SA 550 (AAS 23)

RELATED PARTIES

(Effective for all audits relating to accounting periods beginning on or after April 1, 2001)

Contents

Paragraph(s)

Standard on Auditing (SA) 550[*], "Related Parties" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

[*] Issued in September, 2001.

[1] Published in the July 2007 issue of the Journal.

Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the auditor's responsibilities and audit procedures regarding related parties and transactions with such parties.

2. The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the related party transactions that are material to the financial statements. However, an audit cannot be expected to detect all related party transactions.

3. In certain circumstances there are limitations that may affect the persuasiveness of evidence available to the auditor to draw conclusions on particular financial statement assertions. Because of the degree of uncertainty associated with the financial statement assertions regarding the completeness of information of related parties, the procedures identified in this SA will provide sufficient appropriate audit evidence regarding those assertions in the absence of any circumstance identified by the auditor that:

(a) increases the risk of misstatement beyond that which would ordinarily be expected; or

(b) indicates that a material misstatement regarding related parties has occurred.

Where there is any indication that such circumstances exist, the auditor should perform modified, extended or additional procedures as are appropriate in the circumstances.

4. Definitions regarding related parties are given in Accounting Standard (AS) 18, "Related Party Disclosures" and are adopted for the purposes of this SA.[2]

5. Management is responsible for the identification and disclosure of related parties and transactions with such parties. This responsibility

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[2] Definitions of "Related Party" and "Related Party Transactions" from Accounting Standard (AS) 18 "Related Party Disclosures" are:

Related Party – parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Related Party Transactions – a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

requires management to implement adequate accounting and internal control systems to ensure that transactions with related parties are appropriately identified in the accounting records and disclosed in the financial statements.

6. The auditor needs to have a level of knowledge of the entity's business and industry that will enable identification of the events, transactions and practices that may have a material effect on the financial statements. While the existence of related parties and transactions between such parties are considered ordinary features of business, the auditor needs to be aware of them because:

(a) the financial reporting framework may require disclosure in the financial statements of certain related party relationships and transactions, such as those required by AS 18;

(b) the existence of related parties or related party transactions may affect the financial statements. For example, the entity's tax liability and expense may be affected by the tax laws which require special consideration when related parties exist;

(c) the source of audit evidence affects the auditor's assessment of its reliability. A greater degree of reliance may be placed on audit evidence that is obtained from unrelated third parties; and

(d) a related party transaction may be motivated by other than ordinary business considerations, for example, profit sharing or even fraud.

Existence and Disclosure of Related Parties

7. The auditor should review information provided by the management of the entity, identifying the names of all known related parties and should perform the following procedures in respect of the completeness of this information:

(a) review his working papers for the prior years for names of known related parties;

(b) review the entity's procedures for identification of related parties;

(c) inquire as to the affiliation of directors and key management personnel[3], officers with other entities;

(d) review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a list of principal shareholders from the share register;

(e) review memorandum and articles of association, minutes of the meetings of shareholders and the board of directors and its committees and other relevant statutory records such as the register of directors' interests;

(f) inquire of other auditors[4] of the entity as to their knowledge of additional related parties and review the report of the predecessor auditors;

(g) review the entity's income tax returns and other information supplied to regulatory agencies; and

(h) review the joint venture and other relevant agreements entered into by the entity.

If, in the auditor's judgement, the risk of significant related parties remaining undetected is low, these procedures may be reduced or modified as appropriate.

8. Where the financial reporting framework requires disclosure of related party relationships, the auditor should satisfy himself that the disclosure is adequate.

Transactions with Related Parties

9. The auditor should review information provided by directors and key management personnel of the entity identifying related party transactions and should be alert for other material related party transactions.

10. When obtaining an understanding of the accounting and internal control systems and making a preliminary assessment of control risk,

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[3] Definition of "Key Management Personnel" from AS 18 is:

Key Management Personnel - those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprises.

[4] The term "Other Auditors" includes internal auditor, special auditors appointed under any statute, cost auditors, and concurrent auditors.

the auditor should consider the adequacy of control procedures over the authorisation and recording of related party transactions.

11. During the course of the audit, the auditor needs to be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties. Examples include:

- Transactions which have abnormal terms of trade, such as, unusual prices, interest rates, guarantees, and repayment terms.
- Transactions which lack an apparent logical business reason for their occurrence.
- Transactions in which substance differs from form.
- Transactions processed in an unusual manner.
- High volume or significant transactions with certain customers or suppliers as compared with others.
- Rendition of services without receipt or provision of management services at no charge.

12. During the course of the audit, the auditor carries out procedures which may identify the existence of transactions with related parties. Examples include:

- Performing detailed tests of transactions and balances.
- Reviewing minutes of meetings of shareholders and directors.
- Reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recognised at or near the end of the reporting period.
- Reviewing the entity's income tax returns and other information supplied to regulatory agencies.
- Reviewing confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate guarantor relationship and other related party transactions.
- Reviewing investment transactions, for example, purchase or sale of an equity interest in a joint venture or other entity.

Examining Identified Related Party Transactions

13. In examining the identified related party transactions, the auditor should obtain sufficient appropriate audit evidence as to whether these

transactions have been properly recorded and disclosed.

14. Given the nature of related party relationships, evidence of a related party transactions may be limited, for example, regarding the existence of inventory held by a related party on consignment or an instruction from a parent company to a subsidiary to record a royalty expense. Because of the limited availability of appropriate evidence about such transactions, the auditor would consider performing procedures such as:

- Confirming the terms and amount of the transaction with the related party.
- Obtaining confirmation from persons associated with the transaction, such as, banks, lawyers, guarantors and agents.

Management Representations

15. The auditor should obtain a written representation from management concerning:

(a) the completeness of information provided regarding the identification of related parties; and

(b) the adequacy of related party disclosures in the financial statements.

16. An example of a written representation to be obtained from management is given as an Appendix to this Standard.

Audit Conclusions and Reporting

17. If the auditor is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or concludes that their disclosure in the financial statements is not adequate, the auditor should express a qualified opinion or a disclaimer of opinion in the audit report, as may be appropriate.

Effective Date

18. This Standard on Auditing becomes operative for all audits related to accounting periods beginning on or after 1st April, 2001.

Appendix

Example of a Management Representation Letter Regarding Related Parties

(Refer Paragraph 16)

The following letter is for use as a general guide in conjunction with the considerations set forth in this Statement. Representations by management will vary from one entity to another, and from one year to the next. Therefore, this letter is not intended to be a standard letter and should be adapted in the light of individual requirements and circumstances.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

This representation letter is provided in connection with your audit of the financial statements of ____________ for the year ended _______. We acknowledge our responsibility for preparation of financial statements in accordance with the requirements of the Companies Act, 1956 and recognised accounting policies and practices, including the Accounting Standards issued by the Institute of Chartered Accountants of India.

We confirm the following representation in respect of related parties:

1. We have identified all the related parties and transactions with all such parties. The information provided to you is complete in all respects.
2. The disclosures made in the financial statements are adequate having regard to the framework under which the financial statements have been drawn.
3. The financial statements are free from material misstatements, including omissions with regard to related parties and transactions with related parties.

{Signature of the Authorised Person(s) of the Entity}