principal stockholders.

- f. Review prior years' working papers for the names of known related parties.
- g. Inquire of predecessor, principal, or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions.
- h. Review material investment transactions during the period under audit to determine whether the nature and extent of investments during the period create related parties.

Identifying Transactions With Related Parties

AU Sec. 334 also provides guidance for identifying material transactions with known related parties and for identifying material transactions that may be indicative of the existence of undetermined relationships. They are as follows:

- a. Provide audit personnel performing segments of the audit or auditing and reporting separately on the accounts of related components of the reporting entity with the names of known related parties so that they may become aware of transactions with such parties during their audits.
- b. Review the minutes of meetings of the board of directors and executive or operating committees for information about material transactions authorized or discussed at their meetings.
- c. Review proxy and other material filed with the Securities and Exchange Commission and comparable data filed with other regulatory agencies for information about material transactions with related parties.
- d. Review conflict-of-interests statements obtained by the company from its management.
- e. Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships.
- f. Consider 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.
- g. Review 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.
- h. Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.
- i. Review 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.
- j. Review confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.

Examining Identified Related Party Transactions

Once related parties are identified, the auditor should place emphasis on testing material transactions with parties known to be related or associated to the reporting entity. The auditor should apply the audit procedures he or she considers appropriate to determine the purpose, nature, and extent of the related party transaction and the effect on the financial statements. In obtaining sufficient competent evidential matter, the auditor should extend the procedures beyond just inquiry of management. Procedures that should be considered include the following:

- a. Obtain an understanding of the business purpose of the transaction.
- b. Examine invoices, executed copies of agreements, contracts, and other pertinent documents, such as receiving reports and shipping documents.

- c. Determine whether the transaction has been approved by the board of directors or other appropriate officials.
- d. Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure, in the financial statements.
- e. Arrange for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.
- f. Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

In addition, the auditor may determine that extended procedures should be performed in order to fully understand the transactions. If so, the auditor should consider the following procedures:

- a. Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.
- b. Inspect evidence in possession of the other party or parties to the transaction.
- c. Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.
- d. Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.
- e. With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.

Auditing Disclosures

Certain accounting standards (as previously discussed) including FASB Statement No. 57 require disclosure of material related party transactions or of common ownership or management control relationships. AU Sec. 334 requires the auditor to consider whether sufficient competent evidential matter has been obtained during the audit to understand the relationship of the parties and, for related party transactions, the effects of the transaction on the financial statements. The auditor should then evaluate all the information available concerning the related party transaction or control relationship and determine that the financial statement disclosures are adequate and appropriate.

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 or she should express a qualified or adverse opinion because of a departure from generally accepted accounting principles, depending on materiality.

In addition, Interpretation No.7, *“Management’s and Auditor’s Responsibility With Regard to Related Party Disclosures Prefaced by Terminology Such As “Management Believes That”* of SAS No. 45, *Related Parties* (AICPA, *Professional Standards*, vol. 1, AU sec.9334.22-.23), raises the question:

When management discloses in its financial statements that a related party transaction was consummated on terms equivalent to those that prevail in arm's length transactions, and prefaces the representation with a phrase such as "Management believes that," or "It is the company's belief that", does the use of such terminology change management's responsibility to substantiate the representation?

The interpretive reply is as follows: FASB Statement No. 57, *Related Party Disclosures*, paragraph 3 [AC section R36.103], states that the representations about a related party transaction "shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated." A preface to a disclosure such as "Management believes that," or "It is the company's belief that" does not change management's responsibility to substantiate the representation. AU Section 334, *Related Parties*, paragraph .12 (Section 334.12), indicates that 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.

Audit Documentation

As with other audit areas, the auditor should document related party or related party transaction findings or issues that in his or her judgment are significant, actions taken to address them (including any additional evidence obtained), and the basis for final conclusions reached.

Auditing Off Balance Sheet Arrangements That May Involve Related Parties

As previously discussed, some business entities make use of off-balance sheet arrangements to conduct financing or other business activities. These may involve unconsolidated, non-independent, limited purpose entities, often referred to as structured finance or special purpose entities (hereinafter referred to as "SPEs"). These entities may be in the form of corporations, partnerships, limited liability companies, trusts, structured finance entities or other types of agreements, relationships or understandings. These entities may be used to provide financing, liquidity, market risk or credit support, or involve leasing, hedging, and/or research and development services.

Auditors should be alert to the existence or creation of SPEs. When a SPE has been identified, auditors should ensure that they understand the ownership structure of the entity, all significant terms of the transactions between the entity and the SPE and that management's conclusions regarding nonconsolidation and off-balance sheet treatment are appropriate under generally accepted accounting principles. Due to the complexity of these structures and the scrutiny that this area of accounting is currently undergoing, auditors may need to consult with their national office or other technical experts regarding these types of structures and related transactions to ensure the appropriateness of accounting and disclosures.

These arrangements may present exposures to the company for which the company's maximum possible liability is not reflected in the financial statements. The exposure can consist of exposures arising from contractual or other commitments as well as economic or legal compulsions to fund losses, provide additional funding, purchase capital stock or assets or otherwise be financially impacted by the performance or non-performance of the other party.

In light of the unique nature of SPEs, the auditor should carefully consider whether transactions entered into with the SPE represent related party transactions. Incremental procedures, as appropriate,

may be necessary to understand the nature of the arrangements and to ascertain whether they represent related party transactions. This is particularly the case when an entity enters into transactions with SPEs that are outside the company's normal course of business. Incremental procedures that the auditor may wish to consider include:

- Whether the issuer of loans or investments held or the primary obligor of debt guarantees issued indicate that an SPE may be involved.
- Inquiring as to the nature and terms of any SPE or structured financial arrangements.
- Reviewing significant documents and agreements related to significant transactions involving SPEs.
- Inquiring about any modifications to existing SPEs that may have been made in the current period that could affect the accounting determined at the date of the transaction.

In some circumstances, there may be different auditors for the SPE, or the SPE may not be audited. There also may be situations when the auditor is denied access to the books and records of the SPE because of a lack of an equity interest in the SPE or other legal right to demand such access. Particularly in view of recent events and the risk of material misstatement of the financial statements due to fraud, auditors should consider conducting further procedures with respect to the books and records of the SPE, particularly focusing on whether the requisite outside investment in the SPE existed at the time of the transaction and continues to exist in subsequent periods. If the auditor is not allowed to confirm that generally accepted accounting principles has been followed, either through testing of the SPE's accounting records or through confirmation with other investors, auditors, or other third parties the auditor should consider whether there is a scope limitation.

If the auditor determines that these arrangements and transactions represent related party transactions, the auditor should refer to the related party standards and guidance discussed above. Additionally, the auditor should consider tailoring the management representation letter to include specific representations on critical issues and assumptions related to SPE transactions and confirming that all relevant information and documents have been provided. When warranted, representations should also confirm that there are no side agreements that would materially affect the accounting. See SAS No. 85, *Management Representations*.

Related Party Transactions and Fraud

The number one rule for potentially identifying related parties and related party transactions that management does not disclose to the independent auditor is simply to be alert to that possibility. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, (AICPA, *Professional Standards*, vol. 1, AU sec. 316) requires the auditor to "assess the risk of material misstatement of the financial statements due to fraud and consider that assessment in designing the audit procedures to be performed." This assessment is based on the auditor's consideration of certain risk factors that relate to misstatements that may arise from fraudulent financial reporting and misappropriation of assets. When considering risk factors relating to an entity's operating characteristics and financial stability, the auditor may conclude that related parties and/or related party transactions are a potential source for material misstatement. Following are examples of indicators that may cause the auditor to conclude that such a potential exists:

- Significant related party transaction not in the ordinary course of business or with related entities not audited or audited by another firm.

- Significant, unusual, or highly complex transactions, especially those close to year-end, that pose difficult “substance over form” questions.
- Highly complex business practices that enhance the ability of management to mask the economic substance of a business transaction.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
- Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose.
- Difficulty in determining the organization or individual(s) that control(s) an off-balance sheet entity.

When the auditor concludes there is a significant risk of material misstatement due to fraud he or she might respond in a number of ways, such as assigning more experienced staff to the engagement. As discussed in the planning section, ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement. Higher risk also may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of the balance sheet date, or modify the nature of procedures to obtain more persuasive evidence. Other procedures that can be performed to help identify potential related party transactions if the auditor decides to modify his or her procedures based on the consideration of fraud risk factors include the following:

- Review material cash disbursements, advances, and investments to consider whether the company provided funds to a related entity.
- Discuss with tax and consulting personnel who have provided services to the client their knowledge of the client’s relationships and knowledge of related parties.
- Discuss with intermediaries (such as lawyers, predecessor auditors, and others providing professional services to the client) their knowledge of the identity of principal parties to material transactions.
- Use sources of information about principal parties to material transactions (such as newspapers, phone books, industry or trade publications, the Internet, etc.) to search for information about key members of management and the company. (For example, the Internet can be used to search for corporation and limited partnership records in which a particular person’s name appears.)

According to generally accepted auditing standards, evidential matter obtained from independent outside sources provides a greater assurance of reliability than evidence secured solely within the company (SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to Statement on Auditing Standards No. 31, Evidential Matter*, (AICPA, *Professional Standard*, vol. 1, AU sec. 326.21a). Higher risk will also ordinarily cause the auditor to be more skeptical of the audit evidence obtained.

Management Representations

SAS No. 85, *Management Representations*, (AICPA, *Professional Standards*, vol. 1, AU sec. 333) requires the auditor to obtain written representations from management and provides guidance concerning the representations to be obtained. Although SAS No. 45 requires the auditor to perform specific procedures regarding related parties, SAS No. 85 requires the auditor to also obtain specific written representation regarding information concerning related party transactions and amounts receivable from or payable to related parties. AU Section 333.16, Appendix A, *Illustrative Management Representation Letter*, (AICPA, *Professional Standards*, vol. 1, AU sec. 333.16) provides auditors with an example management representation letter. Included in that letter is an example representation regarding related parties; it is as follows:

...The following have been properly recorded or disclosed in the financial statements:

- a. Related party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
- b. Guarantees, whether written or oral, under which the company is contingently liable.
- c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. [Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.]

Engagement Staffing and other Q.C. Considerations

It is clear that while auditing related parties and related party transactions the auditor needs to be alert for many complex audit issues as well as changes in the client's business strategy. These changes and conditions, which may be reflective of higher audit risks, may call for changes in engagement capabilities to include partners and staff with the expertise to address audit issues effectively. This may also require the auditor to consider certain quality control considerations such as:

- Assignment of personnel
- Competencies required by a Practitioner-in-Charge
- Consultation
- Concurring reviewer requirements for SEC engagements

Disclosure Update and Considerations

Reliable and transparent financial reporting is particularly important in this troubled environment. This requires the special attention of CPAs to work together with management and audit committees, when applicable, to ensure that related parties and related party transactions are identified and that management's disclosure of related party transactions are appropriately and completely disclosed in accordance with GAAP.

While long an important part of full disclosure in financial statements, the SEC has recently called on registrants and auditors to increase disclosure of the critical accounting policies or those "three-to-

five” accounting issues that require significant judgment or involve complex estimation processes. SEC Chief Accountant Robert Herdman introduced this concept during a speech on December 6, 2001. A copy of the speech can be viewed on the SEC’s web site. The SEC expanded on the matters covered in the speech in a release issued December 12, 2001, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*.

Since this speech only occurred recently, management may be unaware of the issue. Compliance with this area should be a top priority to both management and audit committees, as the SEC staff will be focusing on these disclosures in their reviews of Form 10-K filings next spring. In another recent press release the Securities and Exchange Commission said its accountants and attorneys would review annual reports of all Fortune 500 companies for possible instances of unorthodox accounting or lack of clarity. The SEC said it was taking the action as part of its process of reviewing both financial and non-financial disclosures made by publicly held companies. Matters of particular interest to the SEC are the judgments and uncertainties affecting the application of these critical accounting policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

Engagement teams auditing public companies should meet with management and the audit committee to discuss how disclosure issues surrounding these “top accounting issues” will affect them, and the work that will need to be done in order to comply. Engagement teams may find it helpful to review the guidance in AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, in addressing these accounting policies.

POTENTIAL RELATED PARTY INDICATORS

Auditors should be alert to indicators of potential related party issues that may require special attention when performing the audit. This section provides best practices guidance through the use of examples of related party relationships and related party issues that, if present, should alert the auditor to the possible existence of material related party relationships or transactions. Difficult economic times increase the possibility that the economic substance of certain transactions may be other than their legal form, or that transactions may lack economic substance. These examples are oriented to identification of related parties and do not address accounting issues that may be involved. Thus, the auditor should never infer from reading these examples that improper accounting can be cured by mere disclosure. A key to consider is whether the accounting for the transaction is appropriate given its substance.

Agreements under which one party pays expenses on behalf of another party. A related party is to pay certain expenses on behalf of a company and then pass through the expenses back to that company. Under this type of arrangement, the auditor should be alert to the fact that the pass through and expense recognition by the company may never occur, resulting in understated expenses on the company's financial statements, particularly when the company is struggling financially.

Circular arrangements between related parties: Sales arrangements in which the seller of goods or services has concurrent obligations to the buyer to purchase goods or services or provide other benefits should be examined closely. In addition, collectibility and liquidity should be closely examined in cases in which a party's ability to repay a loan is dependent on continued cash funding or sales from a related party.

Engaging in business deals (such as leases) at more or less than market value: A company may enter into a lease agreement with another party owned in part by a member of an officer's family at less than market rates. This relationship and the related transactions should be appropriately disclosed in the company's financial statements.

Identification of an unidentified related party: When an undisclosed related party has been identified, the audit team should assess whether management's failure to disclose was merely an oversight or a deliberate attempt to hide the relationship. If the latter, the auditor should reassess the overall audit scope and the ability to rely on management's representations in other areas. If the auditor believes management can no longer be trusted, the best course of action, after consulting others in the firm designated as consultants in accounting and auditing matters, as well as legal counsel, may be to withdraw from the engagement.

Inadequate disclosures: A common observation regarding related parties is that companies fail to satisfactorily describe the nature of related party relationships and transactions and to disclose the terms and dollar amounts of related party transactions and amounts due to or from related parties as required by FASB Statement No. 57, *Related Party Disclosures*. Including a lack of disclosure of related party pledges of financial support that help mitigate doubt about going concern. The auditor should consider guidance in FASB Statement No. 57 when evaluating the company's related party disclosures.

Payments for services at inflated prices: An officer, director or management representative of a company also may be employed by a professional services or consulting firm utilized by the company.

This could lead to the professional services or consulting firm charging inflated fees for services rendered.

Revenue recognition: Auditors should be aware that revenue recognition is not appropriate when a substantive exchange is not present. Sales transactions should stem from express or implied contracts and represent exchanges between independent parties at arm's-length prices and terms. Arm's-length transactions may be difficult to achieve between related parties as well as in situations in which a seller can exercise substantial control over a buyer or vice-versa. Instances of fictitious sales and sales to related parties lacking economic substance have been attributed in the past to management representatives who are anxious to meet sales quotas and earnings performance goals. See AICPA Audit Guide, *Auditing Revenue*, for additional guidance on revenue recognition.

Sale of land with arranged financing: If a principal owner of a company sold land at fair market value and obtained financing for the buyer who was a marginal credit risk, the transaction would require related party disclosure by the company if the financing were obtained from a lender who agreed to the transaction primarily to preserve a significant business relationship with the company.

Sale of securities: The sale of marketable securities, by a principal owner of a company, at a significant discount from quoted market prices to a large customer of the company, would be a related party transaction. As such a transaction has no apparent business purpose absent the principal owner's relationship to the company, it appears that the facts may require disclosure of the transaction to reflect a fair presentation of financial position and results of operations of the company. However, it should be noted that if the owner had sold the securities to the same party at fair market value, there would be no presumption of a related party transaction.

Sales without substance: Funds transferred to the company from a related party for goods or services that were never rendered.

Services or goods are purchased from a party at little or no cost: Goods are purchased from another party at less than cost. An arrangement like this should be investigated for related party relationships and if they exist, disclosed accordingly.

Unusual, material transactions, particularly close to quarter or year-end: A company may recognize revenue on large, unusual transactions with another party conducted close to quarter end. Consideration should be given to whether or not the two parties might be related in some way. These transactions may not always be individually significant, but rather may involve several small sales transactions that in total are material. Repetitive quarter or year-end transactions with the same party should also be investigated for potential related party relationships.

Utilization of related party to mitigate market risks: A company and its advisers create a "shell company" to help mitigate market risks on various equity transactions. Circumstances may change over time, requiring the company to consolidate the shell company. Earnings may be affected if the company failed to consolidate. Auditors should continuously work with their consultants in accounting and auditing matters to review these complex structures for changes in consolidation, tax, and accounting implications. The nature of the structure established and the details of the related transactions must be adequately disclosed in the financial statements from the time of inception.

APPENDIX I - ILLUSTRATIVE AUDIT PROGRAM FOR RELATED PARTIES

The audit program provided in this section is presented for illustrative purposes only. The illustrative audit objectives and procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

Financial Statement Assertions:

1. Existence or occurrence.
2. Completeness.
3. Rights and obligations.
4. Valuation or allocation.
5. Presentation and disclosure.

Objectives:

- A. To identify related parties and related party transactions. (Assertions 1 and 2)
- B. To determine the substance of such transactions is reflected in the accounts. (Assertions 2,3, and 4)
- C. To obtain all information necessary for footnote and/or report disclosure. (Assertions 2 and 5)

	Done By	Date	References/ Comments
<p>Procedures:</p> <p>A. Preliminary Procedures</p> <ol style="list-style-type: none"> 1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures: <ol style="list-style-type: none"> a. Preliminary analytical review b. Assessment of risk of material misstatement c. Other planning documents and risk assessments 			

	Done By	Date	References/ Comments
<p>2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.</p> <p>3. Evaluate the company's procedures used to identify, authorize, account for and disclose related party transactions.</p>			
<p>B. Substantive Test Procedures</p>			
<p>1. Obtain from appropriate management representatives a list of all known related parties and any transactions with those parties during the period, including the affiliations of directors and officers with other entities. The list of transactions should include significant related party transactions that were not recognized for accounting purposes.</p> <p>2. Obtain names of stockholders and directors for evidence of related party transactions.</p> <p>3. Review the list of related parties for completeness by performing the following procedures:</p> <ul style="list-style-type: none"> ▪ Review the company's income tax returns and SEC and other regulatory filings for related party information and for the involvement of officers and directors in other businesses. ▪ Review "conflict-of-interests" statements obtained by the company from management. ▪ Determine the names of all pension and other trusts established for the benefit of employees and the names of their officers and trustees. ▪ Review stockholder listings of closely-held companies to identify major stockholders. ▪ Review prior year working papers for the names of known related parties. ▪ Inquire of predecessor or principal auditors or auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions. 			

	Done By	Date	References/ Comments
<ul style="list-style-type: none"> ▪ Inquire of the principal auditors regarding their knowledge of any plans of the parent, which may affect the subsidiary's assets or liabilities. ▪ Review material investment and sales transactions during the audit period to determine whether the nature and extent of such transactions create related parties. ▪ Review board of directors and other committee minutes for indications of related parties. <p>4. In determining the scope of procedures the auditors should perform with respect to possible related party transactions, the auditors should perform the following:</p> <ul style="list-style-type: none"> ▪ Obtain an understanding of management responsibilities and the relationships of each component of the total entity. ▪ Consider controls over management activities. ▪ Consider the business purpose served by the various components of the entity. (The auditors should be particularly alert to a business or organizational structure that appears to be designed to obscure related party transactions.) ▪ If the audit procedures reveal the existence of previously undisclosed related parties or related party transactions, consider their effect on the fraud assessment and the possible need to perform additional procedures. <p>5. Distribute the list of all related parties and all known related party transactions to all engagement personnel, participating offices, other auditors and predecessor auditors and inquire whether any of them are aware of additional related parties or related party transactions.</p> <p>6. The following procedures should be performed in identifying related party transactions:</p> <ul style="list-style-type: none"> ▪ Review the minutes of all meetings of the board of directors and other committees for information about material transactions authorized or discussed at their meetings. ▪ Review proxy and other material filed with the SEC and comparable filings with other regulatory 			

	Done By	Date	References/ Comments
<p>agencies for information about material transactions with related parties.</p> <ul style="list-style-type: none"> ▪ Review the extent and nature of business transacted with major customers, suppliers, borrowers and lenders for indications of previously undisclosed relationships by determining who the principals are and whether the entity and the transaction have economic substance. ▪ Consider whether transactions are occurring, but are not recorded, such as receiving or providing accounting, management, or other services at no charge or a major stockholder absorbing corporate expenses. ▪ Review accounting records and manual journal entries for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions at or near the end of the reporting period. ▪ Review correspondence and invoices from all law firms that have performed work for the company for indications of the existence of related parties or related party transactions. ▪ Review confirmations of compensating balances arrangements for indications that balances are or were maintained for or by related parties. ▪ For significant loans (receivable and payable), review for unusual interest rates and terms. ▪ Review confirmations of loans receivable and payable for indications of guarantees. If guarantees are indicated, determine their nature and the relationship of the guarantor with the company. ▪ Consider whether the performance of detailed tests of transactions and balances in other areas of the audit indicated the possibility that related party transactions may exist. ▪ If the company does not have adequate controls and processes in place to identify related party transactions and the auditor has not otherwise been satisfied as to the extent of related party transactions, obtain a related party confirmation letter from all directors, principal officers and major stockholders. (See example related party confirmation letter in Appendix III) 			

	Done By	Date	References/ Comments
<p>7. Consider the effect, if any, of the related party transactions on the tax provision. Notify the tax engagement team of all related party transactions for purposes of their review of taxes under FASB Statement No. 109, <i>Accounting for Income Taxes</i>, and the preparation of tax returns.</p> <p>8. Document the identification and testing of all related parties and related party transactions in the workpapers.</p> <p>9. Obtain written representations from management regarding the completeness of information provided regarding related parties and related party transactions and the adequacy of related party disclosures in the financial statements.</p>			
<p>C. Reporting Considerations</p>			
<p>1. If representations are made by management in their financial statement disclosures about transactions with related parties, the representations should not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated. If such representations do imply this and the engagement team believes that the representation is unsubstantiated by management, it should, depending on materiality, express a qualified or adverse opinion because of a departure from generally accepted accounting principles.</p> <p>2. If the auditor is unable to obtain sufficient appropriate audit assurance concerning related parties and transactions with such parties, a report modification may be necessary.</p> <p>3. When there are significant transactions with related parties, in certain circumstances, the auditor may wish to emphasize a matter by adding an explanatory paragraph (for example, in cases where the entity is dependent upon few customers, the entity is heavily dependent upon parent financing, or the entity had a</p>			

	Done By	Date	References/ Comments
<p>significant sale to a related party).</p> <p>D. Additional Procedures (If any)</p> <p>E. Section Completion</p> <p>The objectives of this audit program have been met. This audit program section has been completed in accordance with firm policy.</p> <p><i>Done by:</i></p> <p><i>Reviewed by:</i></p>			

APPENDIX II - ILLUSTRATIVE DISCLOSURE CHECKLIST FOR RELATED PARTIES

This checklist should be read in conjunction with the [Summary of Accounting Literature section of this toolkit](#).

	<u>Reference⁶:</u>	<u>Compliance:</u>
<p>1. Consolidation and Combination Principles:</p> <ul style="list-style-type: none"> ▪ If there is a difference in fiscal periods of not more than 93 days between a consolidated entity and the registrant, such difference should be disclosed as follows: <ul style="list-style-type: none"> ➤ The closing date of the entity should be expressly indicated ➤ The necessity for the use of different closing dates should be briefly explained ➤ The effect of intervening events which materially affect the financial position or results of operations ▪ Consider the propriety of consolidating foreign subsidiaries that operate under political, economic or currency restrictions. If consolidated, disclose the effects of foreign exchange restrictions on financial positions and operating results. ▪ Describe the principles followed in consolidation, including those followed in determining the inclusion or exclusion of subsidiaries. Disclose the circumstances involved in any departure from the general practice of consolidating majority-owned subsidiaries and not consolidating entities that are less than majority-owned. Consider the guidance in EITF 96-16 that prohibits the consolidation of a majority owned entity when the minority interest has certain participating rights. ▪ Disclose any material change from the preceding fiscal period in the entities included or excluded in consolidation. ▪ Disclose changes in fiscal periods of consolidated entities that have a material effect on the financial statements, and indicate the manner of treatment. ▪ Eliminate intercompany items and transactions in consolidated financial statements, and unrealized intercompany profits and losses on transactions with equity method investees. If eliminations are not made, state reasons and method of treatment. 	<p>S-X 3A-02</p> <p>S-X 3A-02(d)</p> <p>FAS 94, par 9-10; ARB 51, par 5; APB 22, par 13; FRP 105; S-X 3A-02 & 3A-03(a); EITF 96-16; EITF 96-20; EITF 97-2</p> <p>S-X 3A-03(b)</p> <p>ARB 51, par 6; S-X 3A-04</p>	
<p>2. Securities of Related Parties:</p> <p>a) For investments accounted for under the equity method, disclose:</p> <ul style="list-style-type: none"> ▪ Name of each investee and percentage of common stock ownership ▪ Accounting policies of investor with respect to investments in common stock 	<p>S-X 4-08(k), 5-02.10</p> <p>APB 18, par 19-20</p>	

⁶ [See key explaining literature references in table at the bottom of the checklist.](#)

	<u>Reference⁶:</u>	<u>Compliance:</u>
<ul style="list-style-type: none"> ▪ Difference, if any between carrying amount and amount of underlying equity in net assets, and accounting treatment for the difference ▪ Aggregate value of each investment (except subsidiaries), based on quoted market price if available ▪ The investments (as a single amount) in the investor's balance sheet, with earnings and losses from applying the equity method generally disclosed as a single amount as part of income from continuing operations ▪ The investor's share of extraordinary items and prior-period adjustments classified in a manner similar to the investee's classification as extraordinary items or prior-period adjustments, if material ▪ Material effects of possible conversions, exercises or other contingent issuances of investee ▪ Names of significant investees in which less than 20% of the voting stock is held and the common stock is accounted for on the equity method and the reason for using the equity method ▪ Investments in investee debt ▪ Material subsequent events and transactions, labeled as unaudited information <p>b) For investments not accounted for under the equity method, disclose:</p> <ul style="list-style-type: none"> ▪ Accounting basis used ▪ Quoted market value, if available ▪ Allowance for losses ▪ Equity in underlying net assets and net income of subsidiaries or affiliates for the current period ▪ Dividends received in current period ▪ Any other applicable debt or equity security disclosures; ▪ The names of significant investees in which 20% or more of voting stock is held and the reason for not using the equity method <p>c) For unconsolidated subsidiaries and for 50 percent or less owned entities accounted for by the equity method, disclosures of the following summarized financial information are required as of the same dates and for the same periods presented in the audited financial statements, if <u>any</u> of the "significant subsidiary" tests in S-X Rule 1-02(w), individually or in aggregate, are met by any combination of such subsidiaries or persons:</p> <ul style="list-style-type: none"> ▪ Current assets ▪ Noncurrent assets 	<p>S-X 5-02.11, 4-08(k) SAS 1 Sec 332.13</p> <p>S-X 5-02.12</p> <p>APB 12, par 3</p> <p>APB 18, par 20a</p> <p>S-X 1-02(w), 1-02(bb) and 4-08(g)(1)</p>	

	<u>Reference⁶:</u>	<u>Compliance:</u>
<ul style="list-style-type: none"> ▪ Current liabilities ▪ Noncurrent liabilities ▪ Redeemable preferred stock ▪ Minority interest ▪ Specialized industries that do not normally present a classified balance sheet should disclose the nature and amount of the major components of assets and liabilities ▪ Net sales or gross revenues ▪ Gross profit, or costs and expenses applicable to net sales or gross revenues ▪ Income or loss from continuing operations before extraordinary items and cumulative effect of a change in accounting principle ▪ Net income or loss ▪ Specialized industries may substitute other information for sales and related costs and expenses if necessary for a more meaningful presentation ▪ The provisions of SAB Topic 5-J (Push-down Accounting) should be considered with respect to these disclosures 	SAB Topic 5-J	
<p>3. For related party transactions that are material, individually or in the aggregate, other than compensation arrangements, expense allowances and other similar items in the ordinary course of business, disclose:</p> <ul style="list-style-type: none"> ▪ The nature of the relationship ▪ A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which an income statement is presented, and such other information as is necessary to understand the effects of the transactions on the financial statements ▪ Amounts of the transactions for each of the periods for which an income statement is presented ▪ The effects of any change in the method of establishing the terms from that used in the preceding period ▪ Amounts due to or from related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement ▪ Amounts of investments in related parties ▪ Material receivables, payables, revenue, expense, gains or losses, or cash flows from related parties, should be disclosed separately on the face of the applicable financial statement (Details may be provided in the notes) ▪ Compensating balances maintained for the benefit of affiliates, officers, directors, principal stockholders, or related parties 	FAS 57, par 2, 4 and Note 3; S-X 4-08(k)	

	<u>Reference⁶:</u>	<u>Compliance:</u>
<ul style="list-style-type: none"> ▪ Compensating balances maintained by affiliates, officers, directors, principal stockholders or related parties on behalf of the company ▪ Any pledges by a parent company or major investor to provide financial support 		
4. If representations about transactions with related parties are made, do they avoid the implication that the related party transactions were consummated at arm's length? If such implications are made, can they be substantiated?	FAS 57, par 3	
5. If the entity and one or more other entities are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the entities were autonomous, disclose the nature of the control relationship even if there are no transactions between the entities.	FAS 57, par 4	
6. Nature and extent of leasing transactions between related parties.	FAS 13, par 29-30; S-X 4-08(k)	

Key to Literature References Above:

FRP	SEC Codification of Financial Reporting Policies (section)
S-X	SEC Financial Statement Requirements Regulation S-X (article, rule & paragraph)
FAS	Statement of Financial Accounting Standards Board (number & paragraph)
ARB	Accounting Research Bulletin (number & paragraph)
APB	Accounting Principles Board Opinion (number & paragraph (Current Text reference))
EITF	Emerging Issues Task Force (number)
SAS	Statement of Auditing Standards Board (number & Codification of Statements on Auditing Standards AU section reference)
SAB	SEC Staff Accounting Bulletin

APPENDIX III - ILLUSTRATIVE RELATED PARTY LETTERS

Illustrative Related party Confirmation Letter

In certain situations, the auditor may want to confirm the existence of related parties with directors, principal officers, major shareholders, or others. For example, a company does not have adequate controls and processes in place to identify related party transactions and the auditor has not otherwise been satisfied as to the extent of related party transactions. The following is an illustrative related party confirmation letter that an auditor may use when the auditor is not otherwise satisfied as to the extent of related party transactions.

[Date]

[Name of Director, Principal Officer or Major Stockholder]

[Address line 1]

[Address line 2]

Dear [Name]:

In connection with the audit of our financial statements, please furnish answers to the attached questionnaire, sign your name and return the questionnaire in the enclosed stamped, addressed envelope directly to our auditors, [*Name of the firm*], [*Local office address*]. The questionnaire is designed to provide the auditors with information about the interests of officers, directors and other related parties in transactions with the Company.

Please answer all questions. If the answer to any question is "Yes," explain. Certain terms used in the questions are defined at the end of the questionnaire. Please read the definitions carefully before answering the questions. Thank you for your cooperation.

Sincerely,

[Chief executive officer and title]

[Client name]

[Client Name]
Related party Questionnaire

Please answer all questions. If the answer to any question is "Yes," explain. Certain terms used in the questions are defined at the end of the questionnaire. Please read the definitions carefully before answering the questions.

1. Have you or any related party of yours had any interest, direct or indirect, in any sales, purchases, transfers, leasing arrangements or guarantees or other transactions since [*Beginning of period of audit*] to which the company [*Or specify and pension, retirement, savings or similar plan provided by the client*] was, or is to be, a party?

2. Do you or any related party of yours have any interest, direct or indirect, in any pending or incomplete sales, purchases, transfers, leasing arrangements, guarantees or other transactions to which the company [*Or specify any pension, retirement, savings or similar plan provided by the client*] is, or is to be, a party?

3. Have you or any related party of yours been indebted to the company [*Or specify any pension, retirement, savings or similar plan provided by the client*] at any time since [*Beginning of period of audit*]? Please exclude amounts due for purchases on usual trade terms and for ordinary travel and expense advances.

The answers to the foregoing questions are correct to the best of my knowledge and belief.

Date: _____

Signature: _____

DEFINITIONS:

COMPANY - parent company, any subsidiary or investee for which investments are accounted for by the equity method.

RELATED PARTY - any: (1) party (other than the Company) of which you are an officer, director or partner or are, directly or indirectly, the beneficial owner of 10% or more of the voting interests, (2) trust or other estate in which you have a substantial beneficial ownership or for which you serve as trustee or in a similar fiduciary capacity, (3) any member of your immediate family, and (4) other party with which you may deal if you (or the other party) control or can significantly influence the other to an extent that either of you might be prevented from fully pursuing your own separate interests.

CONTROL - possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a party, whether through ownership, by contract or otherwise.

PARTY - an individual, a corporation, a partnership, an association, a joint-stock company, a business trust or an unincorporated organization.

BENEFICIAL OWNER - a party who enjoys or has the right to secure benefits substantially equivalent to those of the ownership of securities, even though the securities are not registered in the party's name. Examples of beneficial ownership include securities held for the party's benefit in the name of others, such as nominees, custodians, brokers, trustees, executors and other fiduciaries; a partnership of which the person is a partner; and a corporation for which the party owns substantially all of the stock. Shares: (1) held (individually or in a fiduciary capacity) by the party's spouse, the party's or his or her spouse's minor children or a relative of the party or his or her spouse who shares the same home with the party; or (2) as to which the party can vest or re-vest title in himself at once or at some future time are also considered as being beneficially owned.

Illustrative Letter To Other Auditors Regarding Related Parties

The following illustrative letter may be used when using the work of other auditors. This letter will help facilitate a timely exchange of information regarding known related parties and related party transactions.

Date

[Name of firm]

[Address line 1]

[Address line 2]

Dear Sir or Madam:

In connection with our audit of the consolidated financial statements of Example Company, Inc. and subsidiaries for the year ended December 31, 20X3, in which you are participating as auditors of ABC Company, enclosed is a list of related parties (as defined in FASB Statement No. 57, *Related Party Disclosures*) of which we are aware and a description of transactions with such parties. (Note: If additional related parties or transactions are identified later in the engagement, a list of transactions with those parties should be forwarded to the other auditors.)

Our primary audit objectives associated with related party transactions are the following:

- Determine the existence of related parties
- Identify transactions with related parties
- Examine identified related party transactions
- Determine the adequacy of disclosure

As a participant in this audit, you should refer to the enclosed list and should be alert for any transactions with related parties (those on the list or others that may come to your attention) during the conduct of your audit.

Based on your knowledge, please advise us of other related parties not included on the list and of transactions with related parties that differ from those described herein.

Very truly yours,

YOUR FIRM'S NAME

Note:

If this letter is sent at interim, wording should be added, if applicable, to note that updated information may be forwarded at year-end. Additionally, before completion of the audit it may be desirable to confirm with the other auditors matters such as the following:

- A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods under audit
- Dollar volume of transactions with related parties for each of the periods under audit and the effects of any change in the method of establishing the terms from that used in the preceding period
- Amounts due to or from related parties as of the date of each of the balance sheet presented along with the terms and manner of settlement