

## **Auditing the related party transactions of a client firm: an applied case**

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### **ABSTRACT**

As part of the risk assessment of a client firm, auditors are required to evaluate the risks of material misstatement associated with related party transactions. Related party transactions may be evaluated at a higher risk of material misstatement as they may not occur under normal market settings or they may be motivated by an intent to perpetrate fraud. This case presents information about the related party transactions and other facts surrounding the audit of a client firm in the software services industry. The case requires students to evaluate the risks of material misstatements associated with the client firm's related party transactions. Students are also required to consider audit procedures for identifying the client firm's related party transactions. Finally, students will be required to prepare an audit program for the client firm's related party transactions.

Keywords: Audit, related party transaction, risk of material misstatement, fraud

## INTRODUCTION

Related party transactions are transactions between a company and related parties such as the company's subsidiaries, affiliates, owners, officers or businesses that are owned by the company's officers or their families (SEC Regulation S-K; SEC 2006).<sup>1</sup> Accounting Standards Codification ("ASC") Topic 850, Related Party Disclosures, requires companies to disclose material related party transactions in their financial statements (ASC 850-10-50, FASB 2009). Given that the nature of related party transactions may increase the risk that they will be improperly reported, auditors must evaluate the risk of material misstatement associated with related party transactions, and design appropriate audit procedures in response to the assessed risks (AS 2410; PCAOB, 2014).

This case presents information about the related party transactions and other facts surrounding the audit of a client firm in the software services industry. Jane Smith was a senior at the audit firm for a little over a year when she was assigned to the audit of the client firm. As the audit senior on the engagement, Jane was assigned the responsibility of gathering and summarizing information for the evaluation of the client firm's related party transactions.

## BACKGROUND

The audit client is a software services firm established in California. It is a publicly-owned company with shares listed on the New York Stock Exchange (NYSE). Richard Newman is the chief executive officer of the firm, and the chairman of the board is George Lucas. Since its incorporation, the firm has been performing very well in the highly competitive software services industry. The firm sells its software and services not only in the U.S. but also in Canada, Asia and Europe. Majority of the firm's revenues are from product licensing and services. Service revenue is from maintenance, professional services, network services, and training. Licensing revenues are derived from the sale of licensing agreements which include a one-year warranty period.

## RELATED PARTY TRANSACTION DISCLOSURES

The firm disclosed in its most recent financial statements that its policy required the entire board to review and approve related party transactions. The firm disclosed in its financial statements that the terms of the following related party transactions were equivalent to the terms that would apply if the transactions were at arms-length or with unrelated parties:

1. The company purchased a property for its new corporate headquarters from BTS Services. BTS Services received \$5.3 million from the firm as payment for the property. The company disclosed that the purchase was at the fair market value of the property as determined by an independent appraisal. BTS Services is a real estate partnership whose founder and managing partner is the daughter of George Lucas (chairman of the board of the client firm).

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<sup>1</sup> Item 404(a) of Regulation S-K requires companies to disclose transactions with related parties that exceed \$120,000. The definition of a related party in Item 404(a) of Regulation S-K includes any director and executive officer of a company and their immediate family members such as spouses, children, and siblings. Affiliate of a company is defined under Regulation S-X (17 CFR part 210) as "an entity that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the company."

2. The company paid \$600,000 for legal services provided by Phillips & Johnson LLP of which James F. Newman is a partner. James F. Newman's brother is Richard Newman (chief executive officer). According to the company, the amount paid represents the fair market value of the legal services provided.

3. The company leases 12,000 square feet of offices from Modesco Inc., which is a wholly owned subsidiary of the client firm. Total rent paid during the past fiscal year was \$250,000. According to the company, the rent paid reflects the fair market rate for comparable facilities in the geographic area.

4. The company also disclosed that it paid management fees of \$850,000 to Western Financial Consultants, Inc., of which David Sewell is the chief executive officer. David Sewell's brother is Mark Sewell, chief financial officer and a director of the client firm. The firm disclosed that the amount paid was based on fair market rates.

### **BOARD AND AUDIT COMMITTEE OF THE CLIENT FIRM**

There are six directors on the board of the client firm. Two directors are executive officers of the firm while the remaining four are non-executive officers. The two executive directors are Richard Newman (chief executive officer) and Mark Sewell (chief financial officer). Mr. Newman was previously employed by a large technology firm. Mr. Newman has a bachelor's degree in computer science and a master's degree in information systems. Mark Sewell was previously the controller of an apparel manufacturer and retailer. He holds a bachelor's and master's degree in accounting, and he is a certified public accountant.

The non-executive officers on the board are George Lucas, Ellen Michaels, Mike Morales, and Charles Jacobs. George Lucas is a former chief executive officer of the client firm. He retired as chief executive officer of the client firm 4 years ago, but he continues as non-executive chairman. Mr. Lucas holds an M.B.A. The remaining three non-executive directors also serve as the members of the audit committee.

Ellen Michaels is a certified public accountant and an attorney. She is a partner at a law firm in Los Angeles, California. Ms. Michaels holds bachelor's, M.B.A. and J. D. degrees. Mike Morales is the president of a publishing company in Los Angeles, California. Mr. Morales holds an M.B.A. Charles Jacobs is managing partner of a private equity firm in Chicago, Illinois. Mr. Jacobs holds a bachelor's and an M.B.A. in finance.

The company's board of directors met five times in the past fiscal year. The audit committee held three meetings in the most recent fiscal year. According to the firm's audit committee charter, the functions of the audit committee include reviewing the scope, timing and other matters that are related to the audit firm's annual audit of the financial statements.

### **REQUIREMENTS**

The questions that follow will help you to understand the reason special attention is given to related party transactions. You will be required to evaluate the risks of material misstatement associated with the client firm's related party transactions. You will also be required to consider audit procedures to identify the client firm's related party transactions. Finally, you will be required to prepare an audit program for the related party transactions.

#### **Questions**

1. Why do the client firm's related party transactions require special attention from the auditors?
2. Summarize the professional auditing standards for identifying and evaluating the risks of material misstatement associated with the client firm's related party transactions.
3. How might Jane identify related party transactions that have not been disclosed by the client firm?
4. Prepare a list of evidence sources for identifying the client firm's related party transactions.
5. Prepare an audit program for the client firm's related party transactions.
6. What recommendations would you make for deterring fraud in the client firm's related party transactions?

## **CASE LEARNING OBJECTIVES, AND IMPLEMENTATION GUIDANCE**

### **Case Learning Objectives**

The case is designed to enable students understand the reasons for which related party transaction require special attention during an audit. The case aims at enabling students to not only identify related party transactions but also to evaluate the risks associated with related party transactions and design appropriate audit procedures in response to the assessed risks. It is expected that the case will encourage students to research applicable rules for auditing related party transactions. The case also aims at encouraging students to critically think of ways to deter fraud in related party transactions.

The case has five specific learning objectives. On completing the case analysis, students must be able to understand:

1. Assessment of the risks of material misstatement associated with related party transactions.
2. The reasons why related party transactions require special attention from auditors.
3. Audit procedures for related party transactions.
4. Evidence the auditor should seek in the evaluation of related party transactions.
5. Procedures to identify related party transactions.

### **Implementation Guidance<sup>2</sup>**

The case is intended to be used in an undergraduate level auditing course. It should be used after covering auditing and corporate governance, audit of related-party transactions and financial statement fraud. The case can also be used in a graduate-level auditing course. For either the graduate or undergraduate class, it is recommended that students are assigned the discussion questions prior to class to enable them to prepare adequately for the class discussion. If students do not have any experience conducting research of professional guidance, it would be helpful if the instructor demonstrates how to access and interpret information from the auditing standards.

The case was used in an undergraduate class and a graduate auditing class. In the graduate class, the case was used after covering financial statement fraud. Students were assigned the case in groups of three to five prior to class and their written responses were graded. The instructor led an in-class discussion of the case, and student participation was graded. No formal feedback on students' learning experiences with the case was collected. In the

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<sup>2</sup> Detailed teaching notes for this case will be made available to instructors by emailing the authors.

undergraduate auditing class, the case was assigned after covering auditing and corporate governance, audit of related-party transactions and financial statement fraud. Students were required to work in groups and submit their answers to the discussion questions.<sup>3</sup> Beginning with the discussion questions, the instructor led an in-class discussion of the case. Students' performance was graded based on their group work, contribution to the group assignment, and the quality of their participation during the in-class case discussion.<sup>4</sup>



## REFERENCES

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<sup>3</sup> Students were randomly assigned to groups of three.

<sup>4</sup> Each group member evaluated other members' contribution to the group work on a scale of 1 to 5.



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