

# SA 550 Related parties



# SA 550 Related Parties



SA 550 (Revised), Related Parties, deals with auditor's responsibilities regarding related party relationships and transactions. Among others, SA 550 requires that:

- When management makes an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, sufficient appropriate audit evidence should be obtained to support this assertion
- Auditor should in any case evaluate whether the effects of related party transactions are such that they prevent the financial statements from achieving a true and fair presentation

The Standard expands on application of SA 240, 315 and 330 in relation to the risk of material misstatement associated with related party relationships and transactions

Limited revisions to SA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment

- Effective for periods beginning on or after 1 April 2010





## Potential Risks relating to audit of related party transactions

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions
- Transactions may not be on an arm's length basis - pricing policies, manner of settlement and other terms of such transactions may be different from those with independent third parties
  - e.g., if an entity intends to shift some of its profits from a high tax regime to a lower one, it may be inclined to set up a transfer pricing strategy to sell goods to a related party (e.g. a wholly-owned subsidiary) at a lower-than-market price
- Fraud may be more easily committed through related parties - related party relationships may present a greater opportunity for collusion, concealment or manipulation by management



# Key points of focus



Who is a related party?

Inquiry with management and others

Understanding related parties and controls

Ensuring completeness of related parties

Indicators of existence of connected related parties

Previously undisclosed / unidentified related parties

Fraud risk and its indicators

RPTs outside normal course of business and arms length assertion of RPT

Communicate with those charged with governance



# Who is a related party



## Legal and accounting framework

Section 2(76) of  
the Companies  
Act, 2013

Regulation  
2(1)(z)(b) of  
SEBI LODR  
2015

IND AS 24

Accounting  
Standard 18

# Related Party as defined in SA 550

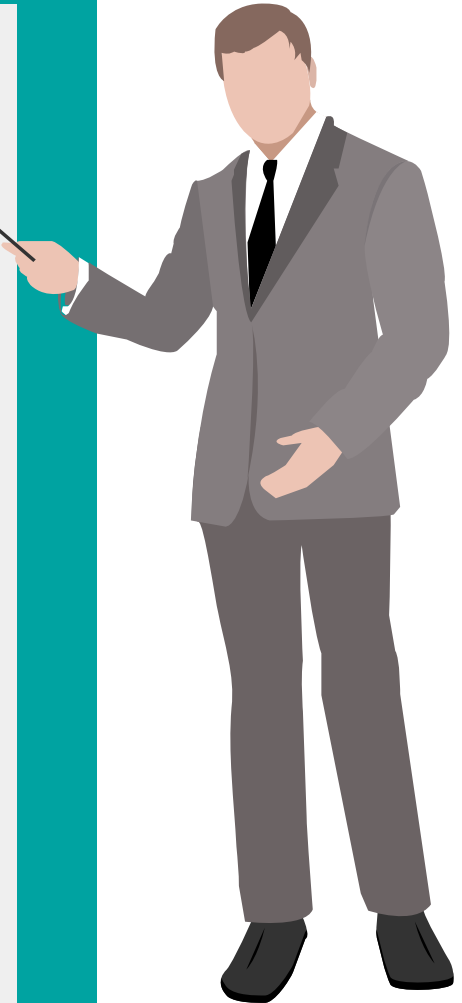


A related party as defined in the applicable financial reporting framework; or

Where the financial reporting framework establishes minimal or no related party requirements:

- person/entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity
- entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries
- entity that is under common control with the reporting entity through having:
  - common controlling ownership;
  - owners who are close family members; or
  - common key management

Entities under common control by a state are not considered related unless they engage in significant transactions or share resources to significant extent with one another





## Requirements of SA 550

Understanding of RP process and related controls

Evaluate ROMM

Testing of RPs appropriately (a) identified (b) accounted and (c) disclosed in FS

Communication with those charged with governance

Existence of fraud risk  
RPTs outside normal course of business

Enquiries with management and others

Whether all RPTs are disclosed  
Are there any undisclosed RPTs

# Inquiry with management and others



## With whom?

**Management**

**Those charged with governance**

**Internal Audit**

**In-house legal counsel**

**Compliance officer**



## What to inquire?

**Entity's ownership and governance structure**

**Approval as per policy**

**Business rationale and justification**

**How is the entity structured and how is it financed**

**Understanding of related party process and controls**



# Understanding of RP process and controls



## Entity Level Controls

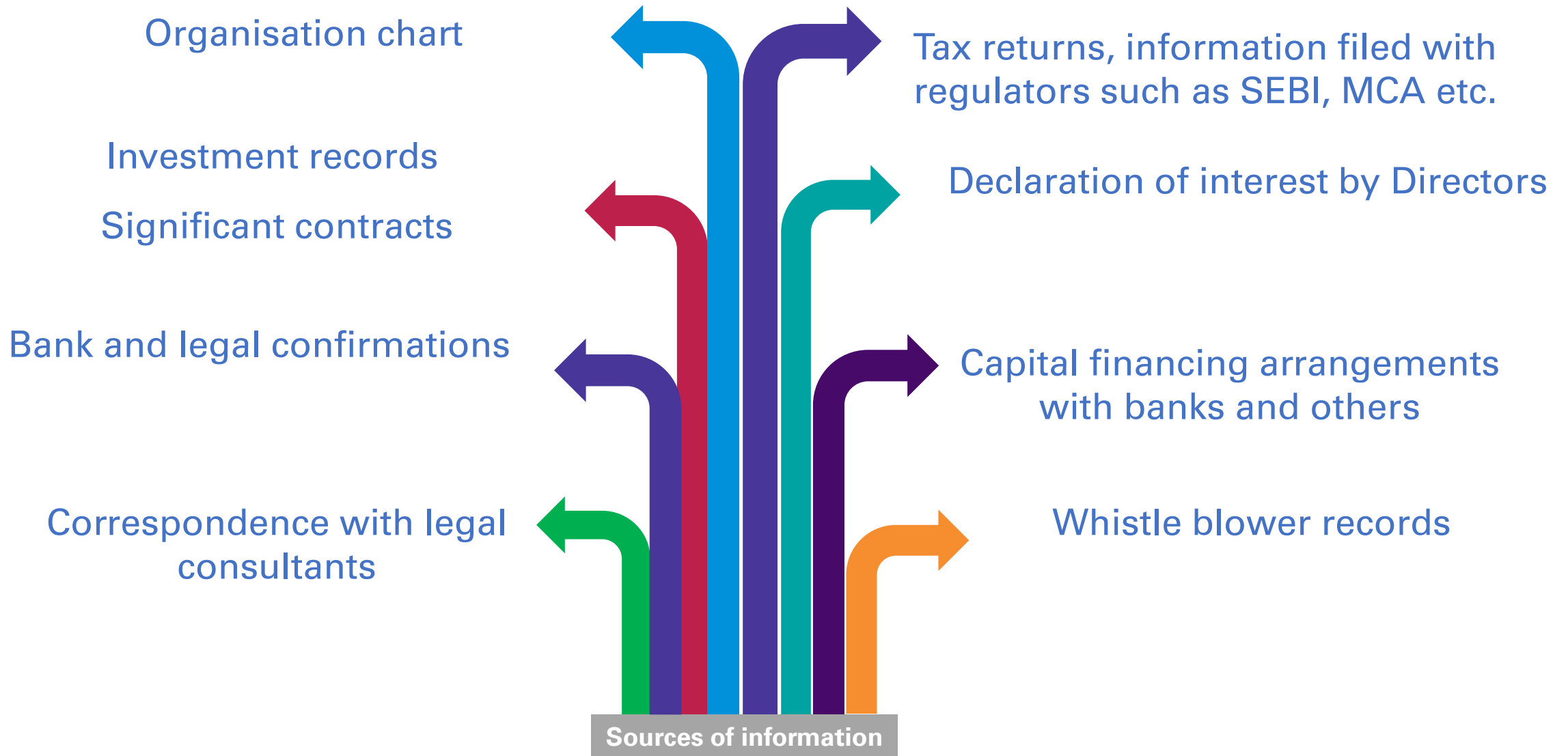
- Approval mechanism
- Whistle blower policy
- Ethics Policy
- Policy on related party transactions

## Process Level Controls

- Identification of related party and RPT
- Authorisation and approval including segregation of duties for RPTs
- Periodic review of RPT register by management
- Review of accounting and disclosures of RPT
- Internal audit review of RPTs

**Evaluation of D&I of RP controls is mandatory irrespective of whether RPT is identified as significant risk**  
**Documentation of understanding of RP process and testing of controls around RPT**

# Ensuring completeness of RPTs



# Completeness of RPTs



- Request from management a list of related parties and transactions with them
- Review the minutes of meetings of shareholders, the board of directors and other meetings for material transactions authorised or disclosed
- Statutory registers for e.g., register required to be maintained under section 184 of the Companies Act 2013
- Understand and evaluate investment transactions, for example, purchase or sale of an equity interest in a joint venture or other entity
- Review confirmations of loan receivable and payable for indications of guarantees and determine the relationships, if any, with the guarantors
- Examine accounting records for material, unusual or nonrecurring transactions including loans to officers, directors, associated companies and individual parties, with special attention to transactions recognized at or near the period end

# Completeness of RPTs



- Check background of parties which have material or unusual transactions with the enterprise by performing company search etc.
- Test entity's controls over completeness and accuracy of recording of related party relationships and transactions
- Review prior-year working papers for names of known related parties including changes from the prior period
- Obtain and review a listing of principal shareholders from the share register
- Examine correspondence and invoices from law firms
- Refer to entity income tax returns
- Refer to information supplied by entity to regulatory authorities

# Indicators of existence of connected RPs



## Loans

- Granting of loan despite insufficient cash flow
- Loans to parties who do not have the wherewithal to repay
- Loans advanced for valid reasons and then written off
- Loans with no scheduled terms of repayment
- Loans at terms which are significantly in variance to normal prevailing practice

## Sales, purchases and other transactions

- Round tripping sales – sales with commitment to repurchase
- Large discounts and sales returns
- Goods purchased or sold at below cost
- Transactions with offshore entities with weak enforcement laws
- No tendering process or contracts awarded without diligence
- Remuneration arrangements with directors, members of management
- Non-monetary transactions – exchange at less than or more than fair value
- Transactions under contracts whose terms are changed before expiry

# Previously unidentified related party transactions



## Case Study

Company A was engaged in selling inventory to an entity in which the CFO was interested at an inflated value and at extended credit terms. The Company recovered only 25% of the sale value and there was a large receivable balance. The entity provided confirmation of the year-end balance.

### Relevant factors to consider

- Abnormal margin
- Balance receivable remaining outstanding for an extended period of time
- Relevance of confirmation provided by the entity
- Remain alert as to whether there are any other transactions of such nature
- Failure on management's part to identify this as RPT

# Previously unidentified related party transactions



## Case Study

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### Relevant factors to consider

- Whether non-disclosure by management of such an arrangement should be assessed as a significant risk of error or fraud
- Consider this as a high-risk criteria while testing journal entries
- Whether management representation can be placed reliance on
- Control deficiency and impact on IFC reporting where applicable

# Fraud risks in RPTs



- Significant business decisions taken by RPs and lack of challenge or independent review by management or TCWG
- Use of intermediate entities for routing of significant transactions for which there does not appear to be a clear justification
- Complex web of entities which do not qualify as related parties under any standard or statute but which are under the control of the RP
- Participation in unincorporated partnerships with other parties
- Excessive participation or pre-occupation of RP in the selection of accounting policies, determination of significant estimates
- High turnover of senior management
- Degree of autonomy to operating management and their involvement in business decision making

**Apparent beneficiary is not a related party, however underlying benefits may be transferred to the real beneficiary who is a related party**



# RPTs outside normal course of business



- Transactions that lack apparent or logical business justification
- Significant transactions with entities not falling within the ambit of related parties, unconsolidated entities
- Emphasis on a particular accounting treatment for RPT
- Transaction processed in a manner that is in deviation of normal practice
- Transactions requiring use of specialist knowledge or use of an expert
- Funding arrangements – loans, advances in the nature of loans, guarantees
- Volume of business transacted with major suppliers, customers, borrowers and lenders

# Arms length assertion for RPT



Arms length means that the terms and conditions of the transaction reflect those conducted between a willing buyer and a willing seller who are unrelated and acting independently and in their own best interest

- Arms length of the transaction, not necessarily restricted to only arms length of the price charged
- Prevalent market conditions/practice
- Terms and conditions with non-related parties
- Involvement of experts for e.g., transfer pricing experts
- Auditor reporting responsibility under applicable statute/standard

# Communications with TWCG



Non-compliance with laws and regulations

Control deficiency relating to RPT



Disagreement with management on RPT

Disclosures of RPT

Whether effects of RP relationships/transactions prevent financial statements from achieving true and fair presentation



**Sale of a property by the entity to a controlling shareholder is at a price significantly below fair market value**

**Profit or loss is recognised based on actual sale price**

- True and fair view may not be achieved
- In economic substance, the differential between fair market value and sale price would constitute a return of capital or dividend

# Other additional points to remember



- New disclosure requirements under the amended Schedule III
- Definition of related parties – concept of person in control (PIC) - significant shift by SEBI in terms of SEBI LODR 2015 reporting requirements
- Interplay of related party definitions between Companies Act, 2013, SEBI LODR 2015, Accounting standards and Direct and Indirect tax laws
- Element of unpredictability in audit procedures, involvement of forensics
- Documentation to be robust enough as evidence of work performed
- Qualified audit and IFC opinions for RPT – recent experience
- Scrutiny by regulators of work performed by auditors around RPT – NFRA reports
- New reporting requirements in Auditors Report and CARO

# Q&A

