

AU-C Section 550

Related Parties

Source: SAS No. 122; SAS No. 128.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

Introduction

Scope of This Section

.01 This section addresses the auditor's responsibilities relating to related party relationships and transactions in an audit of financial statements. Specifically, it expands on how section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*; section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*; and section 240, *Consideration of Fraud in a Financial Statement Audit*, are to be applied regarding risks of material misstatement associated with related party relationships and transactions.

.02 Section 700, *Forming an Opinion and Reporting on Financial Statements*, requires the auditor to evaluate whether the financial statements achieve fair presentation.¹ Section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, requires that, in audits of special purpose financial statements that contain related party transactions, the auditor evaluate whether the financial statements include informative disclosures similar to those required by generally accepted accounting principles (GAAP).² Section 800 also requires the auditor to evaluate whether additional disclosures beyond those specifically required by the framework and related to matters that are not specifically identified on the face of the financial statements or other disclosures may be necessary for the financial statements to achieve fair presentation.³ Thus, this section applies to all audits of financial statements. (Ref: par. .A1–.A3)

Nature of Related Party Relationships and Transactions (Ref: par. .A1–.A6)

.03 Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example

- 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.

¹ Paragraph .17 of section 700, *Forming an Opinion and Reporting on Financial Statements*.

² Paragraph .17 of section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*.

³ Paragraph .17 of section 800.

- information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties.
- related party transactions may not be conducted under normal market terms and conditions (for example, some related party transactions may be conducted with no exchange of consideration).
- related party transactions may be motivated solely or in large measure to engage in fraudulent financial reporting or conceal misappropriation of assets.

Responsibilities of the Auditor

.04 Because related parties are not independent of each other, financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions, and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Therefore, the auditor has 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. (Ref: par. .A3)

.05 In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether one or more fraud risk factors are present, as required by section 240, because fraud may be more easily committed through related parties.⁴

.06 Owing to the inherent limitations of an audit, an unavoidable risk exists that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with generally accepted auditing standards (GAAS).⁵ In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater because of reasons such as the following:

- Management may be unaware of the existence of all related party relationships and transactions.
- Related party relationships may present a greater opportunity for collusion, concealment, or manipulation by management.

.07 Planning and performing the audit with professional skepticism as required by section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, is, therefore, particularly important in this context, given the potential for undisclosed related party relationships and transactions.⁶ The requirements in this section are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions and in designing audit procedures to respond to the assessed risks.

Effective Date

.08 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

⁴ Paragraph .24 of section 240, *Consideration of Fraud in a Financial Statement Audit*.

⁵ Paragraph .A56 of section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

⁶ Paragraph .17 of section 200.

Objectives

- .09 The objectives of the auditor are to
- a. obtain an understanding of related party relationships and transactions sufficient to be able to
 - i. recognize 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.
 - ii. conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions, achieve fair presentation.
 - b. obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for, and disclosed in the financial statements.

Definitions

.10 For purposes of GAAS, the following terms have the meanings attributed as follows:

Arm's length transaction. A transaction conducted on such terms and conditions between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

Related party. A party defined as a related party in GAAP. (Ref: par. .A1)

.11 Reference to GAAP in GAAS means generally accepted accounting principles promulgated by bodies designated by the Council of the AICPA pursuant to the "Compliance With Standards Rule" (ET sec. 1.310.001) and the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct. [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

Requirements

Risk Assessment Procedures and Related Activities

.12 As part of the risk assessment procedures and related activities that section 240 and section 315 require the auditor to perform during the audit, the auditor should perform the audit procedures and related activities set out in paragraphs .13–.18 to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.^{7,8}

⁷ Paragraph .16 of section 240.

⁸ Paragraph .05 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

Understanding the Entity's Related Party Relationships and Transactions

.13 In connection with the engagement team discussion(s) that section 240 and section 315 require, the auditor should include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.^{9,10} (Ref: par. .A7–.A8)

.14 The auditor should inquire of management regarding the following:

- a. The identity of the entity's related parties, including changes from the prior period (Ref: par. .A9–.A14)
- b. The nature of the relationships between the entity and these related parties
- c. Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions

.15 The auditor should inquire of management and others within the entity and perform other risk assessment procedures¹¹ considered appropriate to obtain an understanding of the controls, if any, that management has established to (Ref: par. .A15–.A20)

- a. identify, account for, and disclose related party relationships and transactions.
- b. authorize and approve significant transactions and arrangements with related parties. (Ref: par. .A21)
- c. authorize and approve significant transactions and arrangements outside the normal course of business.

Maintaining Alertness for Related Party Information When Reviewing Records or Documents

.16 During the audit, the auditor should remain alert when inspecting records or documents for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. In particular, the auditor should inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor: (Ref: par. .A22–.A24)

- a. Bank and legal confirmations obtained as part of the auditor's procedures
- b. Minutes of meetings of shareholders and of those charged with governance
- c. Such other records or documents as the auditor considers necessary in the circumstances of the entity

.17 If the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required by paragraph .16 or through other audit procedures, the auditor should inquire of management about the following: (Ref: par. .A25–.A26)

⁹ Paragraph .15 of section 240.

¹⁰ Paragraph .11 of section 315.

¹¹ Paragraph .06 of section 315.

- a. The nature of these transactions (Ref: par. .A27)
- b. Whether related parties could be involved (Ref: par. .A28)

Sharing Related Party Information With the Engagement Team

.18 The auditor should share with the other members of the engagement team the identity of the entity's related parties and other relevant information obtained about the related parties. (Ref: par. .A29–.A30)

Identification and Assessment of the Risks of Material Misstatement Associated With Related Party Relationships and Transactions

.19 In meeting the requirement of section 315 to identify and assess the risks of material misstatement, the auditor should identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks.¹² In making this determination, the auditor should treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks.

.20 If the auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor should consider such information when identifying and assessing the risks of material misstatement due to fraud, in accordance with section 240.¹³ (Ref: par. .A31–.A33)

Responses to the Risks of Material Misstatement Associated With Related Party Relationships and Transactions

.21 As part of the requirement in section 330 that the auditor respond to assessed risks, that the auditor respond to assessed risks, the auditor should design and perform further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions.¹⁴ (Ref: par. .A34–.A37)

Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

.22 If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor should determine whether the underlying circumstances confirm the existence of those relationships or transactions.

.23 If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor should

¹² Paragraph .26 of section 315.

¹³ Paragraph .24 of section 240.

¹⁴ Paragraphs .05–.06 of section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

- a. promptly communicate the relevant information to the other members of the engagement team. (Ref: par. .A29 and .A38)
- b. request management to identify all transactions with the newly identified related parties for the auditor's further evaluation.
- c. inquire why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions.
- d. perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions. (Ref: par. .A39)
- e. reconsider the risk that other 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.
- f. evaluate the implications for the audit if the nondisclosure by management appears intentional (and, therefore, indicative of a risk of material misstatement due to fraud). (Ref: par. .A40)

Identified Significant Related Party Transactions Outside the Entity's Normal Course of Business

.24 For identified significant related party transactions outside the entity's normal course of business, the auditor should

- a. inspect the underlying contracts or agreements, if any, and evaluate whether
 - i. 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.¹⁵ (Ref: par. .A41–.A42)
 - ii. the terms of the transactions are consistent with management's explanations.
 - iii. the transactions have been appropriately accounted for and disclosed.
- b. obtain audit evidence that the transactions have been appropriately authorized and approved. (Ref: par. .A43–.A44)

Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's Length Transaction

.25 If management has made 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, the auditor should obtain sufficient appropriate audit evidence about the assertion. (Ref: par. .A45–.A49)

Evaluation of the Accounting for, and Disclosure of, Identified Related Party Relationships and Transactions

.26 In forming an opinion on the financial statements, in accordance with section 700, the auditor should evaluate the following:¹⁶ (Ref: par. .A50)

¹⁵ Paragraph .32c of section 240.

¹⁶ Paragraphs .13–.18 of section 700.

- a. Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed (Ref: par. .A51)
- b. Whether the effects of the related party relationships and transactions prevent the financial statements from achieving fair presentation (Ref: par. .A3)

Communication With Those Charged With Governance

.27 Unless all of those charged with governance are involved in managing the entity, the auditor should communicate with those charged with governance significant findings and issues arising during the audit in connection with the entity's related parties.¹⁷ (Ref: par. .A52)

Documentation

.28 The auditor should include in the audit documentation the names of the identified related parties and the nature of the related party relationships.¹⁸

Application and Other Explanatory Material

Nature of Related Party Relationships and Transactions (Ref: par. .02–.04, .10, and .26b)

.A1 GAAP frameworks include or refer to specific disclosure requirements for related party relationships and transactions. If the applicable financial reporting framework does not have specific disclosure requirements, the auditor, nonetheless, evaluates whether related party information is disclosed in a manner comparable to GAAP in order for the financial statements to achieve fair presentation.¹⁹

.A2 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. In addition, the substance of a particular transaction may be significantly different from its form. Accordingly, financial statements prepared in accordance with GAAP generally recognize the substance of particular transactions rather than merely their legal form.

.A3 Related party relationships and transactions may cause the financial statements to fail to achieve fair presentation if, for example, the economic reality of such relationships and transactions is not appropriately reflected in the financial statements. For instance, fair presentation may not be achieved if the sale of a property by the entity to a controlling shareholder at a price above or below fair market value has been accounted for as a transaction involving a profit or loss for the entity when it may constitute a contribution or return of capital or the payment of a dividend.

.A4 Transactions that because of their nature may be indicative of the existence of related parties include the following:

¹⁷ Paragraph .09 of section 260, *The Auditor's Communication With Those Charged With Governance*.

¹⁸ Paragraphs .08–.12 and .A8 of section 230, *Audit Documentation*.

¹⁹ Paragraph .17 of section 800.

- 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

.A5 Although many related party transactions are in the normal course of business, a possibility exists 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 overly optimistic earnings forecast
- c. Dependence on a single or relatively few products, customers, or transactions for the continued success of the venture
- d. A declining industry characterized by a large number of business failures
- e. Excess capacity
- f. Significant litigation, especially litigation between stockholders and management
- g. Significant obsolescence dangers because the company is in a high technology industry

For these reasons, related party transactions may indicate an increased risk of material misstatement of the financial statements.

Considerations Specific to Governmental Entities

.A6 For state and local governmental entities, related party relationships and transactions can result from interactions with other governments, not-for-profit entities, for-profit entities, and individuals. The applicable financial reporting framework used by most state and local governmental entities addresses related party relationships and transactions using terms that include *related parties*, *related organizations*, and *component units*, and can result in the inclusion of the related parties' financial statements as a reporting unit, inclusion within a reporting unit, disclosure of the related party transactions, or disclosure about why the related party or its transactions are not included. In all such cases, the objectives described in paragraph .09 are relevant to the auditor.

Risk Assessment Procedures and Related Activities

Understanding the Entity's Related Party Relationships and Transactions

Discussion Among the Engagement Team (Ref: par. .13)

.A7 Matters that may be addressed in the discussion among the engagement team include the following:

- The nature and extent of the entity's relationships and transactions with related parties (using, for example, the auditor's record of identified related parties updated after each audit)

- An emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions
- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (for example, a complex organizational structure, use of entities formed to accomplish specific purposes,²⁰ or an inadequate information system)
- The records or documents that may indicate the existence of related party relationships or transactions
- The importance that management and those charged with governance attach to the identification of, appropriate accounting for, and disclosure of related party relationships and transactions and the related risk of management override of relevant controls

.A8 In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:

- Entities formed to accomplish specific purposes and that are controlled by management might be used to facilitate earnings management.
- Transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.
- As indicated in paragraph .A2, the form of a related party transaction may mask its substance. For example, equity distributions or capital contributions may be structured as loans.
- Related party transactions may be subject to period-end window dressing. For example, a stockholder may pay a loan shortly before period-end, but the entity loans the same amount to the stockholder shortly after period-end.
- Certain entities, such as governmental entities or entities operating in regulated industries, may circumvent laws or regulations that limit or restrict their ability to engage in transactions with related parties.

The Identity of the Entity's Related Parties (Ref: par. .14a)

.A9 Information regarding the identity of the entity's related parties is likely to be readily available to management if the entity's information systems record, process, and summarize related party relationships and transactions to enable the entity to meet applicable disclosure requirements. Therefore, management may have a comprehensive list of related parties and changes from the prior period. For recurring engagements, making the inquiries specified by paragraph .14 provides a basis for comparing the information supplied by management with the auditor's record of related parties noted in previous audits.

.A10 However, if the entity does not have such information systems in place, management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the inquiries specified by paragraph .14 still applies because management may be aware of parties that meet the related party definition set out in GAAP. In such a case, however, the auditor's inquiries

²⁰ Entities formed to accomplish specific purposes are discussed in paragraphs .A26–.A27 of section 315.

regarding the identity of the entity's related parties are likely to form part of the auditor's risk assessment procedures and related activities performed in accordance with section 315 to obtain information regarding the following:²¹

- The entity's ownership and governance structures
- The types of investments that the entity is making and plans to make
- The way the entity is structured and how it is financed

In the particular case of common control relationships, because management is more likely to be aware of such relationships if they have economic significance to the entity, the auditor's inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions or shares resources to a significant degree are related parties.

.A11 In the context of a group audit, section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, requires the group engagement team to provide each component auditor with a list of related parties prepared by group management and any other related parties of which the group engagement team is aware.²² When the entity is a component within a group, this information provides a useful basis for the auditor's inquiries of management regarding the identity of the entity's related parties.

.A12 The auditor also may obtain some information regarding the identity of the entity's related parties through inquiries of management during the engagement acceptance or continuance process.

.A13 Section 580, *Written Representations*, addresses requirements to obtain management representations, including representations that management and, when appropriate, those charged with governance have²³

- a. disclosed to the auditor the identity of the entity's related parties and all the related party relationships of which they are aware.
- b. appropriately accounted for and disclosed such relationships and transactions.

.A14 *Considerations specific to governmental entities.* Because of the variety of the types of relationships and transactions among governmental and other entities, some of which are highly complex, identifying the nature of the related party relationship and its appropriate treatment in the financial statements relies heavily on a governmental entity's application of its financial reporting framework. Further, in some circumstances, the governmental entity may have no legal jurisdiction over the related party even when the application of the financial reporting framework concludes that the related party's financial statements are to be included in the governmental entity's financial statements. In such cases, the auditor's inquiries regarding the identity of the entity's related parties are likely to include the concepts and guidance from the applicable financial reporting framework to assist in making appropriate assessments about the existence and nature of related party relationships.

The Entity's Controls Over Related Party Relationships and Transactions (Ref: par. .15)

.A15 Others within the entity are those considered likely to have knowledge of the entity's related party relationships and transactions and the entity's

²¹ Paragraph .12 of section 315.

²² Paragraph .40c of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

²³ Paragraph .17 of section 580, *Written Representations*.

controls over such relationships and transactions. These may include, to the extent that they do not form part of management, the following:

- Those charged with governance
- Personnel in a position to initiate, authorize, process, or record transactions that are both significant and outside the entity's normal course of business and those who supervise or monitor such personnel
- The internal audit function
- In-house legal counsel
- The chief ethics officer or equivalent person
- Chief compliance officer

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A16 The audit is conducted on the premise that management and, when appropriate, those charged with governance have acknowledged and understand that they have responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.²⁴ Accordingly, the preparation of the financial statements requires management, with oversight from those charged with governance, to design, implement, and maintain adequate controls over related party relationships and transactions so that these are identified and appropriately accounted for and disclosed. In their oversight role, those charged with governance monitor how management is discharging its responsibility for such controls. Those charged with governance may, in their oversight role, obtain information from management to enable them to understand the nature and business rationale of the entity's related party relationships and transactions.

.A17 In meeting the requirement of section 315 to obtain an understanding of internal control, the auditor may consider features or elements relevant to mitigating the risks of material misstatement associated with related party relationships and transactions, such as the following.²⁵

- Internal ethical codes, appropriately communicated to the entity's personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions
- Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions
- The assignment of responsibilities within the entity for identifying, recording, summarizing, and disclosing related party transactions
- Timely disclosure and discussion between management and those charged with governance of significant related party transactions outside the entity's normal course of business, including whether those charged with governance have appropriately challenged the business rationale of such transactions (for example, by seeking advice from external professional advisors)

²⁴ Paragraphs .05 and .A2 of section 200.

²⁵ Paragraph .13 of section 315.

- Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest, such as approval by a subcommittee of those charged with governance comprising individuals independent of management
- Periodic reviews by the internal audit function, when applicable
- Proactive action taken by management to resolve related party disclosure issues, such as by seeking advice from the auditor or external legal counsel
- The existence of whistle-blowing policies and procedures, when applicable

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A18 Controls over related party relationships and transactions within some entities may be deficient or nonexistent for a number of reasons, such as the following:

- The low importance attached by management to identifying and disclosing related party relationships and transactions
- The lack of appropriate oversight by those charged with governance
- An intentional disregard for such controls because related party disclosures may reveal information that management considers sensitive (for example, the existence of transactions involving family members of management)
- An insufficient understanding by management of the applicable related party disclosure requirements

When such controls are ineffective or nonexistent, the auditor may be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions. If this were the case, the auditor would, in accordance with section 705, *Modifications to the Opinion in the Independent Auditor's Report*, consider the implications for the audit, including the opinion in the auditor's report.

.A19 Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.²⁶ The risk of management override of controls is higher if management has relationships that involve control or significant influence with parties with which the entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud. For example, management's financial interests in certain related parties may provide incentives for management to override controls by (a) directing the entity, against its interests, to conclude transactions for the benefit of these parties, or (b) colluding with such parties or controlling their actions. Examples of possible fraud include the following:

- Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions
- Fraudulently organizing the transfer of assets from or to management or others at amounts significantly above or below market value

²⁶ Paragraph .31 of section 240.

- Engaging in complex transactions with related parties, such as entities formed to accomplish specific purposes, that are structured to misrepresent the financial position or financial performance of the entity

.A20 *Considerations specific to smaller entities.* Control activities in smaller entities are likely to be less formal, and smaller entities may have no documented processes for dealing with related party relationships and transactions. An owner-manager may mitigate some of the risks arising from related party transactions or potentially increase those risks through active involvement in all the main aspects of the transactions. For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities and inspection of available relevant documentation.

.A21 *Authorization and approval of significant transactions and arrangements (Ref: par. .15b).* Authorization involves the granting of permission by a party or parties with the appropriate authority (whether management, those charged with governance, or the entity's shareholders) for the entity to enter into specific transactions in accordance with predetermined criteria, whether or not judgmental. Approval involves those parties' acceptance of the transactions the entity has entered into as having satisfied the criteria on which authorization was granted. Examples of controls the entity may have established to authorize and approve significant transactions and arrangements with related parties or significant transactions and arrangements outside the normal course of business include the following:

- Monitoring controls to identify such transactions and arrangements for authorization and approval
- Approval of the terms and conditions of the transactions and arrangements by management, those charged with governance, or, when applicable, shareholders

Maintaining Alertness for Related Party Information When Reviewing Records or Documents

Records or Documents That the Auditor May Inspect (Ref: par. .16)

.A22 During the audit, the auditor may inspect records or documents that indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. Examples of those records or documents include the following:

- Third party confirmations obtained by the auditor (in addition to bank and legal confirmations)
- Entity income tax returns
- Information supplied by the entity to regulatory authorities
- Shareholder registers to identify the entity's principal shareholders
- Statements of conflicts of interest from management and those charged with governance
- Records of the entity's investments and those of its benefit plans
- Contracts and agreements with key management or those charged with governance

- Significant contracts and agreements not in the entity's ordinary course of business
- Specific invoices and correspondence from the entity's professional advisors
- Life insurance policies acquired by the entity
- Significant contracts renegotiated by the entity during the period
- Reports of the internal audit function
- Capital financing arrangements with entities other than financial institutions (for example, construction of a governmental entity facility associated with the issuance of debt by a related not-for-profit entity)
- Economic development arrangements for capital additions (for example, a governmental entity's use and eventual ownership of properties and facilities financed and operated by a company or another governmental entity)

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A23 Additionally, the auditor may review the prior years' audit documentation for information about related party relationships and transactions. If applicable, the auditor may inquire of a predecessor auditor about the predecessor's knowledge of existing relationships and the extent of management involvement in material transactions.

.A24 *Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions.* An arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as the following:

- The establishment of a business relationship through appropriate vehicles or structures
- The conduct of certain types of transactions under specific terms and conditions
- The provision of designated services or financial support

Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include the following:

- Participation in unincorporated partnerships with other parties
- Agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business
- Guarantees and guarantor relationships

Identification of Significant Transactions Outside the Normal Course of Business (Ref: par. .17)

.A25 Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and to identify the risks of material misstatement due to fraud.

.A26 Examples of transactions outside the entity's normal course of business may include the following:

- Complex equity transactions, such as corporate restructurings or acquisitions
- Transactions with offshore entities in jurisdictions with less rigorous corporate governance structures, laws, or regulations
- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged
- Sales transactions with unusually large discounts or returns
- Transactions with circular arrangements (for example, sales with a commitment to repurchase)
- Transactions under contracts whose terms are changed before expiration

.A27 *Understanding the nature of significant transactions outside the normal course of business (Ref: par. .17a).* Inquiring into the nature of the significant transactions outside the entity's normal course of business involves obtaining an understanding of the business rationale of the transactions and the terms and conditions under which these have been entered into.²⁷

.A28 *Inquiring into whether related parties could be involved (Ref: par. .17b).* A related party could be involved in a significant transaction outside the entity's normal course of business not only by directly influencing the transaction by being a party to the transaction but also by indirectly influencing it through an intermediary. Such influence may indicate the presence of a fraud risk factor.

Sharing Related Party Information With the Engagement Team (Ref: par. .18 and .23a)

.A29 Relevant related party information shared with the engagement team members may include the following:

- The nature of the related party relationships and transactions
- Significant or complex related party relationships or transactions that may require special audit consideration, particularly transactions in which management or those charged with governance are financially involved

The exchange of information is most useful if made at an early stage of the audit.

.A30 Section 600 addresses the communications that apply to group audits, particularly those that involve component auditors.

Identification and Assessment of the Risks of Material Misstatement Associated With Related Party Relationships and Transactions

Fraud Risk Factors Associated With a Related Party With Dominant Influence (Ref: par. .20)

.A31 Related parties with the ability to exert control or significant influence may be in a position to exert dominant influence over the entity or its management. Consideration of such behavior is relevant when identifying and

²⁷ Paragraph .32c of section 240.

assessing the risks of material misstatement due to fraud, as further explained in paragraphs .A32–.A33.

.A32 Domination of management by a single person or small group of persons without compensating controls is a fraud risk factor.²⁸ Indicators of dominant influence exerted by a related party include the following:

- The related party has vetoed significant business decisions taken by management or those charged with governance.
- Significant transactions are referred to the related party for final approval.
- Little or no debate occurs among management and those charged with governance regarding business proposals initiated by the related party.
- Transactions involving the related party (or a close family member of the related party) are rarely independently reviewed and approved.

Dominant influence also may exist, in some cases, if the related party has played a leading role in founding the entity and continues to play a leading role in managing the entity.

.A33 In the presence of other risk factors, the existence of a related party with dominant influence may indicate significant risks of material misstatement due to fraud. For example

- an unusually high turnover of senior management or professional advisors may suggest unethical or fraudulent business practices that serve the related party's purposes.
- the use of business intermediaries for significant transactions for which there appears to be no clear business justification may suggest that the related party could have an interest in such transactions through control of such intermediaries for fraudulent purposes.

Evidence of the related party's excessive participation in, or preoccupation with, the selection of accounting policies or the determination of significant estimates may suggest the possibility of fraudulent financial reporting.

Responses to the Risks of Material Misstatement Associated With Related Party Relationships and Transactions (Ref: par. .21)

.A34 The nature, timing, and extent of the further audit procedures that the auditor may select to respond to the assessed risks of material misstatement associated with related party relationships and transactions depend upon the nature of those risks and the circumstances of the entity.

.A35 Examples of substantive audit procedures that the auditor may perform when the auditor has assessed a significant risk that management has not appropriately accounted for or disclosed specific related party transactions (whether due to fraud or error) include the following:

- Confirming the purposes, specific terms, or amounts of the transactions with the related parties (this audit procedure may be less effective when the auditor judges that the entity is likely to influence the related parties in their responses to the auditor).

²⁸ Paragraph .A75 of section 240.

- Inspecting evidence in possession of the other party or parties to the transaction.
- Confirming or discussing significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.
- Referring 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.
- With respect to material uncollected balances, guarantees, and other obligations, obtaining information about the financial capability of the 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.

.A36 If the auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a related party with dominant influence, the auditor may, in addition to the general requirements of section 240, perform audit procedures such as the following to obtain an understanding of the business relationships that such a related party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive audit procedures:

- Inquiries of, and discussion with, management and those charged with governance
- Inquiries of the related party
- Inspection of significant contracts with the related party
- Appropriate background research, such as through the Internet or specific external business information databases
- Review of employee whistle-blowing reports when these are retained

.A37 Depending upon the results of the auditor's risk assessment procedures, the auditor may consider it appropriate to obtain audit evidence without testing the entity's controls over related party relationships and transactions. In some circumstances, however, it may not be possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone, regarding the risks of material misstatement associated with related party relationships and transactions. For example, when intragroup transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, authorized, recorded, processed, or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive audit procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such a case, in meeting the requirement of section 330 to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls, the auditor is required to test the entity's controls over the completeness and accuracy of the recording of the related party relationships and transactions.²⁹

²⁹ Paragraph .08b of section 330.

Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

Communicating Newly Identified Related Party Information to the Engagement Team (Ref: par. .23a)

.A38 Promptly communicating any newly identified related parties to the other members of the engagement team assists them in determining whether this information affects the results of, and conclusions drawn from, risk assessment procedures already performed, including whether the risks of material misstatement need to be reassessed.

Substantive Procedures Relating to Newly Identified Related Parties or Significant Related Party Transactions (Ref: par. .23d)

.A39 Examples of substantive audit procedures that the auditor may perform relating to newly identified related parties or significant related party transactions include the following:

- Making inquiries regarding the nature of the entity's relationships with the newly identified related parties, including inquiring of parties outside the entity who are presumed to have significant knowledge of the entity and its business, such as legal counsel, principal agents, major representatives, consultants, guarantors, or other close business partners.
- Conducting an analysis of accounting records for transactions with the newly identified related parties. Such an analysis may be facilitated using computer assisted audit techniques.
- Verifying the terms and conditions of the newly identified related party transactions and evaluating whether the transactions have been appropriately accounted for and disclosed.

Intentional Nondisclosure by Management (Ref: par. .23f)

.A40 The requirements and guidance in section 240 regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant when management appears to have intentionally failed to disclose related parties or significant related party transactions to the auditor. The auditor also may consider whether it is necessary to reevaluate the reliability of management's responses to the auditor's inquiries and management's representations to the auditor.³⁰

Identified Significant Related Party Transactions Outside the Entity's Normal Course of Business

Evaluating the Business Rationale of Significant Related Party Transactions (Ref: par. .24a(i))

.A41 In evaluating the business rationale of a significant related party transaction outside the entity's normal course of business, the auditor may consider the following:

- Whether the transaction
 - is overly complex (for example, it may involve multiple related parties within a consolidated group)
 - has unusual terms of trade, such as unusual prices, interest rates, guarantees, and repayment terms

³⁰ Paragraphs .22–.24 and .26 of section 580.

- lacks an apparent logical business reason for its occurrence
- involves previously unidentified related parties
- is processed in an unusual manner
- Whether management has discussed the nature of, and accounting for, such a transaction with those charged with governance
- Whether management is placing more emphasis on a particular accounting treatment rather than giving due regard to the underlying economics of the transaction

If management's explanations are materially inconsistent with the terms of the related party transaction, the auditor is required to consider the reliability of management's explanations and representations on other significant matters.³¹

.A42 The auditor also may seek to understand the business rationale of such a transaction from the related party's perspective because this may help the auditor to better understand the economic reality of the transaction and why it was carried out. A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

Authorization and Approval of Significant Related Party Transactions (Ref: par. .24b)

.A43 Authorization and approval by management, those charged with governance, or, when applicable, the shareholders of significant related party transactions outside the entity's normal course of business may provide audit evidence that these have been duly considered at the appropriate levels within the entity, and that their terms and conditions have been appropriately reflected in the financial statements. The existence of transactions of this nature that were not subject to such authorization and approval, in the absence of rational explanations based on discussion with management or those charged with governance, may indicate risks of material misstatement due to fraud or error. In these circumstances, the auditor may need to be alert for other transactions of a similar nature. Authorization and approval alone, however, may not be sufficient in concluding whether risks of material misstatement due to fraud are absent because authorization and approval may be ineffective if there has been collusion between the related parties or if the entity is subject to the dominant influence of a related party.

.A44 *Considerations specific to smaller entities.* A smaller entity may not have the same controls provided by different levels of authority and approval that may exist in a larger entity. Accordingly, when auditing a smaller entity, the auditor may rely to a lesser degree on authorization and approval for audit evidence regarding the validity of significant related party transactions outside the entity's normal course of business. Instead, the auditor may consider performing other audit procedures, such as inspecting relevant documents, confirming specific aspects of the transactions with relevant parties, or observing the owner-manager's involvement with the transactions. The discussion of management domination in paragraph .A32 and the fraud considerations discussed in paragraph .A8 provide further relevant guidance.

Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's Length Transaction (Ref: par. .25)

.A45 It will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related or,

³¹ Paragraph .10 of section 500, *Audit Evidence*.

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.

.A46 Although audit evidence may be readily available regarding how the price of a related party transaction compares to that of a similar arm's length transaction, practical difficulties ordinarily limit the auditor's ability to obtain audit evidence that all other aspects of the transaction are equivalent to those of the arm's length transaction. For example, although the auditor may be able to confirm that a related party transaction has been conducted at a market price, it may be impracticable to confirm whether other terms and conditions of the transaction (such as credit terms, contingencies, and specific charges) are equivalent to those that would ordinarily be agreed between independent parties. Accordingly, there may be a risk that management's assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction may be materially misstated.

.A47 The preparation and fair presentation of the financial statements requires management to substantiate an assertion included in financial statements that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, giving appropriate consideration to the difficulties described in paragraphs .A45–.A46. Management's support for the assertion may include the following:

- Comparing the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties
- Engaging an external specialist to determine a market value and confirm market terms and conditions for the transaction
- Comparing the terms of the transaction to known market terms for broadly similar transactions on an open market

.A48 Evaluating management's support for this assertion may involve one or more of the following:

- Considering the appropriateness of management's process for supporting the assertion
- Verifying the source of the internal or external data supporting the assertion and testing the data to determine their accuracy, completeness, and relevance

.A49 If the auditor believes that management's assertion is unsubstantiated or the auditor cannot obtain sufficient appropriate audit evidence to support the assertion, the auditor, in accordance with section 705, considers the implications for the audit, including the opinion in the auditor's report.

Evaluation of the Accounting for, and Disclosure of, Identified Related Party Relationships and Transactions

Materiality Considerations in Evaluating Misstatements (Ref: par. .26)

.A50 Section 450, *Evaluation of Misstatements Identified During the Audit*, requires the auditor to consider both the size and nature of a misstatement and the particular circumstances of its occurrence when evaluating whether the misstatement is material.³² The significance of the transaction to the

³² Paragraph .11a of section 450, *Evaluation of Misstatements Identified During the Audit*.

financial statement users may not depend solely on the recorded amount of the transaction but also on other specific relevant factors, such as the nature of the related party relationship.

Evaluation of Related Party Disclosures (Ref: par. .26a)

.A51 Evaluating the related party disclosures means considering whether the facts and circumstances of the entity's related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable. Disclosures of related party transactions may not be understandable if

- a. the business rationale and the effects of the transactions on the financial statements are unclear or misstated.
- b. key terms, conditions, or other important elements of the transactions necessary for understanding them are not appropriately disclosed.

**Communication With Those Charged With Governance
(Ref: par. .27)**

.A52 Communicating significant findings and issues arising during the audit in connection with the entity's related parties helps the auditor establish a common understanding with those charged with governance of the nature and resolution of these matters.³³ Examples of significant related party findings and issues include the following:

- Nondisclosure (whether or not intentional) by management to the auditor of related parties or significant related party transactions, which may alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware
- The identification of significant related party transactions that have not been appropriately authorized and approved, which may give rise to suspected fraud
- Disagreement with management regarding the accounting for, and disclosure of, significant related party transactions
- Noncompliance with applicable laws or regulations prohibiting or restricting specific types of related party transactions
- Difficulties in identifying the party that ultimately controls the entity

³³ Paragraph .A10 of section 230 provides further guidance on the nature of significant findings or issues arising during the audit.

