

ASA 550 Related Parties

OBJECTIVE

The objective of ASA 550 *Related Parties* is to prescribe mandatory requirements for auditors regarding related parties and transactions with such parties when AASB 124 *Related Party Disclosures*, or similar requirement, is part of the applicable financial reporting framework; or in other circumstances, the auditor considers it appropriate to identify related parties and related party transactions.

APPLICATION

Financial reporting periods commencing on or after 1 July 2006.

Responsibility of those charged with governance in relation to related parties

Those charged with governance and management are responsible for the identification and disclosure of related parties and transactions with such parties. This responsibility requires those charged with governance and management to implement adequate internal control to ensure that transactions with related parties are appropriately identified in the information system and disclosed in the financial report.

Why are related parties and related party transactions of interest to auditors?

While the existence of related parties and transactions between such parties are considered ordinary features of business, the auditor ordinarily maintains an awareness of them because:

- The applicable financial reporting framework may require disclosure in the financial report of certain related party relationships and transactions, such as those required by Accounting Standards AASB 124 *Related Parties* and AASB 101 *Presentation of Financial Statements*.
- The existence of related parties or related party transactions may affect the financial report. For example, provisions relating to financial benefits to related parties under the *Corporations Act 2001*, or where the entity's tax liability and expense may be affected by the tax laws in various jurisdictions which require special consideration when related parties exist.
- The source of audit evidence affects the auditor's assessment of its reliability. Generally a greater degree of reliance may be placed on audit evidence that is obtained from or created by unrelated third parties.
- A related party transaction may be motivated by other than ordinary business considerations, for example, profit sharing or even fraud.
- The potential for error may increase because documentation regarding related party transactions may receive less scrutiny than documentation regarding other transactions.

Related parties and related party transactions can be difficult to identify and measure because:

- Related parties may operate through an extensive and complex range of relationships and structures.
- Related party transactions may not always involve an exchange of consideration.
- Transactions with related parties may not be at arm's length and may be controlled, manipulated and/or concealed by those charged with governance and management.

When determining materiality regarding related parties, it may often be difficult to extend materiality levels used in other aspects of the audit to those involving related parties because, for example:

- there is no objective value or basis of measurement for some related party transactions;
- the requirement to measure qualitative aspects such as the extent and impact of control or significant influence, or the impact of transactions on the users of the financial report; and
- director related disclosures are deemed material regardless of the quantum of the amounts involved.

The auditor may consider it appropriate to request those charged with governance and management to estimate or place an imputed value on transactions in order to determine the impact on the financial report, for example transactions that have occurred but which have no recorded value.

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The auditor's obligations in relation to related parties and related party transactions

The auditor is under an obligation under ASA 550 to perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure, by those charged with governance and management, of related parties and the effect of related party transactions that are material to the financial report. In addition, the auditor is under an obligation to reduce to a level acceptably low to the auditor the risks of material misstatement in the financial report resulting from the existence of related parties and related party transactions.

Because of the degree of uncertainty associated with management's assertions regarding the completeness of related parties, the auditor needs to apply audit procedures identified in ASA 550 in order to provide sufficient appropriate audit evidence regarding those assertions in the absence of any circumstance identified by the auditor that increases the risk of material misstatement beyond that which would ordinarily be expected or indicates that a material misstatement regarding related parties has occurred.

The auditor's risk assessment procedures in relation to identified parties

Under ASA 550 the auditor, based on knowledge of the business and enquiries of those charged with governance and management, is under an obligation to assess the risk that related parties and related party transactions will not be identified, or that related party transactions will not be disclosed or measured in accordance with the applicable financial reporting framework. In assessing this risk the auditor evaluates the impact of the following:

- A complex organisational or ownership structure may make the identification of related parties more difficult, a situation which may be further complicated when the auditor does not audit all entities within an economic entity.
- The number of related parties and the volume of related party transactions.
- The extent to which the entity operates in foreign jurisdictions.
- Goods or services are provided at no charge.
- Indications of changes in the terms of transactions with related parties, particularly if they no longer reflect normal commercial terms.
- The entity is experiencing difficulty meeting the terms of debt agreements or has going concern problems.
- The entity has aggressive incentive programmes or is experiencing rapid growth in profitability when compared with other entities in the same industry.
- The nature of transactions with related parties, such as those involving intangibles.

The auditor, based on the understanding of the entity and its environment including its internal control, is under an obligation to make an assessment of the risk of material misstatement as it relates to the identification of related parties and the authorisation and recording of related party transactions. Ordinarily, this assessment involves consideration of policies and procedures relating to matters such as:

- ensuring that declarations of interests in other entities are current and communicated by and to those charged with governance and management within the entity;
- identifying related party transactions within information systems, including those policies and procedures which ensure the recording of transactions for which no consideration has been received or paid; and
- authorising and approving prices for transactions with related parties, including those not in the normal course of operations.

Existence and disclosure of related parties

Under ASA 550, the auditor is under an obligation to review information provided by those charged with governance and management identifying the names of all known related parties and to perform audit procedures to reduce the risk of related parties remaining undetected to an acceptably low level. These procedures, modified as appropriate, must include:

- reviewing prior year working papers for names of known related parties.
- reviewing the entity's procedures for identification of related parties.
- enquiring as to the affiliation of those charged with governance and officers with other entities.
- reviewing shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register.
- reviewing minutes of the meetings of shareholders and those charged with governance and other relevant statutory records such as the register of directors' interests.
- enquiring of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties.
- reviewing the entity's income tax returns and other information supplied to regulatory agencies.

In addition the auditor may consider:

- enquiring as to the names of all superannuation and other trusts established for the benefit of employees, and the names of their management, those charged with governance and trustees.
- reviewing invoices and correspondence from lawyers for indications of the existence of related parties.
- reviewing contracts and agreements, for example management agreements and trust agreements.

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Transactions with related parties

Under ASA 550, the auditor is under an obligation to review information provided by those charged with governance and management identifying related party transactions and to be alert for other material related party transactions. Examples of transactions which may indicate the existence of unidentified related parties, and to which the auditor needs to be alert, 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.
- unrecorded transactions such as the receipt or provision of management services at no charge.

The auditor ordinarily carries out other audit 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 those charged with governance.
- 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 confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate a 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.

Further, if, the auditor has reason to suspect the existence of previously unidentified related party transactions, the auditor is under an obligation under ASA 500 to perform further audit procedures which are designed specifically to determine whether related party transactions have occurred. Where the auditor identifies related parties or related party transactions not previously identified, the auditor ordinarily considers the reason for this, and the need to reassess risk of material misstatement concerning the identification of related parties and related party transactions; and the impact on other aspects of the audit when there is a reassessment of these risks.

Examining identified related party transactions

Under ASA 550 in examining the identified related party transactions, the auditor is under an obligation to obtain sufficient appropriate audit evidence as to whether these transactions have been properly recorded and disclosed. Given the nature of related party relationships, audit evidence of a related party transaction may be limited. Because of the limited availability of appropriate audit evidence about such transactions, the auditor ordinarily considers performing audit procedures such as:

- Discussing the purpose of the transaction with those charged with governance and management.
- Confirming the terms and amount of the transaction with the related party.
- Inspecting information in possession of the related party.
- Confirming or discussing information with persons associated with the transaction, such as banks, lawyers, guarantors and agents.

Communication with those charged with governance

Under ASA 550 the auditor is under an obligation to discuss with those charged with governance the nature, extent and business rationale of significant related party relationships and transactions, including those involving actual conflicts of interest. Ordinarily, the discussion enables the auditor to:

- confirm that those charged with governance are fully aware of the nature and extent of significant related party relationships and transactions and their effects on the financial report;
- establish a common understanding with those charged with governance of the business rationale and propriety of the related party relationships and transactions, especially those involving actual or perceived conflicts of interest, and corroborate responses from management to enquiries the auditor has made into related party matters;
- alert those charged with governance to specific related party relationships and transactions of which they may not have been aware, to enable them to take appropriate action where necessary;
- review with those charged with governance the completeness, accuracy and transparency of management's related party disclosures, and the appropriateness of the accounting for related party relationships and transactions; and
- resolve identified related party issues, such as disagreements regarding the nature and extent of disclosure, on a timely basis.

Management representations

Under ASA 550, the auditor is under an obligation to endeavour to obtain a written representation from management concerning the completeness of information provided regarding the identification of related party relationships and transactions; and the adequacy of related party disclosures in the financial report. In the event management is unable to or refuses to provide a written representation the auditor needs to consider the implications of the refusal for the auditor's report.

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Audit conclusions and reporting

If the auditor is unable to obtain sufficient appropriate audit evidence regarding related parties and related party transactions; or form a conclusion as to the completeness of the disclosure of related party relationships and transactions the auditor is obligated under ASA 550 to modify the auditor's report.

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