

## AU Section 334

### *Related Parties*

(Supersedes Statement on Auditing Standards No. 6, sec. 335.01–.19.)\*

Source: SAS No. 45.

See section 9334 for interpretations of this section.

Effective for periods ended after September 30, 1983, unless otherwise indicated.

.01 This section provides guidance on procedures that should be considered by the auditor when he is performing an audit of financial statements in accordance with generally accepted auditing standards to identify related party relationships and transactions and to satisfy himself concerning the required financial statement accounting and disclosure.<sup>1</sup> The procedures set forth in this section should not be considered all-inclusive. Also, not all of them may be required in every audit.

### Accounting Considerations

.02 Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 850, *Related Party Disclosures*, gives the requirements for

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\* This section also withdraws the following auditing interpretations dated March 1976 (AICPA, *Professional Standards*, vol. 1, AU sec. 9335.01–.11):

- Evaluating the Adequacy of Disclosure of Related Party Transactions
- Disclosure of Commonly Controlled Parties
- Definition of "Immediate Family"

<sup>1</sup> Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 850-10-50 contains the disclosure requirements for related party relationships and transactions. The FASB ASC glossary defines *related parties* as

- a. Affiliates of the entity
- b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825–10–15, to be accounted for by the equity method by the investing entity
- c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
- d. Principal owners of the entity and members of their immediate families
- e. Management of the entity and members of their immediate families
- f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
- g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests. The FASB ASC glossary also defines the terms *affiliate*, *control*, *immediate family*, *management*, and *principal owners*. FASB ASC 850-10-05-3 provides examples of related party transactions.

[Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

related party disclosures. Certain accounting pronouncements prescribe the accounting treatment when related parties are involved; however, established accounting principles ordinarily do not require transactions with related parties to be accounted for on a basis different from that which would be appropriate if the parties were not related. The auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure. In addition, the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form.<sup>2</sup> [Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

**.03** Transactions that because of their nature may be indicative of the existence of related parties include<sup>3</sup> —

- a. Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction.
- b. Selling real estate at a price that differs significantly from its appraised value.
- c. Exchanging property for similar property in a nonmonetary transaction.
- d. Making loans with no scheduled terms for when or how the funds will be repaid.

## Audit Procedures

**.04** An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered. Nevertheless, during the course of his audit, the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and of common ownership or management control relationships for which FASB ASC 850-10-50 requires disclosure. Many of the procedures outlined in the following paragraphs are normally performed in an audit in accordance with generally accepted auditing standards, even if the auditor has no reason to suspect that related party transactions or control relationships exist. Other audit procedures set forth in this section are specifically directed to related party transactions. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

**.05** In determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an

<sup>2</sup> Some pronouncements specify criteria for determining, presenting, and accounting for the substance of certain transactions and events. Examples include (1) presenting consolidated financial statements instead of separate statements of the component legal entities (FASB ASC 810, *Consolidation*); (2) capitalizing leases (FASB ASC 840, *Leases*); and (3) imputing an appropriate interest rate when the face amount of a note does not reasonably represent the present value of the consideration given or received in exchange for it (FASB ASC 835, *Interest*). [Footnote revised, June 1993, to reflect conforming changes necessary due to the issuance of Statement of Position 93-3. Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

<sup>3</sup> FASB ASC 850-10-05-4 gives other examples of common types of transactions with related parties. FASB ASC 850-10-05-5 states that "transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition. For example, an entity may receive services from a related party without charge and not record receipt of the services. While not providing accounting or measurement guidance for such transactions, FASB ASC 850 requires their disclosure nonetheless." [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

understanding of management responsibilities and the relationship of each component to the total entity. He should consider controls over management activities, and he should consider the business purpose served by the various components of the entity. Normally, the business structure and style of operating are based on the abilities of management, tax and legal considerations, product diversification, and geographical location. Experience has shown, however, that business structure and operating style are occasionally deliberately designed to obscure related party transactions.

**.06** In the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business. The auditor should, however, be aware of the possibility that transactions with related parties may have been motivated solely, or in large measure, by conditions similar to the following:

- a. Lack of sufficient working capital or credit to continue the business
- b. An urgent desire for a continued favorable earnings record in the hope of supporting the price of the company's stock
- c. An overly optimistic earnings forecast
- d. Dependence on a single or relatively few products, customers, or transactions for the continuing success of the venture
- e. A declining industry characterized by a large number of business failures
- f. Excess capacity
- g. Significant litigation, especially litigation between stockholders and management
- h. Significant obsolescence dangers because the company is in a high-technology industry

## Determining the Existence of Related Parties

**.07** The auditor should place emphasis on testing material transactions with parties he knows are related to the reporting entity. Certain relationships, such as parent-subsidiary or investor-investee, may be clearly evident. Determining the existence of others requires the application of specific audit procedures, which may include the following:

- a. Evaluate the company's procedures for identifying and properly accounting for related party transactions.
- b. Request from appropriate management personnel the names of all related parties and inquire whether there were any transactions with these parties during the period.
- c. Review filings by the reporting entity with the Securities and Exchange Commission and other regulatory agencies for the names of related parties and for other businesses in which officers and directors occupy directorship or management positions.
- d. Determine the names of all pension and other trusts established for the benefit of employees and the names of their officers and trustees.<sup>4</sup>
- e. Review stockholder listings of closely held companies to identify principal stockholders.

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<sup>4</sup> FASB ASC glossary term *related parties* includes "trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management." [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

- f.* Review prior years' working papers for the names of known related parties.
- g.* Inquire of predecessor, principal, or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions.
- h.* Review material investment transactions during the period under audit to determine whether the nature and extent of investments during the period create related parties.

## Identifying Transactions With Related Parties

**.08** The following procedures are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships:

- a.* Provide audit personnel performing segments of the audit or auditing and reporting separately on the accounts of related components of the reporting entity with the names of known related parties so that they may become aware of transactions with such parties during their audits.
- b.* Review the minutes of meetings of the board of directors and executive or operating committees for information about material transactions authorized or discussed at their meetings.
- c.* Review proxy and other material filed with the Securities and Exchange Commission and comparable data filed with other regulatory agencies for information about material transactions with related parties.
- d.* Review conflict-of-interests statements obtained by the company from its management.<sup>5</sup>
- e.* Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships.
- f.* Consider whether transactions are occurring, but are not being given accounting recognition, such as receiving or providing accounting, management or other services at no charge or a major stockholder absorbing corporate expenses.
- g.* Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.
- h.* Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.
- i.* Review invoices from law firms that have performed regular or special services for the company for indications of the existence of related parties or related party transactions.
- j.* Review confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.

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<sup>5</sup> Conflict-of-interests statements are intended to provide those charged with governance with information about the existence or nonexistence of relationships between the reporting persons and parties with whom the company transacts business. [Footnote revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

## Examining Identified Related Party Transactions

**.09** After identifying related party transactions, the auditor should apply the procedures he considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient appropriate audit evidence and should extend beyond inquiry of management. Procedures that should be considered include the following:

- a. Obtain an understanding of the business purpose of the transaction.<sup>6</sup>
- b. Examine invoices, executed copies of agreements, contracts, and other pertinent documents, such as receiving reports and shipping documents.
- c. Determine whether the transaction has been approved by those charged with governance.
- d. Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure, in the financial statements.
- e. Arrange for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.
- f. Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105. Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

**.10** When necessary to fully understand a particular transaction, the following procedures, which might not otherwise be deemed necessary to comply with generally accepted auditing standards, should be considered.<sup>7</sup>

- a. Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.
- b. Inspect evidence in possession of the other party or parties to the transaction.
- c. Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.
- d. Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.
- e. With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the

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<sup>6</sup> Until the auditor understands the business sense of material transactions, he cannot complete his audit. If he lacks sufficient specialized knowledge to understand a particular transaction, he should consult with persons who do have the requisite knowledge.

<sup>7</sup> Arrangements for certain procedures should be made or approved in advance by appropriate client officials.

other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.

## Disclosure

**.11** For each material related party transaction (or aggregation of similar transactions) or common ownership or management control relationship for which FASB ASC 850-10-50 requires disclosure, the auditor should consider whether he has obtained sufficient appropriate audit evidence to understand the relationship of the parties and, for related party transactions, the effects of the transaction on the financial statements. He should then evaluate all the information available to him concerning the related party transaction or control relationship and satisfy himself on the basis of his professional judgment that it is adequately disclosed in the financial statements. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105. Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]<sup>8</sup>

**.12** Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions.<sup>9</sup> If such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, he should express a qualified or adverse opinion because of a departure from generally accepted accounting principles, depending on materiality (see section 508.35 and .36).

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<sup>8</sup> Also, see section 431, *Adequacy of Disclosure in Financial Statements*. [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

<sup>9</sup> FASB ASC 850-10-50-5 states that if representations are made about transactions with related parties, the representations "shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated." [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]