

Broker-Dealer Audit Focus

Related Party Transactions



PCAOB staff continues to identify deficiencies related to the testing of transactions between brokers and dealers ("broker-dealers") and related parties that are typically their parents or affiliates. This edition of Broker-Dealer Audit Focus highlights key reminders for auditors of broker-dealers from PCAOB standards related to audit procedures involving a broker-dealer's revenue and expense transactions with related parties. It also provides the staff's perspective on common deficiencies observed in broker-dealer inspections and shares good practices that staff have observed.

APPLICABLE PCAOB STANDARD

AS 2410, Related Parties ("AS 2410"), states that the auditor's objective is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements. To meet these objectives, the auditor:

- Performs risk assessment procedures to obtain an understanding of the broker-dealer's relationships and transactions with its related parties.

About the Broker-Dealer Audit Focus Series

Broker-Dealer Audit Focus is a series of PCAOB publications that aims to provide easy-to-digest information to auditors of registered broker-dealers. Each edition of Broker-Dealer Audit Focus reviews relevant auditing or attestation standards, rules, and/or staff guidance, as well as offering reminders and describing good practices tailored to PCAOB-registered auditors of smaller broker-dealers – all with an eye toward protecting investors and improving audit quality.

- Identifies and assesses the risks of material misstatement associated with relationships and transactions with the broker-dealer's related parties.
- Responds to the risks of material misstatement.
- Evaluates whether the broker-dealer has properly identified relationships and transactions with its related parties.

- Evaluates the financial statement accounting for and disclosure of the relationships and transactions between the broker-dealer and its related parties.
- Communicates to the audit committee (or its equivalent) the auditor's evaluation of the broker-dealer's identification of, accounting for, and disclosure of relationships and transactions with its related parties.

Common Deficiencies

The following are some of the common deficiencies that the staff has observed in the testing by audit firms of transactions between a broker-dealer and its parent or affiliates:



Not testing the allocation of revenues and expenses

between a broker-dealer and its parent or affiliates, including the accuracy and completeness of information used in the allocation.



Not evaluating whether allocated revenues or expenses are consistent

with the terms of the written agreements between the broker-dealer and its parent or affiliates.

Not evaluating the financial capability

of a broker-dealer's parent or affiliates to satisfy a material uncollected balance owed to the broker-dealer.



Not identifying omitted or inaccurate disclosures

in the broker-dealer's financial statements necessary to understand the effects of transactions between a broker-dealer and its parent or affiliates.



Not communicating to the audit committee

(or its equivalent) the auditor's evaluation of the broker-dealer's identification of, accounting for, and disclosure of transactions with its parent or affiliates.



REMINDERS

Identifying and Assessing Risks of Material Misstatement

Auditors should perform procedures to identify and assess risks of material misstatement associated with relationships and transactions with the broker-dealer's related parties.

The auditor should perform risk assessment procedures to obtain an understanding of the broker-dealer's relationships and transactions with related parties (for example, the broker-dealer's parent or affiliates) that might reasonably be expected to affect the risks of material misstatement of the broker-dealer's financial statements, in conjunction with performing risk assessment procedures in accordance with *AS 2110, Identifying and Assessing Risks of Material Misstatement*.

The auditor's understanding of the broker-dealer's internal control over financial reporting should include an understanding of the broker-dealer's processes involving transactions between the broker-dealer and its parent or affiliates, including revenue and expense transactions. Often, such transactions are governed by revenue allocation and expense sharing agreements. The auditor should inquire of management regarding matters such as the terms, business purposes, and authorization of these transactions. In addition, the auditor should inquire of others within the broker-dealer with knowledge of such matters. The auditor should also make inquiries of the audit committee (or its equivalent) regarding the understanding and concerns of its members over these transactions.

The auditor should identify and assess the risks of material misstatement at the financial statement level and assertion level. This includes identifying and assessing the risks of material misstatement associated with relationships and transactions of a broker-dealer with its related parties, including whether the broker-dealer has properly identified, accounted for, and disclosed relationships and transactions with its related parties, such as revenue and expense transactions with its parent or affiliates.

Auditors of broker-dealers should also reference Financial Industry Regulatory Authority (FINRA) Notice to Members 03-63. The notice emphasizes the importance of appropriate recordkeeping that reflects each expense incurred relating to the broker-dealer's business and any corresponding liability, and states that one proper method for recordkeeping is to record the expense in an amount that is determined according to an allocation made by the third party on a reasonable basis. An unreasonable expense allocation methodology may present a risk of material misstatement associated with allocated expenses. The notice also describes the circumstances where a liability for an expense assumed by a third party may be excluded by the broker-dealer for net capital purposes.

Responding to the Risks of Material Misstatement

Auditors must design and perform audit procedures that address the identified and assessed risks of material misstatement.

The nature and extent of the procedures necessary to address the risks of misstatement associated with relationships and transactions of a broker-dealer with its related parties is commensurate with the auditor's assessment of the risks, including an evaluation of the broker-dealer's facts and circumstances. In the case of revenue and expense transactions between a broker-dealer and its parent or affiliates that are either required to be disclosed in the financial statements or determined to be a significant risk, the auditor's basic procedures should include:

- Reading the underlying documentation and evaluating whether the terms of and other information about the transactions are consistent with explanations from inquiries and other audit evidence about the business purpose (or lack thereof) of the transactions. Often, such underlying documentation will include revenue allocation or expense sharing agreements.
- Determining whether the transactions have been authorized and approved by the broker-dealer, as well as the parent or affiliates, in accordance with the broker-dealer's established policies and procedures.

- Determining whether any exceptions to the broker-dealer's established policies or procedures were granted.
- Evaluating the financial capability of the parent or affiliates with respect to significant uncollected balances, commitments, guarantees, or other obligations. Examples of procedures that might be relevant to the auditor's evaluation include, among other things, review of correspondence between the entities, payment history, and available information about the financial condition of the parent or affiliates.

In addition, the auditor should perform other procedures as necessary to address the identified and assessed risks of material misstatement. These in-depth procedures should also be commensurate with the auditor's assessment of the risks, including an evaluation of the broker-dealer's facts and circumstances. In the case of revenue and expense transactions subject to an allocation agreement, the procedures the auditor might perform to evaluate whether such transactions appear reasonable could include identifying changes in allocation agreements or methodologies and understanding the rationale for those changes, comparing revenue and expense amounts to parent or affiliate records, and testing the completeness and accuracy of allocated revenues and expenses recorded at the parent.

Financial Statement Disclosures and Required Communications

Auditors must evaluate the accounting for and disclosure of relationships and transactions of a broker-dealer with its related parties and should communicate their assessment to the audit committee (or its equivalent).

The auditor must evaluate whether relationships and transactions between a broker-dealer and its parent or affiliates have been properly accounted for and disclosed in the financial statements. This includes evaluating whether the financial statements contain the information regarding

relationships and transactions with related parties essential for a fair presentation in conformity with the applicable financial reporting framework.

Financial Accounting Standards Board ASC Topic 850, *Related Party Disclosures* ("FASB ASC Topic 850") requires, among other things, that broker-dealers disclose the following:

- The nature of the relationships involved.
- A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements.
- The dollar amounts of the transactions.
- Amounts due from or to related parties as of the date of the balance sheet and, if not otherwise apparent, the terms and manner of settlement.

The auditor should communicate to the audit committee (or its equivalent) the auditor's evaluation of the broker-dealer's identification of, accounting for, and disclosure of its relationships and transactions with its related parties (for example, the broker-dealer's parent and affiliates). The auditor also should communicate other significant matters arising from the audit regarding the broker-dealer's relationships and transactions with its related parties.

Good Practices

The following good practices may assist audit firms who audit broker-dealers with the testing of transactions between a broker-dealer and its parent or affiliates:



Practice Aid

Use of a practice aid that contains guidance to assist engagement teams with (1) understanding the broker-dealer's relationships and transactions with its related parties that includes the broker-dealer's process for identification, authorization, accounting, and disclosure of related party transactions, (2) performing inquiries of management, others at the broker-dealer, and the audit committee (or its equivalent), and (3) responding to the identified risks of material misstatement, including guidance for testing of allocated revenues and expenses.

Checklists

Use of financial statement disclosure and audit committee communication checklists identifying the required financial statement disclosures and communications for the audit committee (or its equivalent).



Training

Training audit personnel on the requirements of AS 2410 and FASB ASC Topic 850, as well as the industry-specific requirements of FINRA Notice to Members 03-63 and related audit considerations for broker-dealers with management service, expense sharing, or similar agreements.



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