

Audit Committee Update

Revenue Recognition, Related Party Transactions,
Executive Compensation, and Internal Controls

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Today's Presenters



Frank Burke
Partner
Foley & Lardner LLP



Jennifer Cavanaugh
Partner
Grant Thornton LLP



Mark Zorko
Corporate Director & CFO
Brentwood Advisory LLC

SEC Revenue Recognition Enforcement Trends

Why important?

45% of SEC enforcement and private litigation accounting fraud cases involve revenue recognition issues

Examples:

- Revenue recognition timing issues
- Earnings management issues
- Reporting of fictitious sales
- Channel stuffing, pull-in sales, bill and holds, paying for the costs of storage, shipment and insurance of products, extended return privileges, extended payment terms
- Fraudulent parking transactions, fraudulent round trip transactions, booking income from conditional sales or consignments
- Improper off balance sheet transactions, use of special purpose entities
- Asset, inventory, receivables valuation and impairment

SEC Revenue Recognition Enforcement Priorities

- Financial Reporting and Audit Task Force/Group since 2013;
- Revenue recognition, valuation and impairment issues, earnings management, missing or insufficient disclosure, internal accounting controls, clawbacks of bonuses and incentive based compensation
- Importance of gatekeepers: accountants, audit committees, especially audit committee chairs, and auditors- should be looking for red flags
- Demand objective evidence and internal investigation; national office personnel key role;
- If audit committee learns of material inaccuracies in company filings, must take concrete steps to learn all relevant facts and cease annual and quarterly filings until satisfied with accuracy
- SEC Center for Risk and Quantitative Analysis using data analytics: Accounting Quality Model; Corporate issuer Risk Assessment Program; word search in MD&A. Compare companies with their peers; look for anomalies.
- Importance of whistleblowers

Revenue Recognition Principles in ASC 606

1. Identify the contract with a customer
2. Identify the performance obligations in the contract (distinct)
3. Determine the transaction price (fixed or variable; financing component)
4. Allocate the transaction price to the performance obligations in the contract (standalone selling price or estimate)
5. Recognize revenue when (or as) the reporting organization satisfies a performance obligation (at a point in time or over time)

ASC 606 Disclosure Principles: Provide Information About:

1. Revenue recognized from contracts with customers, including a breakout into appropriate categories
2. Contract balances, including the opening and closing balances of receivables, contract assets, and contract liabilities
3. Performance obligations including when the reporting obligation typically satisfies its performance obligations and the transaction price that is allocate to the remaining performance obligations in a contract
4. Significant judgments, and changes in judgments, made in applying the requirements to those contracts

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Transition Rules

- Eliminates Industry Specific Revenue Recognition: Rules for Software, Construction and Production Type Contracts, PPE- Real Estate Sales, Multiple Element Arrangements
- Apply retrospectively to each prior reporting period presented or
- Retrospectively with the cumulative effect of initially applying this Update recognized at the date of initial application

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Related Party Transactions

Transactions with Related Parties

- Why is this important?
- PCAOB states that these were contributing factors in numerous financial reporting frauds, including Enron, Tyco, Refco, and WorldCom. Others also include Adelphia, Hollinger and Rite Aid
- Related party disclosure issues appear in 20% of SEC enforcement and private litigation accounting cases
- The following types of activities have led to enforcement actions:

The following types of activities have led to enforcement actions:

- Sales to, and purchases from related parties of goods and services: if sales are fictitious, or non-sale receipts mischaracterized as revenues, or are at below market prices; or purchases are not reported or involve non-existent or unnecessary goods and services or are at above market prices
- Asset sales to or purchases from related parties: sales at below market prices; purchases of non-existent assets or over-priced assets; over-valuing sold or purchased assets
- Borrowings from or loans to related parties: non-recognition of borrowings, or not disclosing obligations incurred via a co-guaranty or co-borrowing; borrowing at above market rates or lending at below market rates or off market terms; on loans, over-estimating collectability
- Investments in or sale of equity stake to related parties: if reported incorrectly, can lead to the overstatement of assets; related party investment in the company's equity can mislead about insider activity. Investing at above market prices or selling equity at below market prices can transfer wealth

PCAOB Auditing Standard No. 18

- **Related Parties**
- **Significant Unusual Transactions**
- **Financial Relationships and Transactions with Executives**

Risk Assessment

- **Obtaining an Understanding of the Company's Process**
- **Performing Inquiries**
- **Communicating with the Audit Engagement Team and Other Auditors**

Obtaining an Understanding of the Company's Process

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

Performing inquiries regarding related parties

- Names
- Background information
- Nature of the relationships
- Transactions entered into and the terms and business purposes
- Business purpose for transaction with a related party versus an unrelated party
- Transactions not authorized or approved in accordance with established company procedures
- Transactions excepted from established company procedures and the reasons
- Identifying and responding to risks of material misstatement
- Evaluating whether the company has properly identified its related parties and relationships and transactions with them
- Evaluating financial statement accounting and disclosures
- Communicating with the audit committee

Auditing Significant Unusual Transactions

- Significant unusual transactions
- Outside the normal course of business
- Unusual due to timing size or nature
- Evaluate internal controls
- Evaluate whether the business purpose indicates transactions entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets

Auditing Executive Compensation

- Executive compensation
- To evaluate material misstatements in financial relationships and transactions with executive officers (e.g. executive compensation, perquisites and other arrangements)
- Read employment and compensation contracts
- Read proxy statement
- For other senior management, review incentive compensation arrangements and special bonuses

What are related parties?

- Same as Before
- ASC 850
- Item 404(a) of SEC Regulation S-K, related persons

Internal Controls Requirements

- Required by Foreign Corrupt Practices Act §78(m)(b)
- SOX §404(a) requires management reporting and certification of effectiveness of ICFR
- SOX § 404(b) and JOBS Act require audit of internal controls 5 years after IPO or \$1 billion annual revenue or \$700 million market cap
- COSO Framework (2013) must be followed-emphasizes the Board's role in overseeing internal controls and risk assessment

Internal Controls Enforcement Issues

- SEC emphasizing the importance of a robust internal control environment in speeches
- SEC recent internal controls enforcement cases
- Class action securities suits on accounting issues show 65% of matters cite material weakness in internal controls

Questions & Answers

Contact Information

- Frank Burke
Foley & Lardner LLP
(415) 984-9870
fburke@foley.com
- Jennifer Cavanaugh
Grant Thornton LLP
(312) 602-8715
jennifer.cavanaugh@us.gt.com
- Mark Zorko
Brentwood Advisory LLC
(847) 477-2784
mzorko@brentwoodadvisory.com

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