ICAEW AUDIT & ASSURANCE FACULTY

THE AUDIT OF RELATED PARTIES IN PRACTICE

INSPIRING CONFIDENCE

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The Audit and Assurance Faculty (the faculty) is a leading UK authority on external audit and other assurance activities. It is recognised nationally and internationally by members, professional bodies and others as a source of expertise on all audit issues. The faculty's membership includes internal and external auditors from a wide range of organisations and within practice, which enables it to speak on audit matters.

The faculty membership consists of nearly 8,000 members drawn from practising firms and organisations of all sizes from both the private and public sectors.

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FOREWORD FROM THE FACULTY CHAIRMAN

The Audit and Assurance Faculty (the faculty) has, in recent years, produced practical guidance for members in several areas to help them deliver continuous improvement in audit quality. This publication is the latest step in the faculty's work programme aimed at promoting audit quality; it tackles the practical issues surrounding the audit of related party relationships and transactions.

In the light of increasing public interest in the quality of audits, the faculty considers that the audit of related parties is an area where further improvements in audit quality and efficiency can be achieved. This is especially relevant, given the introduction in the UK of the clarified and revised International Standard on Auditing 550, *Related Parties* for 2010 audits. The revised standard will require a significant shift in the focus of work carried out by auditors and we therefore encourage auditors to review the manner in which they conduct the audit of related parties.

This publication, originally issued as an exposure draft in September 2008, provides guidance for members in the form of a five-point action plan on planning, consideration of risk, understanding the company's internal controls, designing procedures to respond to risks, and completion procedures.

I would like to take this opportunity to thank the volunteers from the related parties working group and the faculty's Technical and Practical Auditing Committee who helped produce this publication. I hope that members find the action plan useful and that it proves valuable in planning for the introduction of the revised ISA and in helping improve audit quality.

This publication is not a substitute for, and should be read in conjunction with, ISA (UK and Ireland) 550 (Revised and Redrafted), *Related Parties* which can be found at http://www.frc.org.uk/apb/publications/pub2095.html

Gerry Murphy
Chairman, Audit and Assurance Faculty
February 2010

EXECUTIVE SUMMARY

BACKGROUND

The work currently performed by auditors on related party relationships and transactions varies. Auditors often see related party relationships and transactions as disclosure issues under IAS 24, FRS 8 and companies legislation, and they audit disclosures to confirm that the requirements have been met, rather than responding to the risk of material misstatement as a result of fraud or error.[1] The audit of related parties may not always be perceived as a sufficiently high risk area.

Related parties are often involved in cases of fraudulent financial reporting, as highlighted in many major corporate scandals. Transactions with related parties provide scope for distorting financial information in financial statements and hiding the economic substance of transactions or fraud in companies. The audit of related party relationships and transactions presents particular challenges to auditors because:

- related party relationships and transactions are not always easy to identify;
- management is responsible for identifying all related parties yet may not fully understand the definition of a related party or may not wish to provide information on the grounds of sensitivity;
- not all companies have effective internal controls in place for authorising, recording and tracking related party transactions.

Auditors of smaller companies may find it difficult to identify related party relationships and transactions because management may not understand related party disclosure requirements or their significance. It is therefore important for auditors to be clear about what needs to be disclosed so that they can advise management on the responsibility to prepare financial statements that comply with the relevant accounting framework.

While larger companies might have a better understanding of the importance of disclosing related party relationships and transactions and have some relevant controls in place, they may also deal with more complex transactions that can be more difficult for auditors to understand and follow.

PREPARING FOR THE REVISED ISA

The International Auditing and Assurance Standards Board (IAASB) took the opportunity when redrafting ISA 550, *Related Parties* under the 'clarity' conventions to revise the standard to address these issues. The revised and redrafted standard will have a significant impact on the audit of related party relationships and transactions when implemented in the UK.

The Auditing Practices Board (APB) announced in early 2009 its intention to adopt a suite of clarified and revised ISAs including ISA 550. In October 2009, APB published the final version of ISA (UK and Ireland) 550 (Revised and Redrafted), *Related Parties* to be applied (along with other revised and redrafted ISAs and ISQC 1) to audits of financial statements for periods ending on or after 15 December 2010.

APB's 2008 consultation on whether to adopt clarified ISAs in the UK highlighted ISA 550 (as well as ISA 540 on the audit of accounting estimates) as potentially being the prime driver of cost increases for some audits, although the average estimated increase in work effort was only 3.5% for the audit of smaller and mid-sized entities (and less than this for the audit of larger entities).

[1] A summary of the definitions in IAS 24 and FRS 8 is provided in Appendix 1.

The revised ISA emphasises planning and risk assessment. It requires auditors to consider the susceptibility of financial statements to material misstatement as a result of fraud or error arising from related party relationships, as part of the audit team discussions required under ISAs 315 and 240[2] on fraud. Auditors are required to focus on three areas:

- identification of previously unidentified or undisclosed related parties or transactions;
- significant related party transactions outside the normal course of business;
- assertions that related party transactions are at arm's length.

The revised ISA also requires an understanding of controls over related party transactions and requires significant related party transactions outside the normal course of business to be treated as significant risks. Specific procedures are required for such transactions as they are for transactions identified by auditors but not identified by management.

Required procedures include evaluating the business rationale for the transactions, inspecting underlying documentation and evaluating whether such evidence is consistent with management's explanations. Requirements also cover assertions by management that related party relationships are at arm's length, the need for auditors to document the names of related parties and the nature of related party relationships, and to communicate any significant matters identified to those charged with governance. It is important to note that many firms already comply with these 'new' requirements because many were already suggested, but were not mandatory, under the extant standard.[3]

A PRACTICAL GUIDE

This publication is a practical guide to the audit of related party relationships and transactions, providing suggestions in the form of a five-point action plan to strengthen audit quality in this area. It is set in the context of the significant change in approach that will be required under the revised ISA. It highlights the critical importance of planning the audit of related party relationships and transactions, the need to involve the entire audit team in this, to assign staff with the appropriate level of experience to audit this area and upfront discussions with the client to identify related parties.

A key part of the planning process is assessing the risk of material misstatement associated with related party relationships and transactions. This publication highlights potential indicators of the existence of related party relationships and transactions and some of the problem areas. It also looks at understanding companies' internal controls, which identify related parties and record related party transactions, designing procedures to respond to identified risks and performing completion procedures.

CONCLUSION

The audit of related party relationships and transactions is a difficult, yet important part of the audit. We encourage firms to review the five-point action plan included in this publication and to consider whether there are any opportunities in their practice to improve audit quality in this area. We also encourage firms to plan for the introduction of this and other clarified ISAs ahead of their implementation for 2010 audits.

[2] ISA (UK and Ireland) 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and ISA (UK and Ireland) 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

[3] Appendix 2 provides a detailed summary of the objectives and requirements in the revised ISA.

THE FIVE-POINT ACTION PLAN

The following five-point action plan focuses on the specific areas where existing audit work on related party relationships and transactions could be developed to enhance the quality of the audit.

1 PLAN YOUR WORK ON THE AUDIT OF RELATED PARTY RELATIONSHIPS AND TRANSACTIONS THOROUGHLY

- Plan the audit of related party relationships and transactions by updating existing information, and, where possible, obtain a list of related parties from clients or compile a list based on discussions with clients.
- Ask management about changes from the prior period, the nature of the relationships, whether any transactions have been entered into and the type and purpose of the transactions.
- Ensure that the client understands who or what related parties are and why the relevant disclosure requirements are necessary.
- Speak to the right person 'in authority' at the client who can answer questions.
- Plan for concerns raised by audit team members and others to be considered and reviewed by suitably experienced staff.
- Brief all audit team members on related party relationships and transactions and the risks of material misstatement due to fraud or error that could arise from such transactions.
- Ensure that all staff are informed about any changes to related party relationships throughout the engagement and are aware of the need to bring such changes to the attention of the rest of the team.

2 FOCUS ON THE RISK OF MATERIAL MISSTATEMENT THAT MIGHT ARISE FROM RELATED PARTY TRANSACTIONS

- Understand the nature, size and complexity of the businesses and use family trees or document group structures to help identify related parties and relationships between the client and related parties.
- Follow up indicators of the existence of undisclosed related parties or related party transactions.
- Consider the impact of undisclosed related party relationships and transactions as a potential fraud risk.
- Consider the qualitative aspects of materiality.
- Emphasise the importance of the audit team remaining alert for related party relationships and transactions as the audit proceeds.
- Discuss related party relationships with others within the firm who provide services to the client, such as staff in the tax, accounting or corporate finance departments.

3 UNDERSTAND THE INTERNAL CONTROLS AT THE COMPANY TO IDENTIFY RELATED PARTIES AND TO RECORD RELATED PARTY TRANSACTIONS

- Understand the controls, if any, that management has put in place to identify, account for and disclose related party transactions and to approve significant transactions with related parties, and significant transactions outside the normal course of business.

- If few or no processes are in place for dealing with related party relationships and transactions, seek to obtain an understanding of those relationships and transactions by asking management.

4 DESIGN PROCEDURES TO RESPOND TO RISKS IDENTIFIED

- Perform procedures to confirm identified related party relationships and transactions and identify others including:
  - inspecting bank and legal confirmations obtained as part of other audit procedures;
  - inspecting minutes of shareholder and management meetings and any other records or documents considered necessary, such as regulatory returns, tax returns and records of investments.
- Where the existence of related party relationships or transactions that management has not previously identified or disclosed is indicated, communicate the information to team members promptly and;
  - request management to identify all such transactions;
  - ask why controls failed to identify or disclose the related parties or transactions;
  - perform appropriate substantive procedures;
  - reconsider the risk that further unidentified or undisclosed relationships or transactions may exist and evaluate the implications for the audit.
- Consider any fraud risk factors in the context of the requirements of ISA 240.
- Establish the nature of significant transactions outside the company's normal course of business and whether related parties could be involved, by inquiring of management.
- Consider any arm's-length assertions and obtain supporting evidence from third parties.
- Treat significant related party transactions outside the normal course of business as significant risks and inspect relevant documentation to evaluate the business rationale of the transactions, whether they have been appropriately authorised and approved, whether the terms are consistent with management's explanations and whether they have been appropriately accounted for.
- Document the identity of related parties and the nature of related party relationships.

5 PERFORM COMPLETION PROCEDURES

- Obtain a representation that management has disclosed the identity of related parties, relationships and transactions of which they are aware and that related parties and transactions have been appropriately accounted for and disclosed.
- Communicate significant related party matters arising during the audit to those charged with governance unless all of those charged with governance are involved in its management.
- Ensure that the accounting for and disclosure of related parties and related party transactions are appropriate.
- Consider the implications of the findings from work performed on related parties and related party transactions for the audit opinion.

1. PLANNING

PLAN YOUR WORK ON THE AUDIT OF RELATED PARTY RELATIONSHIPS AND TRANSACTIONS THOROUGHLY

Some auditors might not have previously devoted much time to planning the audit of related parties. Planning might have consisted of a review of last year's file and the auditors' previous knowledge of the client. Discussions with clients at this stage about related parties would perhaps only happen where auditors were taking on a new client. The revised ISA requires more of auditors and effective planning will help deal with the new requirements.

The objectives of auditors set out in the revised ISA are:

To obtain an understanding of related party relationships and transactions sufficient to be able:

- to recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
- to conclude whether the financial statements, in so far as they are affected by those relationships and transactions:
  - achieve fair presentation; or
  - are not misleading; and
- to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in accordance with the applicable financial reporting framework.

Furthermore, the revised ISA specifically requires that auditors ask management about the identity of the entity's related parties, including changes from the prior period, the nature of the relationships, whether any transactions have been entered into and the type and purpose of the transactions.

Irrespective of the size of client, planning the audit of related party relationships and transactions and sharing information about related party relationships is important. Planning the audit of related parties for smaller clients might be more difficult particularly where auditors are also involved in helping them draft the disclosures. In all cases, auditors at least consider obtaining a list of related parties from clients or compiling a list based on their knowledge of the business and discussions with clients.

In discussions with clients, it is important to explain who or what related parties are, and their importance. This is particularly relevant to the audits of smaller companies where management is unlikely to have a detailed knowledge of the requirements and their implications. Discussions with clients might cover:

- the fact that there is a requirement to disclose related party relationships and transactions under financial reporting standards;
- without such disclosures the financial statements would be considered to be misleading; and
- the potential impact on the audit opinion.

Discussing related parties is often a sensitive area so it is important for auditors to consider how they explain the issues to clients. Clients should be encouraged to take the disclosure of related parties seriously as there are significant areas that might be easily overlooked. For example, auditors may inquire about the existence of any trusts in which the directors, employees or the entity have an interest. There may also be a number of 'in kind' transactions that could be unintentionally overlooked, covering, for example:

- a company that purchases boats where there may be a mixture of business and personal use;
- provision of gifts of food or products to staff at estates or farms for no consideration and/or without entry into the books and records;
- builders who improve homes of directors;
- loans to directors and/or employees;
- property lessors where space is also let to related (but not group) companies;
- provision of guarantees or collateral;
- settlement of liabilities of directors or other related parties.

Identifying the right person to speak to at the client will depend on the size and nature of the client. More sensitive and detailed questions are generally addressed to senior management such as the finance director, if there is one. More general queries can be addressed to finance or accounts staff.

Auditors should plan for concerns about related parties raised by audit team members and others to be considered and reviewed by suitably experienced staff.

The revised ISA requires that auditors consider the susceptibility of the financial statements to material misstatements that could result from the company's related party transactions in the team discussions required by ISAs 315 and 240.[4] The planning meeting has related parties on its agenda so that all team members can be made aware of related party relationships. This is important as more junior members of the team might not be aware of the existence of related parties. Audit partners should ensure that they highlight to the audit team any relevant issues that have come to their attention through discussions with the client or from other sources. The audit team should be briefed on the identity of known related parties and any potential risks of material misstatement prior to commencement of the fieldwork. This allows team members to be alert for such relationships and transactions in the areas they are auditing. If one team member then becomes aware of undisclosed related parties or transactions, it is important to have mechanisms in place to ensure that the whole team is informed.

[4] ISA (UK and Ireland) 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and ISA (UK and Ireland) 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.*

RECOMMENDATIONS

1. Plan the audit of related party relationships and transactions by updating existing information, and, where possible, obtain a list of related parties from clients or compile a list based on discussions with clients.
2. Ask management about changes from the prior period, the nature of the relationships, whether any transactions have been entered into and the type and purpose of the transactions.
3. Ensure that the client understands who or what related parties are and why the relevant disclosure requirements are necessary.
4. Speak to the right person 'in authority' at the client who can answer questions.
5. Plan for concerns raised by audit team members and others to be considered and reviewed by suitably experienced staff.
6. Brief all audit team members on related party relationships and transactions and the risks of material misstatement due to fraud or error that could arise from such transactions.
7. Ensure that all staff are informed about any changes to related party relationships throughout the engagement and are aware of the need to bring such changes to the attention of the rest of the team.

2. RISK OF MATERIAL MISSTATEMENT

FOCUS ON THE RISK OF MATERIAL MISSTATEMENT THAT MIGHT ARISE FROM RELATED PARTY TRANSACTIONS

The risk of material misstatement of related party relationships and transactions arises because clients may:

- fail to identify or disclose related party relationships and transactions, either because they do not recognise the need to do so or are not aware of the relationships that fall within the definition;
- use unidentified related parties to cover up fraudulent activities or financial reporting.

Identifying the risk of material misstatement is an important aspect of planning the audit of related party relationships and transactions and is therefore considered at the planning meeting. The revised ISA explains the risk assessment procedures to be carried out in order to obtain the relevant information.

Clients' failure to identify and disclose related party relationships and transactions
Although auditors are required to ask management about the identity of related parties and transactions when planning the audit, they are also required to remain alert for related party information that management has not previously identified or disclosed. To be able to do this, auditors should understand the business, what it does, the nature of transactions, with whom it trades and its normal terms of trade. Auditors should take account of the company's previous history of related party transactions and consider whether the business is likely to have related party relationships and transactions. Related party relationships may arise because of involvement in the business of family members, or companies they are involved in, or because of trading between companies in the same group. Auditors can determine whether management has disclosed related party relationships and transactions by considering their prior experience, knowledge and understanding of the client's business and operations, and by discussions with others in the firm who may have provided non-audit services.

For new clients, auditors might also consider making inquiries of the previous auditors and if the company is a subsidiary of a group, making enquiries of the parent company's auditors.

Family trees and group structures
A small owner-managed company is unlikely to have controls in place to identify related party relationships and transactions. Auditors might therefore rely on their knowledge of the business and discussions with clients. The use of family trees might also sometimes be helpful in identifying related parties and potential risk areas, as might search tools to identify whether the directors have any interests in other companies.

Auditors should understand the entity's ownership and governance structures, the types of investments it makes and the way it is structured and how it is financed. Common control relationships mean that management is more likely to be aware of such relationships if they have economic significance to the entity. The auditors' inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions, or with which it shares resources, are related parties. However, it is worth noting that many inter-company transactions do not require disclosure.

Larger companies typically have controls in place for capturing information about related parties. However, transactions and the structure of the group might be complex and documenting group structures will be helpful.

It is important for auditors to be wary where companies indicate that they have no related parties or related party transactions.

Indicators of potential related parties and problem areas
At the planning meeting auditors assess the significance of the risks arising from related party transactions. Factors that might affect risk include the nature, size and complexity of the business and the nature of its transactions.

The following tables provide examples of indicators of the existence of related parties and potential problem areas for:

- small owner-managed companies;
- larger or more complex owner-managed companies and large private companies, public companies or groups.

Table 1: Smaller and/or owner-managed companies

Characteristics of companies	Indicators of the existence of related parties and transactions and problem areas
Owner dominance Involvement of family members in the business Trading with other family businesses Use of family contacts in accounting, legal or other advisory capacities Owners with other business interests Might have a finance department but the owner still has overall control or is able to override controls	**SIGNIFICANT INVOLVEMENT OF FAMILY MEMBERS** Family members involved with the entity may not be identified due to changes in surname through marriage or by deed poll which may result in difficulties in identifying family members in third or fourth generation businesses. **TRUST ARRANGEMENTS** Trustees or beneficiaries may not be identified and transactions with them may not be identified. Controlling parties not known. **OWNER-MANAGERS SENSITIVE TO DISCLOSURES** Sensitivity to disclosure of the identity of other businesses that are trading with the company. Sensitivity to the disclosure of loans by or to the company on favourable terms. **TRANSACTIONS WITH NO READILY ASCERTAINABLE MARKET VALUE** Purchase or sale of assets not at arm's length. Services rendered by family members such as consultancy, secretarial, design, decorating or gardening services. Free gifts or services to friends.

Table 1: Smaller and/or owner-managed companies (continued)

Characteristics of companies	Indicators of the existence of related parties and transactions and problem areas
	BUSINESS PROPERTY TRADING Owner rents or buys property below market rates. Company rents or buys property from owner at above market rates. Company buys land or buildings surplus to requirements to accommodate the owner or a related party. **LOANS** Loans at nil or reduced rates of interest. Provision of unsecured loans or preferential security. 'Drawings' by directors, as if the company were a partnership.

Table 2: Larger or more complex private companies, public companies and groups

Characteristics of companies	Indicators of the existence of related parties and transactions and problem areas
Financial and operating controls in place Systems capture information about related parties Compliance with listing rules or corporate governance requirements Some transactions with directors' families Complex transactions with group companies High number of related parties, and volume and value of transactions	**UNUSUAL LOAN ARRANGEMENTS WITH DIRECTORS OR THEIR FAMILIES** Continual roll-over of loans with no repayment. Inadequate or no documentation supporting loans. Additional loans granted despite the business having cash flow problems. **LOANS AND JOINT VENTURES** Transactions not disclosed. Loans that are not straightforward such as loans to employees on unusually favourable terms. Significant cash outflows being expensed inappropriately. Overly complex joint venture arrangements, particularly where the business rationale is unclear. **MANAGEMENT CHARGES AND MANAGEMENT SERVICES** The value received for management charges is difficult to establish which could arise from funds being moved around the group. Employees appearing to work for the company not on the payroll, and employees on the payroll not appearing to work for the company. Management charges to or from other companies.

Table 2: Larger or more complex private companies, public companies and groups (continued)

Characteristics of companies	Indicators of the existence of related parties and transactions and problem areas
	UNKNOWN BUSINESS RELATIONSHIPS BECAUSE AUDITORS DO NOT DEAL WITH ALL OF THE OWNER'S AFFAIRS Discussions at board or management meetings include references to unknown parties. **OTHER DEBTORS, SIGNIFICANT GENERAL EXPENSES, ENTERTAINING COSTS** Owner's or chief executive's credit card statement used to support an expense claim without support for individual items. Unusually high levels of entertaining expense for the nature of the business in which the client is involved. **COLLUSIVE RELATIONSHIPS WITH BUSINESS CONTACTS** Change of suppliers without a tendering process, or to less favourable terms and conditions. Customers taken on without normal credit checks. Unusual levels of activity with certain suppliers or customers. No clear business rationale for unusually large discounts. **CIRCULAR ARRANGEMENTS** Limited documentation supporting lease arrangements. Inadequate documentation of arrangements or a lack of clear business rationale. **SHARE OWNERSHIP** Complex equity transactions and restructurings without a clear business rationale. **SUSPENSE ACCOUNTS** Long-standing uncleared items and a failure to investigate. Offsetting entries in suspense accounts to expense accounts. Difficulties in reconciling inter-company balances. Entries in suspense accounts made to make inter-company accounts balance. **UNUSUAL TRANSACTIONS** Transactions without explanation or supporting documentation. Special purpose vehicles used for financing arrangements. **MANY GROUP AUDITORS** Unclear rationale for splitting the group audit between two or more firms.

Fraud risk and undisclosed related party relationships and transactions
The revised ISA requires auditors to obtain an understanding of related party relationships and transactions sufficient to be able to recognise fraud risk factors relevant to the identification and assessment of the risks of material misstatement due to fraud. Engagement team discussions on fraud may include considering how related parties might be involved in fraud. For example, consider special purpose entities controlled by management which might be used to facilitate earnings management (for purposes such as tax evasion) and transactions with business partners which might facilitate misappropriation of the company's assets.

Misappropriation of assets and fraudulent financial reporting often arise through management override of controls. The revised ISA identifies examples of possible fraud, including:

- fictitious terms of transactions created to misrepresent the business rationale for the transaction;
- fraudulently organising the transfer of assets from or to management or others at amounts significantly above or below market value;
- engaging in complex transactions with related parties such as special purpose entities that are structured in such a way as to misrepresent the performance or position of the company.

Other factors that might indicate a risk of fraud include:

- transactions on abnormal terms such as unusual prices, interest rates, guarantees or repayment terms;
- significant, unusual or highly complex transactions that present 'substance over form' questions where the business rationale for the transaction is not clear;
- high volumes of significant transactions with certain customers or suppliers;
- significant transactions with a related party not audited, or audited by another firm, or not in the ordinary course of business;
- significant or unusual transactions around the year-end;
- complex practices that allow management to hide the economic substance of transactions;
- significant bank accounts or branch or subsidiary operations in other jurisdictions without a clear business rationale.

Auditors are more exposed by fraud risks relating to undisclosed related party transactions than by minor disclosure errors in known transactions. Auditors should therefore be alert to the possibility of undisclosed related party relationships and transactions and plan their work accordingly. They remain alert throughout the audit to this possibility. If undisclosed related parties are identified on further investigation, auditors should reconsider their risk assessment and amend their audit procedures accordingly. This might, for example, require a re-assignment of more experienced staff to the engagement or performing additional audit procedures. Communication within the audit team is essential.

Where frauds have been identified, auditors should also consider their anti-money laundering responsibilities and reporting responsibilities under the proceeds of crime legislation.

Materiality

FRS 8,[5] IAS 24[6] and companies legislation require entities to disclose material transactions with related parties in the financial statements. Transactions are material where their disclosure might reasonably be expected to influence decisions made by the users of general purpose financial statements. FRS 8 requires that materiality is to be judged in terms of significance to the reporting entity and to the other related party. Those companies that apply the FRSSE need only disclose the transactions that are material to the company.

Setting an audit materiality level for related parties requires professional judgement. It is not only quantitative factors that affect materiality, there are also qualitative factors such as the legality of transactions, the nature of the related party relationship and the appropriateness of related party transactions overall when viewed against returns to investors and/or the performance of the group.

Others in the firm involved with the client

Subject to client confidentiality requirements, it may be appropriate to discuss related parties with others in the audit firm such as those working in the tax and corporate finance departments. In completing tax returns for the company and its directors, or helping companies with financial transactions, these departments may have become aware of related parties.

RECOMMENDATIONS

1. Understand the nature, size and complexity of the businesses and use family trees or document group structures to help identify related parties and relationships between the client and related parties.
2. Follow up indicators of the existence of undisclosed related parties or related party transactions.
3. Consider the impact of undisclosed related party relationships and transactions as a potential fraud risk.
4. Consider the qualitative aspects of materiality.
5. Emphasise the importance of the audit team remaining alert for related party relationships and transactions as the audit proceeds.
6. Discuss related party relationships with others within the firm who provide services to the client, such as staff in the tax, accounting or corporate finance departments.

[5] FRS 8, *Related Party Transactions.*

[6] IAS 24, *Related Party Transactions.*

3. INTERNAL CONTROLS

UNDERSTAND THE INTERNAL CONTROLS AT THE COMPANY TO IDENTIFY RELATED PARTIES AND RECORD RELATED PARTY TRANSACTIONS

It is important for auditors to evaluate the procedures in place at the company for identifying, properly accounting for and disclosing related party transactions. The audit is conducted on the premise that management has acknowledged and understands its responsibility for the preparation of financial statements.

The revised ISA requires that auditors ask management and others in the entity, and perform other risk assessment procedures as appropriate, to obtain an understanding of the controls, if any, in place to:

- identify, account for and disclose related party relationships and transactions;
- authorise and approve significant related party transactions and arrangements;
- authorise and approve significant transactions and arrangements outside the normal course of business.

The revised ISA gives examples of features of control environments that could help mitigate the risk of material misstatement associated with related party relationships and transactions.

Smaller companies are likely to have a very different control environment to larger companies and might not have processes in place for specifically identifying and accounting for related parties.

In meeting the requirement to obtain an understanding of the control environment, auditors may consider:

- any policies or procedures for the disclosure of interests of management and those charged with governance in transactions with the company;
- the assignment of responsibilities at the company for identifying, recording, summarising and disclosing related party transactions;
- any discussions between management and those charged with governance about significant related party transactions outside the company's normal course of business;
- the existence of any clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest.

Where controls over related party relationships and transactions are deficient or non-existent, either because of inadequate understanding on the part of management of related party requirements, as is often the case with smaller entities, or because of the low importance attached thereto, or even because of an intentional disregard for such controls (disclosures may reveal information that management considers sensitive), auditors may be unable to obtain sufficient appropriate audit evidence and should consider the implications for their audit report.

Control activities in smaller companies are likely to be informal and smaller companies may have no documented processes for dealing with related party relationships and transactions. Owner-managers may mitigate some of the risks by monitoring activities with related parties, or increase the risks through their active involvement in the business. For smaller companies, auditors may obtain an understanding of related party relationships and transactions and any relevant controls by inquiry of management combined with other procedures, such as observing management oversight and review activities, and inspecting any available relevant documentation.

RECOMMENDATIONS

1. Understand the controls, if any, that management has put in place to identify, account for and disclose related party transactions and to approve significant transactions with related parties, and significant transactions outside the normal course of business.
2. If few or no processes are in place for dealing with related party relationships and transactions, seek to obtain an understanding of those relationships and transactions by inquiry of management.

4. RESPONSES TO RISKS

DESIGN PROCEDURES TO RESPOND TO RISKS IDENTIFIED

Undisclosed related parties
Testing for completeness of related party relationships and transactions can be difficult, especially for those that have not been identified by management. The revised ISA requires that auditors search for unidentified and undisclosed related party relationships and transactions by inspecting bank and legal confirmations obtained as part of other audit procedures, and minutes of shareholder and management meetings and such other records or documents as they consider necessary. Application material in the revised ISA provides examples of other records or documents that auditors may wish to consider including regulatory returns, tax returns and records of the company's investments.

If auditors identify issues suggesting the existence of related party relationships or transactions that management has not previously identified or disclosed, they need to investigate. Specifically, the revised ISA requires that auditors:

- promptly communicate the information to team members;
- request management to identify all transactions with the newly identified related parties;
- ask why controls failed to identify or disclose the related parties or transactions;
- perform appropriate substantive audit procedures such as;
  - ask about entity's relationships with the newly identified related parties, including, where appropriate, inquiring of parties outside the entity such as solicitors, agents and representatives, guarantors, or other close business partners;
  - analysing accounting records for transactions with the newly identified related parties;
  - verifying the terms and conditions of the newly identified transactions and evaluating whether they have been appropriately accounted for and disclosed; and
- reconsider the risk that further unidentified or undisclosed relationships or transactions exist and if the non-disclosure appears intentional, evaluate the implications for the audit.

These procedures will be performed at the planning stage and during the course of the audit. It is important to ask the right questions, couched in the right terms, of the right people. The term 'related parties' is a technical term and may well need to be explained in plainer English for less sophisticated clients.

If auditors identify fraud risk factors, they also consider them in the context of the requirements of ISA 240 on fraud.[7]

Arm's-length assertions
Auditors are also required to consider whether any arm's-length assertions made by management about related party transactionsare appropriate and to obtain sufficient appropriate evidence to support any such assertions. An arm's-length transaction is a transaction conducted on terms and conditions as between unconnected willing buyers and sellers acting independently of each other and pursuing their own best interests. It is often difficult to determine whether transactions are conducted at arm's length. Auditors consider the bargaining power of each party and use their judgement, by considering similar transactions or the market price of similar goods or services, for example. Such transactions could be motivated by the desire to create a particular appearance rather than to reflect the economic substance of the transaction.

[7] ISA (UK and Ireland) 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.*

In seeking sufficient appropriate audit evidence to support arm's-length assertions, auditors may obtain evidence from third parties such as:

- confirmation of loan balances;
- correspondence with solicitors;
- bank confirmations;
- debtor or creditor confirmations (including terms of trade);
- group audit confirmations.

Significant transactions outside the normal course of business
The revised ISA requires that where auditors identify significant transactions outside the company's normal course of business they establish by inquiry whether related parties could be involved.

Identified significant related party transactions outside the normal course of business should be treated as significant risks. For such transactions, auditors inspect the underlying contracts or agreements and evaluate the business rationale of the transactions (which may suggest fraud or misappropriation of assets), whether they have been appropriately authorised and approved, whether the terms are consistent with management's explanations and whether they have been appropriately accounted for.

Factors affecting auditors' assessment of the business rationale of the transaction include the complexity of the transaction, and whether it has unusual terms of trade, is processed in an unusual manner or involves previously unidentified related parties. Understanding the business rationale from the related party's perspective may also help. Where the rationale appears inconsistent with the nature of the business of the company or the related party, it may represent a fraud risk.

While smaller companies may not have the same authorisation and approval controls as larger companies, alternative procedures, such as inspecting documentation and confirming specific aspects of transactions with related parties, or observing management's involvement with the transaction, may provide evidence.

Documentation
Documentation is important. It helps the audit team plan, perform and be accountable for its work. The revised ISA explains that auditors need to document the names of identified related parties and the nature of related party relationships. The assessment of risk for related parties which was carried out at the planning stage should also be documented, including discussions among the engagement team, the understanding of controls and significant risks, the risk assessment procedures performed, and identified risks of material misstatement at the financial statement and assertion levels. Any changes identified during the course of the audit and any additional procedures performed in response to risks identified should also be documented.

This documentation of related parties will be particularly helpful on subsequent audits when it can be used as a starting point for updating information. Increasingly, audit files are held electronically. Irrespective of how the documentation is stored, it is important for the files to be easily accessible for the following year.

RECOMMENDATIONS

- Perform procedures to confirm identified related party relationships and transactions and identify others including:
  - inspecting bank and legal confirmations obtained as part of other audit procedures;
  - inspecting minutes of shareholder and management meetings and any other records or documents considered necessary, such as regulatory returns, tax returns and records of investments.
- Where the existence of related party relationships or transactions that management has not previously identified or disclosed is indicated, communicate the information to team members promptly and;
  - request management to identify all such transactions;
  - ask why controls failed to identify or disclose the related parties or transactions;
  - perform appropriate substantive procedures;
  - reconsider the risk that further unidentified or undisclosed relationships or transactions may exist and evaluate the implications for the audit.
- Consider any fraud risk factors in the context of the requirements of ISA 240.
- Establish the nature of significant transactions outside the company's normal course of business and whether related parties could be involved, by asking management.
- Consider any arm's-length assertions and obtain supporting evidence from third parties.
- Treat significant related party transactions outside the normal course of business as significant risks and inspect relevant documentation to evaluate the business rationale of the transactions, whether they have been appropriately authorised and approved, whether the terms are consistent with management's explanations and whether they have been appropriately accounted for.
- Document the identity of related parties and the nature of related party relationships.

5. COMPLETION PROCEDURES

PERFORM COMPLETION PROCEDURES

The revised ISA requires that auditors obtain written representations from management that they have disclosed the identity of related parties, relationships and transactions of which they are aware, and that these have been appropriately accounted for and disclosed. Management and those charged with governance may be required to sign individual declarations in relation to related party matters. Any such declarations may be addressed jointly to a designated official of the entity and to the auditor. In other cases, the auditor may wish to obtain written representations directly from each of those charged with governance and from members of management.

It is important for auditors to communicate to management and, where different, those charged with governance, significant matters relating to related parties that they have come across during the course of their audit. This might include undisclosed related parties or related party transactions or disagreements with management over the disclosure of significant related party transactions.

Unless all of those charged with governance are involved in managing the entity, the revised ISA requires that auditors communicate significant matters arising during the audit with those charged with governance.

Auditors should ensure that related party disclosures are appropriately included in the financial statements.

They should also consider the implications of their audit work in this area for the audit opinion. If they consider that the financial statements are materially misstated, or prevent the financial statements from achieving fair presentation, or cause the financial statements to be misleading, then it will lead to a qualification in the audit opinion.

RECOMMENDATIONS

1. Obtain a representation that management has disclosed the identity of related parties, relationships and transactions of which they are aware and that related parties and transactions have been appropriately accounted for and disclosed.
2. Communicate significant related party matters arising during the audit to those charged with governance unless all of those charged with governance are involved in its management.
3. Ensure that the accounting for and disclosure of related parties and related party transactions are appropriate.
4. Consider the implications of the findings from work performed on related parties and related party transactions for the audit opinion.

APPENDIX 1

SUMMARY OF DEFINITIONS IN FRS 8 AND IAS 24

FRS 8, *RELATED PARTY DISCLOSURES* (AMENDED 2008)[8]

A party is related to an entity if:

(a) directly, or indirectly through one or more intermediaries, the party:

  (i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);

  (ii) has an interest in the entity that gives it significant influence over the entity; or

  (iii) has joint control over the entity;

(b) the party is an associate of the entity (as defined in FRS 9, *Associates and Joint Ventures*);

(c) the party is a joint venture in which the entity is a venturer (as defined in FRS 9, *Associates and Joint Ventures*);

(d) the party is a member of the key management personnel of the entity or its parent;

(e) the party is a close member of the family of any individual referred to in subparagraph (a) or (d);

(f) the party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with directly or indirectly, any individual referred to in (d) or (e) above; or

(g) the party is a retirement benefit scheme for the benefit of employees of the entity, or of any entity that is a related party of the entity.

IAS 24, *RELATED PARTY DISCLOSURES* (NOVEMBER 2009)[9]

A related party is a person or entity that is related to the entity that is preparing its financial statements (referred to as the 'reporting entity').

(a) A person or a close member of that person's family is related to a reporting entity if that person:

  (i) has control or joint control over the reporting entity;

  (ii) has significant influence over the reporting entity; or

  (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity;

(b) An entity is related to a reporting entity if any of the following conditions applies:

  (i) the entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others);

  (ii) one entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member);

  (iii) both entities are joint ventures of the same third party;

  (iv) one entity is a joint venture of a third entity and the other entity is an associate of the third entity;

(v) the entity is a post-employment defined benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity;

(vi) the entity is controlled or jointly controlled by a person identified in (a);

(vii) a person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

APPENDIX 2

SUMMARY OF THE OBJECTIVES AND REQUIREMENTS OF ISA (UK AND IRELAND) 550, *RELATED PARTIES*

Under the revised ISA auditors have a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework.

OBJECTIVES

To obtain an understanding of related party relationships and transactions sufficient to be able:

- to recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
- to conclude whether the financial statements, in so far as they are affected by those relationships and transactions:

  – achieve fair presentation; or

  – are not misleading: and
- to obtain sufficient appropriate audit evidence about whether related party requirements and transactions have been appropriately identified, accounted for and disclosed in accordance with the applicable financial reporting framework.

The revised ISA is significantly different to the extant standard. A summary of its requirements affecting auditors of UK companies is set out below.

RISK ASSESSMENT PROCEDURES AND RELATED ACTIVITIES

Understanding the entity's related party relationships and transactions

- Consider the susceptibility of the financial statements to material misstatements due to fraud or error that could result from the entity's related party transactions in the team discussion required by ISAs 315 and 240.
- Ask management about the identity of the entity's related parties, including changes from the prior period, the nature of the relationships, whether any transactions have been entered into and the type and purpose of the transactions.
- Ask management and others within the entity and perform other risk assessment procedures as appropriate to obtain an understanding of the controls, if any, in place to identify, account for and disclose related party relationships and transactions, authorise and approve significant related party transactions, and authorise and approve significant transactions and arrangements outside the normal course of business.

Maintaining alertness for related party information when reviewing records or documents

- Share relevant information obtained about the entity's related parties with other members of the engagement team.
- Remain alert for arrangements or other information that might indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

- For information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, inspect bank and legal confirmations obtained as part of the auditor's procedures, minutes of meetings of shareholders and those charged with governance and such other records or documents as the auditor considers necessary.
- If the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required, make inquiries of management about their nature and whether related parties could be involved.

IDENTIFICATION AND ASSESSMENT OF THE RISKS OF MATERIAL MISSTATEMENT ASSOCIATED WITH RELATED PARTY RELATIONSHIPS AND TRANSACTIONS

- Treat identified significant related party transactions outside the normal course of business as giving rise to significant risks of material misstatement.
- If the auditor identifies fraud risk factors when performing procedures, consider such information when identifying and assessing the risks of material misstatement due to fraud in accordance with ISA 240.

RESPONSES TO THE RISKS OF MATERIAL MISSTATEMENT ASSOCIATED WITH RELATED PARTY RELATIONSHIPS AND TRANSACTIONS

Identification of previously unidentified or undisclosed related parties or significant related party transactions
If the auditor identifies arrangements or information suggesting the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, determine whether the underlying circumstances confirm the existence of those relationships or transactions.

If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed:

- Promptly communicate the relevant information to other team members.
- Request management to identify all transactions with the newly identified related parties.
- Ask why the controls in place failed to enable the identification or disclosure of the related parties or related party transactions.
- Perform appropriate substantive audit procedures relating to these newly identified related parties or significant related party transactions.
- Reconsider the risk that related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor and perform additional audit procedures as necessary.
- If non-disclosure by management appears intentional, evaluate the implications for the audit.

Identified significant related party transactions outside the entity's normal course of business
Inspect the underlying contracts or agreements, if any, and evaluate whether:

- The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.
- The terms are consistent with management's explanations.
- The transactions have been appropriately accounted for and disclosed.

Obtain audit evidence that the transactions have been appropriately authorised and approved.

Assertions that related party transactions were conducted on terms equivalent to those prevailing in an arm's-length transaction
Obtain sufficient appropriate evidence about the assertion.

EVALUATION OF THE ACCOUNTING FOR AND DISCLOSURE OF IDENTIFIED RELATED PARTY RELATIONSHIPS AND TRANSACTIONS

Evaluate:

- Whether identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.
- Whether the effects of related party relationships and transactions prevent the financial statements from achieving fair presentation or cause the financial statements to be misleading.

WRITTEN REPRESENTATIONS

Obtain written representations from management that:

- They have disclosed the identity of related parties and all related party relationships and transactions of which they are aware.
- They have appropriately accounted for and disclosed such relationships and transactions in accordance with the required framework.

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

Unless all of those charged with governance are involved in managing the entity, communicate significant matters arising during the audit in connection with the entity's related parties with those charged with governance.

DOCUMENTATION

In meeting the documentation requirements of ISA 230 (redrafted) and other ISAs, include in the audit documentation the names of the identified related parties and the nature of the related party relationships.

APPENDIX 3: MEMBERS OF THE WORKING GROUP

Madhvi Harvey	KPMG
Pauline Irwin	PWC
Nick Jeffrey	GTUK
Robert Holland	James Cowper
Julian Mason	
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