STATEMENT OF AUDITING STANDARDS 460 RELATED PARTIES

*(Effective for audits of financial statements for periods beginning before 15 December 2004)**

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* HKSA 550 "Related Parties" is effective for audits of financial statements for periods beginning on or after 15 December 2004.

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RELATED PARTIES

*Statements of Auditing Standards (SASs) are to be read in the light of SAS 010 "The scope and authority of auditing pronouncements". In particular, they contain basic principles and essential procedures, (auditing standards), indicated by paragraphs in **bold italic type**, with which auditors are required to comply in the conduct of any audit including those of companies applying section 141D of the Companies Ordinance. SASs also include explanatory and other material which is designed to assist auditors in interpreting and applying auditing standards.*

Introduction

1. The purpose of this Statement of Auditing Standards (SAS) is to establish standards and provide guidance on the auditors' responsibilities and audit procedures regarding related parties and transactions with such parties.

2. Definitions of related parties and related party transactions are given in Statement of Standard Accounting Practice (SSAP) 20 "Related party disclosures" and are adopted for the purpose of this SAS. Where auditors following SASs are reporting on financial statements prepared in accordance with a financial reporting framework other than the accounting principles generally accepted in Hong Kong (other financial reporting framework), definitions of related parties and related party transactions given in that other financial reporting framework would also need to be considered.

Auditors' responsibilities

3. The auditors should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by directors and senior management of related parties and the effect of related party transactions that are material to the financial statements. (SAS 460.1)

4. An audit conducted in accordance with SASs cannot be expected to detect all related party relationships and transactions. However, auditors would plan and perform the audit so as to have a reasonable expectation of detecting related party transactions that are material to the financial statements.

5. Directors and senior management are responsible for the identification and disclosure of related parties and transactions with such parties. An adequate internal control system will help directors and senior management to ensure that transactions with related parties are identified in the accounting records, and disclosed in the financial statements if appropriate.

6. The auditors need to have a level of knowledge of the entity's business and industry that will enable identification of the events, transactions and practices that may have a material effect on the financial statements. Guidance on knowledge of the business is set out in SAS 210 "Knowledge of the business". While the existence of related parties and transactions between such parties are considered ordinary features of business, the auditors need to be aware of them because:

   a. the financial reporting framework may require disclosure in the financial statements of certain related party relationships and transactions identified by SSAP 20 or other financial reporting framework;

   b. the existence of related parties or related party transactions may affect the financial statements;

   c. the source of audit evidence affects the auditors' assessment of its reliability. A greater degree of reliance may be placed on audit evidence that is obtained from or created by unrelated third parties;

d. a related party transaction may be motivated by other than ordinary business considerations, for example, profit sharing or even fraud; and

e. the potential for error may increase because related party transactions may be initiated and authorised by directors and senior management, and may therefore not subject to the normal internal control procedures as applicable to other routine transactions.

Audit procedures

7. As indicated in SAS 100 "Objective and general principles governing an audit of financial statements", in certain circumstances there are limitations that may affect the persuasiveness of evidence available to draw conclusions on particular financial statement assertions. Because of the degree of uncertainty associated with the financial statement assertions regarding the completeness of related parties, the results of the procedures identified in paragraphs 8 to 25 below will provide sufficient appropriate audit evidence regarding those assertions in the absence of any circumstances identified by the auditors that:

   a. increase the risk of misstatement beyond that which would ordinarily be expected; or

   b. indicate that a material misstatement regarding related parties has occurred.

Existence and disclosure of related parties

8. The auditors should review information provided by the directors and senior management identifying the names of all known related parties and should perform the following procedures in respect of the completeness of this information:

   a. review prior year working papers for names of known related parties;

   b. review the entity's procedures for identification of related parties;

   c. enquire as to the affiliation of directors and officers with other entities;

   d. review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register;

   e. review minutes of the meetings of shareholders and the board of directors and other relevant statutory records such as the register of directors' interests;

   f. enquire of other auditors currently involved in the audit, or predecessor auditors of the entity, as to their knowledge of additional related parties; and

   g. review the entity's profits tax returns and other information supplied to regulatory agencies. (SAS 460.2)

9. The following would be observed for any exchanges of information among auditors as required in 8(f) above:

   a. it is advisable that the exchanges of information are made at an early stage of the audit, such as the audit planning stage;

   b. guidance on the relationships between the principal auditors and other auditors is set out in SAS 510 "Principal auditors and other auditors"; and

   c. enquiries of predecessor auditors would only be made by the incoming auditors in the first year after the change of auditors.

10. When performing audit procedures which may identify related parties and related party transactions, the auditors would consider the substance of the relationship and/or transaction being tested and not merely the legal form.

11. Where SSAP 20 or other financial reporting framework requires disclosure of related party relationships and transactions, the auditors should be satisfied that the disclosure is adequate. (SAS 460.3)

Transactions with related parties

12. The auditors should review information provided by directors and senior management identifying related party transactions and should be alert for other material related party transactions. (SAS 460.4)

13. The names of identified related parties need to be provided to all personnel involved in the audit so that they will be alerted to recognise transactions with such parties if they are encountered during the audit.

14. When obtaining an understanding of the accounting and internal control systems and making a preliminary assessment of control risk as required by SAS 300 "Audit risk assessments and accounting and internal control systems", the auditors should consider the adequacy of control procedures over the authorisation and recording of related party transactions. (SAS 460.5)

15. During the course of the audit, the auditors need to be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties. Examples include:

    a. transactions which have abnormal terms of trade, such as unusual prices, interest rates, guarantees, and repayment terms;

    b. transactions which lack an apparent logical business reason for their occurrence;

    c. transactions in which substance differs from form;

    d. transactions processed in an unusual manner;

    e. high volume or significant transactions with certain customers or suppliers as compared with others;

    f. unrecorded transactions such as the receipt or provision of management services at no charge.

16. During the course of the audit, the auditors carry out procedures which may identify the existence of transactions with related parties. Examples include:

    a. performing detailed tests of transactions and balances;

    b. reviewing minutes of meetings of shareholders and directors;

    c. reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recognised at or near the end of the reporting period;

    d. reviewing confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate guarantor relationships and other related party transactions;

    e. reviewing investment transactions, for example, purchase or sale of an equity interest in a joint venture or other entity;

f. reviewing invoices from and correspondence with the company's solicitors and legal and other professional advisers that have performed regular or special services for the company for indications of the existence of related parties or related party transactions.

17. In the absence of evidence to the contrary, transactions with related parties need not be assumed to be outside the normal course of business. The auditors would, however, be aware of the possibility that transactions with related parties may have been motivated solely, or in the large measure, by conditions similar to the following:

a. lack of sufficient working capital or credit to continue the business;

b. a desire for a continued favourable earnings record;

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 characterised by a large number of business failures;

f. excess capacity;

g. significant litigation; or

h. significant obsolescence dangers for companies in a high-technology industry.

Examining identified related party transactions

18. In examining the identified related party transactions, the auditors should obtain sufficient appropriate audit evidence as to whether these transactions have been properly recorded and disclosed in the financial statements. (SAS 460.6)

19. Given the nature of related party relationships, evidence of a related party transaction may be limited, for example, regarding the existence of stocks held by a related party on consignment or an instruction from a parent company to a subsidiary to record a royalty expense. Because of the limited availability of appropriate evidence about such transactions, the auditors would consider performing procedures such as:

a. discussing the purpose of the transaction with directors and senior management;

b. confirming the terms and amount of the transaction with the related party;

c. inspecting evidence in possession of the related party; or

d. confirming or discussing information with persons associated with the transaction, such as banks, lawyers, guarantors and agents.

Management representations

20. The auditors should obtain a written representation from directors and/or senior management in accordance with SAS 440 "Representations by management" concerning:

a. the completeness of information provided regarding the identification of related parties;

b. the completeness of related party transactions identified in the accounting records; and

c. the adequacy of related party disclosures in the financial statements. (SAS 460.7)

21. Unless the audit reveals evidence to the contrary, the auditors are entitled to accept representations, by directors and senior management, as truthful and records and documents as genuine. However, the auditors plan and perform the audit with an attitude of professional scepticism, recognising that conditions or events may be found that indicate that undisclosed related party transactions exist. The degree of the auditors' scepticism increases when they have concerns about the integrity of the directors and senior management or where the operating style of management does not place a high priority on financial statement disclosure.

22. For related party transactions which are material or considered unusual in terms of purpose or terms of trade, the auditors may request that they are formally minuted as being approved by the board of directors.

Materiality

23. Guidance on audit materiality is set out in SAS 220 "Audit materiality".

24. When determining materiality regarding related parties, the auditors would consider the nature and circumstances of related party transactions, as it may often be difficult to extend materiality levels used in other aspects of the audit to those involving related parties because, for example:

    a. there is no objective value or basis of measurement for some related party transactions;

    b. there may be a requirement to measure qualitative aspects such as the extent and impact of control or significant influence, or the impact of transactions on the users of the financial statements; and

    c. transactions in which a director or senior management is interested may be deemed material regardless of the quantum of the amounts involved.

25. The auditors may consider it appropriate to request directors and senior management to estimate or place an imputed value on certain transactions for the purpose of determining their impact on the financial statements, for example, transactions that have occurred but for which no price or a nominal price is charged.

Additional audit procedures

26. Where there is any indication that the circumstances set out in paragraph 7 above exist, i.e. those which increase the risk of misstatement beyond that which would ordinarily be expected or indicate that a material misstatement regarding related parties has occurred, the auditors should perform modified, extended or additional procedures as are appropriate in the circumstances. (SAS 460.8)

27. As in examining any other material account balance or class of transactions, the auditors would consider audit risk and design and apply appropriate substantive tests to evaluate management's assertions about related party transactions. This risk is often assessed as higher than for many other types of transactions because of the possibility that the parties to the transaction are motivated by reasons other than those that exist for most business transactions (see paragraph 17 above). Guidance on audit risk assessments is set out in SAS 300 "Audit risk assessments and accounting and internal control systems".

28. The higher the auditors' assessment of risk regarding related party transactions, the more extensive or effective the audit tests would be in order to obtain sufficient appropriate audit evidence as to whether these transactions have been properly recorded and disclosed in the financial statements. For example, the auditors' tests regarding valuation of a debtor balance with an entity under common control might be more extensive than for a trade debtor of the same size because the common parent may be motivated to obscure the substance of the transaction. In assessing the risk of the related party transactions the auditors obtain an understanding of the business purpose of the transactions.

Audit conclusions and reporting

29. The auditors should consider the implications for their report if:

a. they are unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties; or

b. the related party disclosures in the financial statements are not adequate. (SAS 460.9)

30. If the auditors are unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties, this is a limitation on the scope of the audit. Accordingly, the auditors consider the need to issue either a qualified opinion or a disclaimer of opinion in accordance with SAS 600 "Auditors' reports on financial statements".

31. If the auditors conclude that the related party disclosures are not adequate, they consider the need to issue either a qualified or adverse opinion depending on the particular circumstances, in accordance with SAS 600. Where the auditors are aware of material undisclosed related party transactions, that in their opinion are required to be disclosed, the opinion section of their report, whenever practicable, includes the information that would have been included in the financial statements had the relevant requirements been followed.

32. Where material weaknesses in the accounting and internal control systems for the identification and recording of related party transactions are identified during the audit, the auditors would report them in writing to an appropriate level of management on a timely basis. Guidance on reports to directors or management is set out in PN 600.3 "Reports to directors or management".

Compliance with International Standards on Auditing

33. Compliance with the auditing standards contained in this SAS ensures compliance in all material respects with the basic principles and essential procedures in International Standard on Auditing 550 "Related Parties".

Effective date

34. This SAS is effective for audits of financial statements for periods beginning before 15 December 2004.