

Case 16-1 The Audit of SSM

Background

Steve's Shoe Makers Inc. (SSM), a company that is publicly traded on the New York Stock Exchange, manufactures and distributes high-performance athletic footwear and apparel. Established in Philadelphia in 2000 as a small, family-owned business, SSM has expanded to include a wholly owned subsidiary, Steve's Shoes LLC. SSM's corporate management is based in Philadelphia, and the manufacturing and distribution plants are located in Houston and Los Angeles.

You have been hired as SSM's external auditor and have been assigned to test SSM's related parties and its relationships and transactions with related parties in accordance with PCAOB AS 2410 (formerly PCAOB AS 18).

You have spoken with SSM's CEO, Dain Blanton, who believes that the processes and controls in place at SSM would result in the identification of any related-party relationship that would require further investigation or possible disclosure in the financial statements. Further, he has stated that the company does not have any related-party events or transactions that would need to be disclosed in the current-year annual financial statements in accordance with ASC 850.

See the appendix below for SSM's organizational structure.

Management's Processes and Controls

To understand management's processes and controls over related parties and its relationships and transactions with them, you obtain SSM's relevant process flow narrative from management, which states the following:

Before hiring a new employee, the human resources manager performs a background check. Employees hired for management positions must disclose their significant ownership interests. SSM's legal department maintains a listing of these disclosures ("related-parties listing") and periodically checks the disclosed relationships against SSM's vendor and customer master file. Annually, before SSM files its 10-K, management signs representations indicating that to the best of its knowledge, SSM did not enter into any related-party transactions that were not disclosed in the financial statements. Management also discloses any changes in its significant equity ownership or investments at this time. A review of the representations is performed by the legal department, the related-parties listing is updated for any new related parties identified, and the records are maintained in a locked room.

Risks of Material Misstatement

As a result of the risk-assessment procedures performed, you have determined that the risks of material misstatement listed below apply to the audit of SSM. You have also

determined that none of the identified and assessed risks of material misstatement are significant risks. (Note that there are additional risks of material misstatement regarding related parties and relationships and transactions with related parties; however, this case study only focuses on the risks outlined below.)

R_RP_1: Related parties and transactions with related parties may not be appropriately identified.

R_RP_2: Related-party transactions are not recorded in accordance with applicable accounting standards.

R_RP_3: Related-party transactions are recorded:

- For transactions that did not occur or are pending.
- At incorrect amounts.
- In the incorrect period.

R_RP_4: Related-party transactions are recorded:

- For transactions that lack a business purpose.
- Without taking into account the counterparty's financial capability.

R_RP_5: The related-party disclosure includes transactions that:

- May not have occurred.
- Lack a business purpose.
- Are not recorded on terms equivalent to those prevailing in an arm's-length transaction and are not disclosed as such.

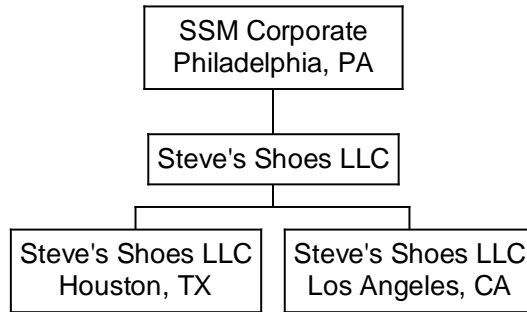
R_RP_6: The related-party disclosure does not sufficiently describe related-party transactions in accordance with the applicable financial reporting framework.

Required

1. In accordance with paragraphs .05–.07 of PCAOB AS 2410 (formerly PCAOB AS 18), auditors are required to inquire of the audit committee, management, and others in the company regarding their knowledge of related parties and relationships and transactions with related parties. Use SSM’s organizational chart in the appendix below as a resource to identify others in the company who you would consider asking about such knowledge. Explain your rationale for selecting these individuals.
2. Are management’s processes and controls over related parties and over related-party relationships and transactions sufficient? Why or why not?
3. Given the need for management to identify, authorize and approve, and account for and disclose its related parties and its relationships and transactions with related parties, what are the types of processes and control activities that management should consider?
4. Given the requirement in paragraph .14 of PCAOB AS 2410 (formerly PCAOB AS 18), what procedures would you perform to test the accuracy and completeness of the related-parties listing and of relationships and transactions with related parties?
5. What would be the implications on the audit if an undisclosed related-party transaction was identified during the completion of audit testing?

Appendix — Organizational Charts

Entity Organizational Chart



Management Organizational Chart

