

UNREGULATED AND AFFILIATE TRANSACTIONS



AFFILIATED OR RELATED PARTIES

- Parties (affiliates) that directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the enterprise.
- Entities for which investments are accounted for by the equity method.
- 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 (more than 10% of voting interest)
- Management
- Members of immediate families of principal owners and its management
- Other parties who can control, or be controlled by, management or operating policies of the company

REQUIRED DISCLOSURES (SFAS 57)

- Must disclose material related party transactions, other than transactions in normal course of business (e.g., compensation)
 - Eliminated in consolidated financial statements
- Disclosures might include:
 - Nature or relationship
 - Description of transaction
 - Amounts due to or from related parties

REQUIRED DISCLOSURES (SFAS 57)

- 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
- Auditor should determine that the financial statement disclosures are adequate and appropriate
- Since it is difficult to substantiate representations that transaction was consummated on arm's-length terms, if such a representation is included in the financial statements and the auditor believes it is unsubstantiated by management, then a qualified or adverse opinion should be expressed because of a departure from generally accepted accounting principles.

U.S. AUDITING LITERATURE



- Statement of Auditing Standard 22,
Planning and Supervision
 - In planning the audit, the auditor should consider among other matters . . . 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.

U.S. AUDITING LITERATURE

- Statement of Auditing Standard 45, *Related Parties*
 - Transactions that may indicate the existence of related parties include:
 - 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 non-monetary transaction
 - Making loans with no scheduled terms for when or how the funds will be repaid

U.S. AUDITING LITERATURE

- Practice Alert No. 95-3, *Auditing Related Parties and Related Party Transactions*
 - 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

U.S. AUDITING LITERATURE

- Practice Alert No. 95-3, *Auditing Related Parties and Related Party Transactions*
 - Events that may be indicative of transactions with undisclosed related parties: (Continued)
 - 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 retaining the difference
 - Purchases of assets at prices in excess of fair market value

U.S. AUDITING LITERATURE

- Statement of Auditing Standard 82, *Consideration of Fraud in a Financial Statement Audit*, 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.
 - The auditor may conclude that related parties and/or related party transactions are a potential source for material misstatement
 - This may be particularly true if management does not identify to the independent auditor the existence of related party transactions

U.S. AUDITING LITERATURE

- Auditing Standard 334 provides a list of procedures for independent auditors examining related party transactions
 - Obtain an understanding of the business purpose of the transaction
 - Examine invoices, executed copies of agreements, contracts, and other pertinent documents, such as receiving reports and shipping documents
 - Determine whether the transaction has been approved by the board of directors or other appropriate officials
 - Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure, in the financial statements
 - 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
 - Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral

U.S. AUDITING LITERATURE

- If more extensive auditing procedures are needed:
 - Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction
 - Inspect evidence in possession of the other party or parties to the transaction
 - Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction
 - 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
 - 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. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance

SOURCE INFORMATION

- A key source of information on these topics used in preparation of this presentation:
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

AFFILIATE TRANSACTIONS REGULATORY CONCERNS



- Cost shifting
- Profit shifting
- Risk shifting
- Anti-competitive behavior
 - Cross subsidization

GUIDELINES FOR COST ALLOCATIONS AND AFFILIATE TRANSACTIONS



- Cost Allocation Principles
 - The maximum extent practicable, costs should be collected and classified on a direct basis for each asset, service or product provided.
 - The general method for charging indirect costs should be on a fully allocated cost basis
 - To the extent possible, all direct and allocated costs should be traceable on the books of the applicable regulated utility to the applicable uniform system of accounts.
Documentation should be made available to the appropriate regulatory authority upon request regarding transactions between the regulated utility and its affiliates.

GUIDELINES FOR COST ALLOCATIONS AND AFFILIATE TRANSACTIONS



- Cost Allocation Principles (Continued)
 - The allocation methods should apply to the regulated entity's affiliates in order to prevent subsidization from, and ensure equitable cost sharing among the regulated entity and its affiliates, and vice versa.
 - All costs should be classified to services or products which, by their very nature, are either regulated, non-regulated, or common to both.
 - The primary cost driver of common costs should be identified and used to allocate the cost between regulated and non-regulated services or products.
 - The indirect costs of each business unit, including the allocated costs of shared services, should be spread to the services or products to which they are related using relevant cost allocators.

GUIDELINES FOR COST ALLOCATIONS AND AFFILIATE TRANSACTIONS



- Affiliate Transaction Pricing Guidelines
 - Generally the price for services, products and the use of assets provided by a regulated entity to its non-regulated affiliates should be at the higher of fully allocated costs or prevailing market prices
 - Generally, the price for services, products and the use of assets provided by a non-regulated affiliate to a regulated affiliate should be at the lower of fully allocated cost or prevailing market prices

GUIDELINES FOR COST ALLOCATIONS AND AFFILIATE TRANSACTIONS



- An audit trail should exist
- The regulator should have complete access to all affiliate records necessary to ensure that cost allocations and affiliate transactions are conducted in accordance with the guidelines
- The regulators, not the utilities, should determine (within reason) what information is relevant for a particular audit objective

REGULATORY OBJECTIVES IN REVIEWING AFFILIATE TRANSACTIONS

- Determine methods of accumulating costs to be allocated are reasonable
- Determine that methods of allocating costs are reasonable based on benefits received and methods are properly computed and applied
- Determine that overhead costs are reasonable and properly allocated
- Determine that any return component is reasonable

REGULATORY OBJECTIVES IN REVIEWING AFFILIATE TRANSACTIONS



- Determine that the percent of shared officers' time is allocated to appropriate entities or services based on the actual time or time studies, and that resulting allocation percentages are reasonable based on benefits received and methods are properly computed and applied
- Determine that charges from affiliates are reasonable as to pricing method and levels and are consistently treated
- Determine that transactions with non-utility affiliates do not result in cross subsidies by or to utility operations

REGULATORY REVIEW OF AFFILIATE TRANSACTIONS



- Useful items
 - A list of all known related parties and any transactions between the utility and those parties
 - List of boards of directors and officers of various entities to check for common directors and officers
 - Establish if there are transactions occurring between entities that are not being recorded or for which charges are not being made
 - Review significant loans for unusual interest rates
 - Obtain description of method used for allocations
 - Compare current allocations and methods to that of prior years
 - Review any fair market value studies completed by the utility

REGULATORY REVIEW OF AFFILIATE TRANSACTIONS



- Useful Items (Continued)
 - Determine method used to allocate common or shared salaries and corporate costs
 - Timesheets for officers may be suspect as may be filled out randomly by office assistant
 - Compare returns included in services from unregulated entities to regulated entities to returns allowed for the regulated entity

CONTACT INFORMATION



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